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NEWS: IMF assesses G8 debt proposal

The G8's Gleneagles Summit reiterated the June proposal of G8 finance ministers to cancel the multilateral debt of the Heavily Indebted Poor Countries and added an initiative to sharply increase official development assistance for low-income countries. IMF staff are assessing the various policy, legal, and financial aspects of the G8 debt relief proposal relating to the Fund. This will provide the basis for a late July Executive Board discussion.

Richard Lewis/H.M. Government

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NEWS: Bernes on IEO challenges

In June, the new head of the IMF's Independent Evaluation Office (IEO), Canadian Thomas A. Bernes, took office. Bernes brings first-hand knowledge about the IMF to his position, having been the Fund's Executive Director for Canada, Ireland, and the Caribbean from 1996 to 2001. Among Bernes' priorities for the IEO, now in its fourth year of operation, are more attention to disseminating the results of IEO evaluations and following up on the changes that the office has recommended.

Eugene Salazar/IMF

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COUNTRY FOCUS: Armenia takes off

Over the past four years, Armenia's economic performance has outpaced that of its neighbors and other low-income countries. Sound policies and selected structural reforms have helped Armenia achieve double-digit growth, low inflation, and rapidly falling poverty. Continued strong performance, however, will require further reforms, notably steps to strengthen certain institutions, fight corruption, and improve corporate governance.

Jimmy McHugh/IMF

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RESEARCH: Public expenditure risks

In most industrial countries, projections of increased fiscal burdens have centered on aging populations. But age-related issues are not the only worry. Two new IMF studies argue that long-term expenditure projections are subject to considerable uncertainty. Governments, with limited scope to reduce non-age-related expenditures or raise already-high tax rates, should move soon to adopt a more ambitious fiscal policy stance that provides "space" to cope with increased demands.

Francis Dean/Dean Pictures

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What's on

July

21 IMF Book Forum, Markus Rodlauer and Alfred Schipke, *Central America: Global Integration and Regional Cooperation*, Washington, D.C.

29–August 5 IMF seminars for Turkish parliamentarians and the media, Joint Vienna Institute, Vienna, Austria

August

22–26 IMF–Singapore Regional Training Institute seminar, "Creditor Rights in Emerging Economies," Singapore

24–September 2 APEC Small and Medium Enterprise Ministerial, Daegu, Republic of Korea

September

6–7 IMF high-level seminar, "Financial Stability—Central Banking and Supervisory Challenges," Washington, D.C.

6–9 APEC Finance Ministers Meeting, Jeju, Republic of Korea

8 IMF Economic Forum, "IMF Conditionality: Good, Bad, or Ugly?" Washington, D.C.

14–16 High-level plenary meeting, UN General Assembly, to review progress on UN Millennium Declaration commitments, New York

19–23 IMF seminar for parliamentarians from Bosnia and Herzegovina, Croatia, Macedonia, and Serbia and Montenegro, Joint Vienna Institute, Vienna, Austria

24–25 IMF and World Bank Annual Meetings, Washington, D.C.

26–30 International Atomic Energy Agency General Conference, Vienna, Austria

27–30 Meeting of the Task Force on the Harmonization of Public Sector Accounting, IMF, Washington, D.C.

October

19 IMF Book Forum, Pietra Rivoli, *Travels of a T-Shirt in the Global Economy: An Economist Examines the Markets, Power, and Politics of World Trade*, Washington, D.C.

23–27 IMF high-level seminar, "Current Developments in Monetary and Financial Law," Washington, D.C.

November

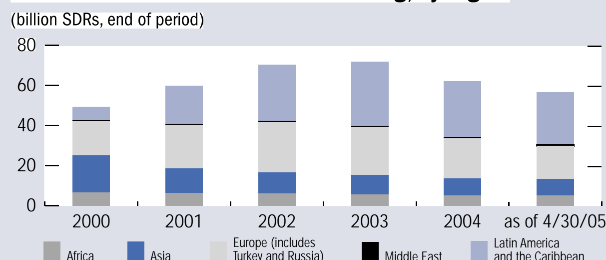
3–4 IMF Jacques Polak Sixth Annual Research Conference, Washington, D.C.

4–5 Fourth Summit of the Americas, Mar del Plata, Argentina

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

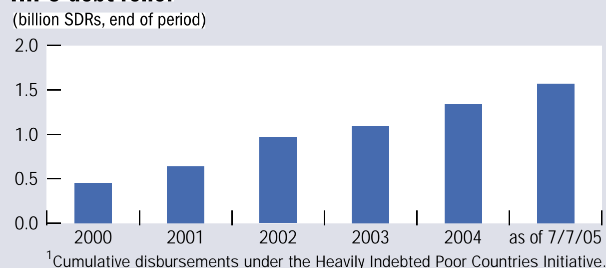
At a glance

IMF financial data

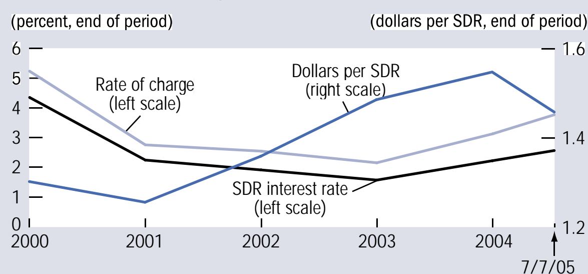


Largest outstanding loans
(billion SDRs, as of 5/31/05)

Nonconcessional		Concessional	
Brazil	15.36	Pakistan	1.02
Turkey	12.42	Zambia	.58
Argentina	8.01	Congo, Dem. Rep. of	.53
Indonesia	5.96	Ghana	.29
Uruguay	1.64	Tanzania	.26



[1]Cumulative disbursements under the Heavily Indebted Poor Countries Initiative.



Note on IMF Special Drawing Rights
Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

IMF Board to discuss G8 debt proposal

IMF Managing Director Rodrigo de Rato lauded agreements reached at the Group of Eight (G8) Gleneagles Summit on July 8 to boost aid and cancel debt, terming them a "major contribution" to helping the poorest and most indebted countries make progress toward the Millennium Development Goals and ending poverty. The IMF, he said, is committed to playing its part in implementing the wide-ranging agreements on climate change, energy, and sustainable development. De Rato attended the summit with the heads of the United Nations, the World Bank, and the World Trade Organization (WTO), and leaders from 11 nations in Africa, Asia, and Latin America.

The leaders of the G8 economies—Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States—reiterated the June G8 finance ministers' proposal for 100 percent cancellation of debt owed to the IMF, World Bank, and African Development Bank by participants in the Heavily Indebted Poor Countries (HIPC) Initiative. The effort has won widespread plaudits, but many important details and much of the logistics remain to be worked out. De Rato said he looked forward to "detailed discussions by the IMF Executive Board in the weeks ahead." At the request of the Executive Board, IMF staff are preparing for its consideration a paper analysing the proposal and how it might be implemented. The paper will examine the various policy, legal, and financial aspects of the proposal, including its implications for the IMF's role in low-income countries.

Richard Lewis/H.M. Government

U.K. Prime Minister Tony Blair takes Nigerian President Elusegun Obasanjo to the podium at the G8 Summit.

Among the specific issues to be looked at are the "uniformity of treatment" of member countries required by the IMF's founding Articles of Agreement and the implications of the proposal in that context. While "uniformity of treatment" does not mean identical treatment for all members, it does require any differentiation to be based on criteria relevant to the Fund's objectives in the context being considered. In addition, the staff paper is expected to consider what will be needed to ensure the good governance and transparency that the G8 proposal calls for in the countries benefiting from the debt forgiveness, and to weigh the potential implications for IMF resources and assistance to its poorer member countries. The IMF's Executive Board is expected to discuss the staff paper in late July. Further work and additional Board discussions will be scheduled, as needed, in advance of the Annual Meeting of the IMF's Board of Governors in late September.

Aid and trade

The G8 leaders also committed themselves to boosting their total official development assistance by $50 billion—and specifically aid to Africa by $25 billion—by 2010. Anticipating skeptics who might point to previous ambitious commitments, which went unrealized, the G8 leaders took the unprecedented step of personally signing the communique.

De Rato welcomed the G8's aid commitments, but cautioned that additional assistance will bear its expected fruits only if it is "associated with sound macroeconomic policies, transparent and accountable government procedures, strong institutions, and well-prioritized expenditures." In a press briefing before the Gleneagles Summit, the IMF's Mark Plant (Policy Development and Review Department) also reiterated the IMF's view that "substantially more aid is needed if we are to fight poverty effectively." For the IMF and other institutions, the priority will be to continue to search for ways to deliver more aid "more efficiently, more effectively, both in a microeconomic sense and in a macroeconomic sense," Plant said.

But less debt and more aid will not translate, in and of themselves, to higher growth and declining poverty. Trade remains an essential piece of the puzzle, and one where progress is needed urgently in the lead-up to a crucial December ministerial meeting of the WTO in Hong Kong SAR. The G8 and its emerging market economy partners pledged to intensify their work on an outline WTO accord—an outline that would then lay the basis, it is hoped, for a final accord in the Doha Round in 2006. De Rato shared this sense of urgency, underscoring that it is "in all of our interests" to use the next six months well.

The G8 reached their wide-ranging agreements in Scotland undeterred by concurrent terrorist attacks in London. De Rato commended their resolve, noting that "The message of the Gleneagles Summit stands in answer to the terrorist attacks in London on July 7." He also conveyed to the victims and to their families condolences on behalf of himself and all of his IMF colleagues. ■

For the full text of Rodrigo de Rato's statement at the G8 Summit and the transcript of a press briefing on issues related to aid, trade, and debt relief to the poorest countries, please see the IMF's website *(www.imf.org)*.

Interview with Thomas A. Bernes

IEO critical for institutional governance and oversight

On June 6, Thomas A. Bernes, a Canadian national, became head of the IMF's Independent Evaluation Office (IEO), succeeding Montek Singh Ahluwalia who led the IEO from its startup in July 2001. Previously an Executive Secretary of the joint IMF–World Bank Development Committee (2001–2005) and IMF Executive Director for Canada, Ireland, and the Caribbean (1996–2001), Bernes brings a wealth of first-hand knowledge about the IMF. Christine Ebrahim-zadeh of the IMF Survey *asked Bernes about his goals for the IEO, which is charged with providing objective and independent assessments of various aspects of the IMF's work, and the challenges ahead.*

IMF Survey: Your duties on the IMF's Executive Board required keeping a critical eye on the Fund and its work. In what ways are your new duties as head of the IEO similar? And in what ways are they different?

Bernes: There are similarities and important differences. Both the Executive Board and the IEO have as a principal objective ensuring the effectiveness of the IMF, but clearly their roles are different. In the Board, Executive Directors are responsible for deciding policy and holding management and staff accountable for the conduct of that policy. The IEO, of course, does not make policy. Its job is to look at how policies, approved by the Board, are carried out, whether they are effective, and what to do if they are not. The IEO provides a very important function in helping to support the Board's institutional governance and oversight functions. But the IEO is also charged with evaluating the effectiveness of the IMF as a whole, which includes the Board itself.

Eugene Salazar/IMF

Bernes: "It's time to take a systematic look at developments that have stemmed from earlier IEO recommendations."

When I was on the Board, I chaired the Evaluation Committee. There had been a long—in fact, a 10-year—discussion as to whether there should be an independent evaluation office. We went through various models before we came up with what is in place today. The startup occurred just at the time that Michel Camdessus was leaving and Horst Köhler was taking over as Managing Director. Horst Köhler very much welcomed the establishment of the office, citing his experience with the European Bank for Reconstruction and Development. He saw independent evaluation as a very important function on behalf of the shareholders as well as external stakeholders, including financial markets, nongovernmental organizations, and academics.

IMF Survey: Your predecessor, Montek Singh Ahluwalia, was more of a true outsider to the IMF. Are there advantages to having been privy to more of the internal workings of the organization, including the kind of real-world trade-offs that staff and management are faced with?

Bernes: We all bring our own backgrounds and experiences to these positions. Montek clearly brought a range of experiences, including having been a member of the Indian government and having worked on the World Bank staff. What I bring is experience as a senior economic official in the Canadian government, on the staff of the Organization for Economic Cooperation and Development, working with the World Trade Organization in Geneva, and with the World Bank and the Development Committee. I bring a range of experiences in cross-cutting issues but also at the governance level. One of the important ways in which the IEO contributes to the IMF is through its capacity to look at governance issues. My experience—including having sat on the Board of the Fund and having seen it in action—hopefully will allow me to anticipate and understand perhaps more readily than some others what the Board could find helpful to carry out its oversight function.

IMF Survey: The IEO's FY2006 work program, which the Executive Board just reviewed, calls for an evaluation of the IMF's advice on exchange rate policy and its role in selected African countries with respect to the external resource envelope, aid predictability, and debt sustainability. It also foresees an evaluation of the IMF's "bilateral" or country surveillance, including issues related to the surveillance of large industrial countries. Is the selection of these topics linked to the Fund's own work program or is the selection process completely independent?

Bernes: It is independent. The choice of topics is the responsibility of the Director of the IEO, taking into account consultations with the Board, IMF management and staff, and outside stakeholders. A number of evaluations are currently under way, including on structural conditionality and Financial Sector Assessment Programs. I recently met with the Board's Evaluation Committee to inform them of my decisions about evaluation topics for the next year. These topics were, in fact, included on an initial list that my predecessor, Montek, had identified and had consulted broadly on. Having been in this office since early June, I had a limited amount of time to talk with Board members, staff, management, and outside stakeholders. I made my choices based on the initial list and on consultations that had taken into account views expressed both inside and outside the IMF.

With respect to surveillance, its effectiveness is a critical issue for the Fund. It is also one of the most reviewed areas of Fund activity. The Board and staff conduct a review of surveillance every two years. With a topic that is looked at so frequently, the IEO's evaluation will hopefully be creative and come up with some new thoughts. We do have under way right now an evaluation of "multilateral" or global surveillance, which is part of overall surveillance. When we've concluded that study, we will turn to the issue of "bilateral" or country surveillance. The Fund's advice on exchange rate policy is also a core responsibility of the IMF. It appears timely to evaluate how this is being carried out.

There is a growing need to ensure internally—with staff and management—and externally that the lessons, messages, and the proposed recommendations of these evaluations are well understood.

—Thomas A. Bernes

IMF Survey: The IEO this year will itself be the object of an external review. What would you like to see this review accomplish?

Bernes: It's only fair that the evaluators should themselves be evaluated. In fact, when I chaired the Evaluation Committee of the Board, which defined the initial terms of reference for the IEO, we built this evaluation into those terms of reference. We were creating a new office that was unlike any that existed in other international financial institutions. In a lot of international development institutions the evaluation work focuses on projects. That is clearly not the case at the Fund.

The Board decided when setting up the IEO, that after three or four years of experience, we should sit back and take a look to see if the model was working. Is the office sufficiently independent? Is the size and composition of staff right? Is the level of output about right? Do its evaluations have credibility with both insiders and outsiders? How has the consultation process worked on the choice of topics? Have these topics enhanced the credibility of the organization with the outside world and also helped the Board, management, and shareholders to enhance the effectiveness of the institution? Is the model right, or does it need some fine-tuning and, if so, in which ways? Those are all questions that I would hope the evaluation of the IEO will address.

IMF Survey: Finally, what are your longer-term goals for the IEO? What do you hope to accomplish as its director?

Bernes: We are entering a new phase. When my predecessor became Director, clearly, it was a start-up operation. He had to put together a staff, identify a number of topics, and conduct his first evaluations. He and the team did a terrific job, and that's a message I've gotten through my consultations to date. The office's independence and its reputation are well established.

The challenge now is to turn it from a start-up operation into a steady state, which will require reflecting on how to design the work program over the medium term. In some ways, the hot topics of the day were, quite naturally, the ones that were looked at first. It would not be appropriate to revisit these every year or every two years, so the challenge is to identify, each year, the key policy and operational issues that can enhance the learning culture within the Fund, support the Board in its oversight function, and bolster the IMF's credibility with outside stakeholders.

Another challenge is the role of the office in disseminating its results and in following up on earlier Board-approved recommendations. There is no point in producing a fine report and then just having it sit there. There is a growing need to ensure internally—with staff and management—and externally that the lessons, messages, and the proposed recommendations of these evaluations are well understood.

We have now had four years of experience with these evaluations. In my view it's time to take a systematic look at developments that have stemmed from earlier IEO recommendations. The IEO should be asking how these have been implemented and whether they have addressed the problems or issues identified in the evaluations. Over time, the IEO's dissemination and follow-up roles will take on increasing importance. ■

Further information about the IMF's Independent Evaluation Office is available at *www.imf.org/external/np/ieo/index.htm.*

Armenia's stepped-up reforms pave way for sustained growth

Over the past four years, real GDP growth in Armenia has outpaced that of its neighbors and other low-income countries, averaging 12 percent a year (see chart). Also, since 2001, inflation has been low, at an annual average rate of 4 percent, and poverty and inequality have fallen rapidly. The government's sustained commitment to economic stability and reform, especially since 2001, has been a critical element in this progress. Armenia is now at a cusp—more reforms can spur further gains, but faltering could put them at risk.

Like many other constituent states of the former Soviet Union, Armenia experienced a major economic downturn after the Union's dissolution. Several early reforms, initiated in 1994–98, attempted to revitalize the economy. The reforms focused on privatizing land holdings and small-scale enterprises, and liberalizing prices, trade, and the foreign exchange regime. These policies allowed a shift to market prices and incentives, setting the stage for a period of market-driven capital formation. The economy rebounded in the second half of the 1990s, and annual inflation declined from triple to single-digit levels.

More ambitious reforms

As the 1990s ended, however, it was clear that imbalances continued to constrain economic performance. Over 50 percent of the population still lived below the poverty line, and emigration continued. Armenia's fiscal position was weak and hampered by a continuous accumulation of internal and external payments arrears. The banking sector also saw the collapse of about one-third of the country's commercial banks. Lastly, corruption in state-owned energy and water companies generated large interenterprise arrears and a sizable quasi-fiscal deficit.

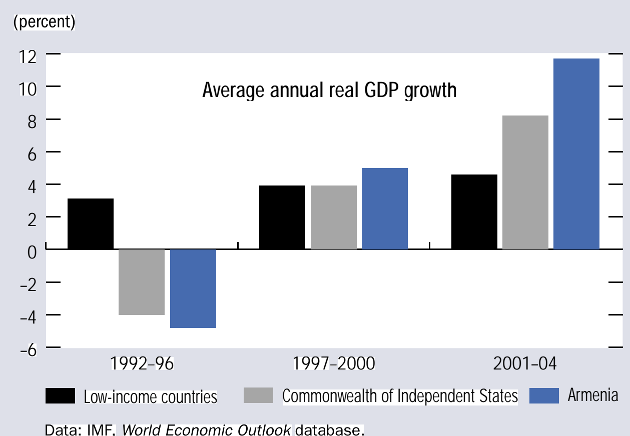
In the face of these concerns, the authorities launched a renewed stabilization and reform effort in 2001 supported by the IMF's Poverty Reduction and Growth Facility. Selected reforms were introduced in the fiscal, banking, and energy sectors, and these reforms were later aligned with a poverty reduction strategy paper (PRSP). The goals were to boost growth through tax reform and deregulation, restore confidence in fiscal management and improve expenditure control, restructure the energy sector, and clean up the banking system.

Tax reform. Armenia simplified and reduced its corporate and income tax rates, removed some exemptions, and introduced a turnover-based tax for small businesses. To improve the environment for private sector activity, the government also took steps to improve tax legislation, simplify licensing procedures, introduce a new criminal code, and disseminate pertinent laws and regulations.

Bolstering confidence in fiscal management. To restore confidence in fiscal management, Armenia needed to control expenditure, realign budget priorities, and clear domestic and external arrears. The authorities implemented a two-year arrears repayment plan that cleared all arrears by mid-2003. Once the plan was completed, interest rates and government debt service fell. After 2001, government budgets became more prudent, which meant cuts in nonpriority expenditures and sensible increases in subsidies and public sector wages. In conjunction with the preparation of the PRSP, the authorities also began to integrate the policies envisaged in that strategy into the budget process and raised the budget allocations for health care, education, and social security.

Restructuring the energy sector. Corruption, inefficiency, and interenterprise arrears had contributed to a decade of large quasi-fiscal deficits. A fundamental shift in ownership and corporate governance was needed to address these deficits, and the authorities responded by reforming and/or privatizing state-owned companies, introducing new audit and cash management systems, and improving financial management.

Cleaning up the banking sector. Financial mismanagement in the energy sector had also exacerbated an already vulnerable banking sector. The central bank had to intervene in, and subsequently close or rehabilitate, eight problem banks, while



breaking the link between the banks and key state-owned energy companies. The authorities also moved to shore up the sector—introducing a new bank bankruptcy law and enforcing stronger provisioning requirements that encouraged banks to reduce their exposure to the energy sector. Improved banking supervision also helped confront the underlying sources of the banking crisis—namely, connected lending and fraud.

The country moves forward

By the end of 2004, the European Bank for Reconstruction and Development's transition indicators showed that Armenia had topped the Commonwealth of Independent States in nearly all areas of structural reforms. The only lagging areas were tax and customs administration, where spotty progress slowed the growth of tax revenues.

On the fiscal side, the magnitude of Armenia's adjustment is noteworthy. The deficit of the general government fell from 6 percent of GDP in 2000 to 1 percent in 2004. Between 2001 and 2003, the government cleared its entire stock of domestic and external payments arrears and drastically improved the financial balances of companies in the energy and water sectors. A debt-management strategy that prioritized the use of low-cost concessional financing and grants also contributed to a notable reduction in debt ratios (see table).

More broadly, a stable economy and determined reforms laid the groundwork for an improved business environment and higher levels of investment, foreign financing, and donor assistance. Foreign resources (loans and transfers) helped supplement domestic savings and facilitate higher consumption and investment. A boom in exports also contributed to a marked improvement in growth performance and to reductions in poverty and inequality.

But more remains to be done

There is still considerable scope, however, for further reforms, especially in strengthening selected institutions and fighting corruption. Over the next few years, economic growth, exports, and capital formation will need to become more broad-based and generate more jobs. Since such growth cannot be financed exclusively with foreign resources, Armenia's fiscal framework and the banking system will have to play a more prominent role in supporting private sector development and channeling resources toward their best possible use. At the same time, Armenia's economic potential relies on an export-led development process that would benefit significantly from improved customs administration, normalized trade relations with Turkey, and a peaceful solution to the territorial dispute with Azerbaijan.

Armenia	1996–98	1999–2001	2002–04
	(Annual average in percent of GDP, unless otherwise noted)		
Public sector balance[1]	–12.7	–10.2	–2.7
External debt-to-exports ratio	185.6	142.7	97.3
Investment	18.5	19.3	23.4
Exports of goods and services	20.7	23.2	29.7
Poverty rate (percent of population)[2]	54.7	47.0	32.0
Income inequality[2, 3]	0.6	0.5	0.4

[1]General government and state-owned companies in the energy and water sectors.
[2]Based on household survey data for 1996, 2001, and 2003.
[3]Based on Gini index, which ranges from 0 (perfect equality) to 1 (total inequality).
Data: Armenian authorities; and IMF staff estimates.

In the fiscal area, revenue administration remains a challenge, with corruption in collection agencies a major obstacle to a better business environment. The authorities can solve these problems by revamping tax and customs administration and adopting modern auditing techniques. To ensure the most productive use of government expenditures, the government is focusing on the efficient provision of health care, education, water, and sanitation services, and improvements in basic infrastructure. This will require additional capacity building, as well as greater transparency and accountability. A public investment program needs to be prepared, and appropriate weight given (as envisaged in the PRSP) to improving the public infrastructure, especially in rural areas and cities beyond the capital, Yerevan.

Although the banking system has strengthened in recent years, financial intermediation could be increased by improving corporate governance and the enforcement of financial contracts. Bank ownership and borrowers' financial conditions should be made more transparent, and the judiciary needs to enforce creditor rights and collateral recovery more efficiently. These actions will help lower lending interest rates and bolster financial intermediation.

Armenia is now at a crucial phase of its development. The implementation of pending reforms and the policies envisaged in the PRSP will help sustain high economic growth and allow the country to achieve the Millennium Development Goals by 2015. With many of these reforms opposed by vested interests, however, the government will need a renewed dose of political resolve to see them take effect. The stakes are high, as a failure to tackle the remaining agenda could lead to poor tax collection, unproductive public investment, lower growth, and lack of further progress in reducing poverty. ■

Enrique Gelbard and Jimmy McHugh
IMF Middle East and Central Asia Department

For more information, please see the forthcoming "Growth and Poverty Reduction in Armenia: Achievements and Challenges," by E. Gelbard, J. McHugh, G. Iradian, C. Beddies, and L. Redifer (expected September 2005).

Reforming Europe—but how?

With weak growth and high unemployment continuing in much of Europe, and with key reforms stalled for lack of popular support—including the much maligned directive that would have liberalized the European Union's (EU's) trade in services—obstacles to a revitalization of economic activity seem formidable. In a recent IMF Working Paper, Professor Tito Boeri from Bocconi University researched the political economy of labor and product market reform in Europe over the past two decades. His findings suggest that there may be effective strategies for those increasingly discouraged policymakers who still wish to fight eurosclerosis but don't know how to.

Institutional "rigidities"—a catch-all phrase used by economists for barriers that keep markets from operating effectively—exist because, somewhere, there is a group benefiting from them and lobbying for their preservation, Boeri writes. What's more, such barriers rarely operate in isolation; a regulation in one area calls for regulations in another area. That's why countries with the most restrictive labor markets usually also have the most tightly regulated product markets.

Removing these rigidities is proving extremely difficult, not because governments do not wish to carry out reforms, but because reforms usually encounter strong political opposition. So what can politicians do? While there are similarities between labor and product markets, there are also important differences, which matter tremendously when it comes to adopting a viable reform strategy.

Reforms 'at the margin' or the unbundling of reforms offers a very powerful way to enforce politically difficult reforms . . . the trick is to devise them in such a way as to gradually extend the new rules to everybody.

—Tito Boeri

Piecemeal does just nicely

Boeri and his colleagues looked at labor market reforms in EU countries during 1985–2003 and categorized them as either marginal or radical. This analysis revealed that—contrary to popular belief—many reforms have, in fact, been carried out over the past two decades. Boeri and his colleagues counted 414 reforms, amounting to more than 1.6 reforms per year per country. But almost all of the reforms—roughly 95 percent—were marginal. What's more, they were almost evenly split between initiatives aimed at increasing labor market participation (for instance, tightening unemployment benefits and making employment contracts more flexible) and policies that moved in the opposite direction.

But as the research also showed, even marginal reforms can help build strong momentum for change. "Reforms 'at the margin' or the unbundling of reforms offers a very powerful way to enforce politically difficult reforms," Boeri writes, adding that "the trick is to devise them in such a way as to gradually extend the new rules to everybody." But since there are potential distortions associated with maintaining a two-tier system for a long time, the speed of the transition from the old to the new rules is crucial to success.

As part of such a strategy, it also pays to target changes to groups that are more likely to have a positive attitude to reform. Younger workers are, for instance, more likely to approve of reforms that expand the scope of private pensions than individuals closer to retirement age are. A similar approach can be used to introduce more flexible working arrangements for new hires or school leavers, with the new rules eventually extending to everybody as old workers leave the workforce.

The findings also show that politically difficult reforms (such as tightening benefits, reducing employment protection, and cutting pensions) often are carried out during recessions, whereas many reforms do the popular job of increasing generosity and protection during times of strong growth. According to Boeri, "a tentative explanation for this rather surprising result is that there may be a stronger perception of emergency when macroeconomic conditions are less favorable—recessions are often times of 'extraordinary politics'." When growth is strong, lobbies often try to appropriate a larger share of the economic pie.

All or nothing

For his study of product market reforms, Boeri looked at the same group of EU countries and once again classified reforms according to their scope (were they radical or marginal?) and orientation (did they increase or decrease competition?). His findings revealed some important qualitative differences between reforms in the two sectors.

In contrast to labor market reforms, product market reforms almost invariably sought to increase competition. Reforms were also much less likely to be marginal. Accord-

ing to Boeri, this is because marginal reform, by nature, cannot succeed in product markets. A marginal reform in a specific sector (for instance, electricity) would result in a market with a different set of rules applied to different firms. Incumbent firms would operate under the old set of rules, providing them with protection and rents (for instance, in the form of government subsidies), whereas new entrants would be forced to operate without, creating an inherently uneven playing field and making it easy for old firms to force out new ones.

To complicate matters further, radical reform in product markets is difficult to undertake for at least two reasons. First, the lobbying power of incumbents is strong—monopolists are likely to oppose any attempt to undo their coveted privileges. Second, the public does not typically care strongly about reforming a specific sector, which diminishes voter pressure for the change. According to Boeri, this is because people are much more likely to identify themselves as workers than as consumers. So while they will happily demonstrate against attempts to undo their pension or unemployment compensation privileges, they care much less about achieving lower electricity prices.

Devising a strategy that works

What can politicians do to overcome these obstacles? Boeri suggests that delegating the regulation of product markets to the supranational level may be a viable option. "This strategy is ultimately what lies behind the success of European countries in liberalizing their product markets in the early 1990s," he writes. EU competition policy—aimed at eliminating anticompetitive agreements, liberalizing monopolistic sectors, controlling mergers between firms, and monitoring state aid—has been very important in liberalizing product markets and in preventing the undoing of earlier reforms. More recently, the introduction of the euro has led to greater price transparency and increased capital flows, which has also encouraged product market reform.

In contrast, a supranational strategy would not work for labor market reform, Boeri says. "In the case of labor market and social policies, the case is instead strong for keeping decentralized, country-level decision making in place. Public insurance schemes, for instance, can be better run at a decentralized level. There is also evidence of diseconomies of scale in social security provisions. The most effective social security systems (those achieving more redistribution relative to the resources allocated to them) in Europe are those of the smallest EU members.

Finally, there are country-specific clusters of institutions, and imposing the same approach on all may end up getting

Jean Paul Pelissier/Reuters

Thousands of people march in the streets of Marseille, France, to protest the government's plan to reform the pension system, June 2003.

the worst of the various systems. It is much better to rely on competition among systems, forcing reforms that imitate best practices," he concludes.

So what does all this mean for the ill-fated services directive, which would have liberalized the product markets that make up 50 percent of the EU's GDP? If it had been adopted, it would have given a strong impetus to freeing up trade in services ranging from plumbing to investment banking. But with the public mood seemingly swinging against a further devolution of power to the EU, national politicians are left fending for themselves—for the moment, at least. ■

Copies of IMF Working Paper No. 05/97, "Reforming Labor and Product Markets: Some Lessons from Two Decades of Experiments in Europe," are available for $15.00 each from IMF Publication Services. Please see page 216 for ordering information. The full text is also available on the IMF's website (*www.imf.org*).

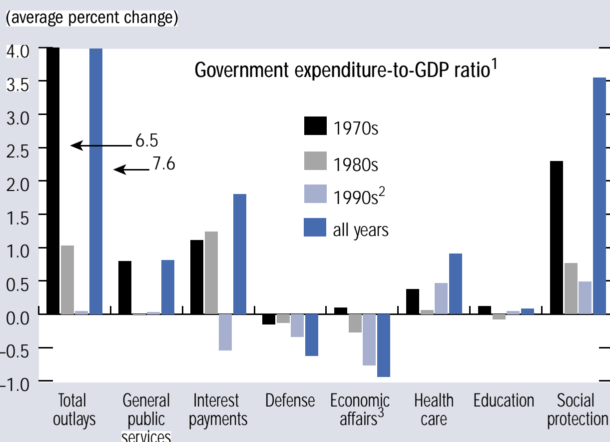
Aging, uncertainties argue for more ambitious fiscal policy

The challenge of addressing aging-related fiscal pressures looms large on the policy agendas of most industrial country governments. Yet the analysis of long-term expenditure trends has focused mainly on the implications of aging populations for government spending on pensions and health care. Two new IMF Working Papers shed light on a number of policy issues pertaining to long-term expenditure uncertainties that are relatively unexplored. They conclude that governments will have to adopt a more ambitious fiscal policy stance sooner rather than later to allow for gradual fiscal adjustment to aging and create space for potential additional expenditure risks.

Much has been written on the "fiscal time bomb" of age-related spending on pensions and health, including long-term care, in industrial countries. For example, the European Commission suggests the need for a fiscal adjustment—in the form of up-front and sustained tax or expenditure adjustments—of 2–3 percent of GDP until 2050 in most countries to hold current debt ratios constant in the face of pressures related to aging populations. Yet two long-term expenditure uncertainties typically remain relatively unexplored: those associated with the assumptions underlying the projections, and those related to the potential to reduce spending on non-age-related expenditure.

Not set in stone

On average, ratios of government expenditure to GDP in industrial countries have changed significantly in almost all categories.



[1]Median of 17 industrial countries.
[2]Including data available for 2000 and onward.
[3]Includes, among others, corporate and agricultural subsidies, and transportation.
Data: IMF, *Government Finance Statistics* and authors' calculations.

Projections highly uncertain

In carrying out long-term budget sustainability projections, technocrats are often constrained in a number of ways. Policymakers may dictate that projections be based solely on legislation currently in force, thus incorporating policies that may, in fact, be unsustainable in the future. Such an approach may not appropriately account for underlying uncertainties and can therefore carry substantial risks. For example, 50 years hence, errors in the assumed fertility rate, the real interest rate, or output growth can make large differences to the projected change in debt ratios.

Long-term fiscal projections also typically assume the absence of other pressures that are likely, but whose timing is hard to predict, such as higher welfare costs, outlays related to geopolitical shocks, incidents of terrorism, or climate change. In many countries, for example, health-care inflation—not aging—has been the most important driver of public health spending. Moreover, the larger share of the elderly in the population may create new demands for government outlays beyond what is implied by current legislation, for example, to bail out poorly performing private pension schemes.

Where is the fiscal space?

A further uncertainty concerns the potential to create fiscal space for age-related expenditures by trimming non-age-related expenditures. After all, even if all education, health care, and social protection spending were to be generously treated as age-related, what is left still amounts to 30 percent of total general government expenditure in the average industrial country.

A constant share of non-age-related expenditure in GDP is typically assumed, but, based on a sample of 17 industrial countries, the ratios to GDP of all expenditure categories except education have indeed changed a great deal over the past decades (see chart). In the 1970s and 1980s, rapid growth of government was driven nearly exclusively by interest payments and social protection. Between 1990 and end-2003, the size of government has remained virtually unchanged, as growth in health-care and social protection costs has been offset by cuts in interest payments, defense, and economic affairs.

Where is the fiscal space? And how much could come from expenditure cuts? Examining expenditure trends since the 1970s, two optimistic and two pessimistic arguments come to mind.

Optimistic Argument 1: There seems to be scope for more expenditure reductions. While classification issues might explain country-specific peculiarities, some functional expen-

diture categories (mainly in social protection, subsidies, the government wage bill, and capital expenditure) seem high in some countries, yielding potential savings of 5 percent of GDP and more in most continental European countries, but far less for Japan and the Anglo-Saxon countries. Also, given a country's own historical perspective on a sector, there seems room to retrench. In some countries, there might be scope for cutbacks of 2–5 percent of GDP, with the largest potential being in public services (excluding interest) and economic affairs (such as corporate and agricultural subsidies). However, a number of countries seem to have already hit historic lows in some of the expenditure categories, mostly in defense, but also public order and safety.

Optimistic Argument 2: Rising GDP could help countries "grow out of the problem." As discussed above, ratios to GDP have historically not been very reliable guideposts for expenditures. Real growth numbers yield more sanguine conclusions: a rule to freeze the ratio of total expenditure to GDP would still allow real non-age-related expenditure growth of about 1 percent per year from 2000 to the peak year of age-related expenditure in the average industrial country, despite age-related expenditure hikes. This is more growth than in the 1990s. Slowing population growth could also have a benign effect in some population-related (as opposed to age-related) areas, such as unemployment benefits. However, any acceleration of health-care inflation—resulting from technology, not aging—would further reduce fiscal space in addition to the impact of specifically age-related expenditures.

Pessimistic Argument 1: Governments have a weak record in implementing their consolidation plans, particularly on the expenditure side. Although some governments managed to reduce their expenditure-to-GDP ratios during the 1990s, most achieved less than they had planned to do.

Pessimistic Argument 2: For two main reasons, the knife could soon reach the bone. First, governments have already cut a lot. The average country has cut 5.1 percent of GDP in non-age-related and 0.7 percent in age-related expenditure categories, mostly in economic affairs, social protection, general public services, and defense. Second, a large share of the past cuts was thanks to the end of the Cold War, a secular decline in interest rates since the 1980s, and the abandonment of subsidies for inefficient industries—factors that are unlikely to be repeated.

What about higher taxes? Revenues are unlikely to provide much consolation to those governments most pressed on the expenditure side. Naturally, countries with the least scope to raise taxes are the ones with the most potential to reduce expenditure (high tax rates and high expenditure levels come together). But while raising taxes has often in the past been politically less painful than cutting spending, tax rates cannot go up much more in many high-tax countries. Thus, governments in high-tax, high-(age-related-)expenditure countries will face the toughest choices. In contrast, countries with low tax and expenditure shares have much more room to finance expenditure pressures through higher taxes.

More ambitious fiscal stance needed

What should policymakers and others take from all this? First, the current approach to setting fiscal policy frameworks tends to understate the downside risks arising from the uncertainty of the policy environment facing governments. Second, only narrow scope remains for most governments to obtain further savings from non-age-related expenditures quickly. Third, if adjustment starts early and is sustained, however, expenditure reduction would, over the long run, be facilitated by GDP growth and stagnating or shrinking populations. Fourth, on the revenue side, only a few countries seem to have room to raise taxes.

Taken together, this means that most governments will have to adopt a more ambitious fiscal policy stance and policy reform framework. With little scope left for tinkering with existing expenditure frameworks, the focus now must be on long-term structural reform programs that achieve a steady and sustainable decline in expenditure commitments arising from aging populations.

Furthermore, the risks stemming from potentially overly optimistic assumptions in current medium-term fiscal projections, including those in the EU Stability Programs, must be addressed more consistently. As a first step, governments of countries facing severe fiscal challenges from aging should be attuned to potential vulnerabilities in making long-term expenditure forecasts of economic and functional expenditure categories. Such vulnerabilities should be reflected in some way in framing annual budgets. Certainly, long-term projections should be informed by scenario analyses. Most important, such scenario analyses can serve to focus the public debate on key long-term policy challenges and provide a continuous reality check of current expenditure trends relative to long-term goals. ■

Peter S. Heller and David Hauner
IMF Fiscal Affairs Department

Copies of IMF Working Papers No. 05/91, "Characterizing the Expenditure Uncertainty of Industrial Countries in the 21st Century," and No. 05/71, "Aging: Some Pleasant Fiscal Arithmetic," are available for $15.00 each from IMF Publication Services. Please see page 216 for ordering details. The full texts are also available on the IMF's website (*www.imf.org*).

World Economic Outlook

Rapidly growing workers' remittances can boost development

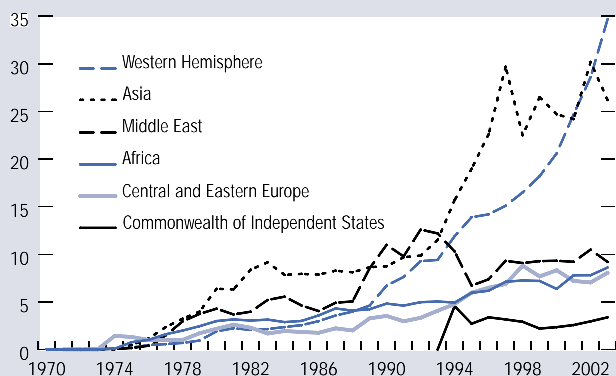
Workers' remittances are a large and rapidly growing source of foreign exchange for many developing countries, but surprisingly little is known about their economic effects, what determines their size and growth rate, and what policymakers can do to maximize their benefits. To address this analytical void, the IMF's April 2005 *World Economic Outlook (WEO)* undertook a systematic cross-country analysis of remittances. One key lesson is that more can be done to reduce the cost of sending remittances. Nikola Spatafora (IMF Research Department and author of the *WEO* study) outlines this and other findings.

Remittance flows to developing countries—defined as the transfers made by migrant workers to family and friends in their home country—have grown steadily over the past 30 years. In 2003, remittance inflows for 90 developing countries analyzed in the *WEO* study amounted to about $100 billion—the equivalent of 50 percent of total capital inflows or 1.4 percent of aggregate GDP (see chart).

For many developing countries, remittances constitute the single-largest source of foreign exchange, exceeding export revenues, official aid, foreign direct investment (FDI), and other private capital inflows. Mexico, for instance, currently receives about $15 billion in remittances a year. In smaller economies, such as many Caribbean countries, remittances often exceed 10 percent of GDP. On the sending side, the United States remains the main source of remittances, providing over $30 billion in 2003. Indeed, outflows from the United States have almost quadrupled over the past 15 years, partly reflecting the recent rapid increase in immigration into the United States.

Some regions benefit more

Developing countries in the Western Hemisphere and Asia have received the bulk of remittance inflows.



Note: Regional groups are based on the current IMF *World Economic Outlook* country groupings. Only developing countries are included.
Data: IMF, *World Economic Outlook*, April 2005.

Overall, remittances have proved remarkably resilient in the face of economic downturns, displaying greater stability and lower pro-cyclicality than, say, exports or private capital flows. Over time, remittances are also likely to continue growing as populations in industrial countries continue to age and as pressures for migration from developing to advanced economies intensify.

Not surprisingly, given all this, interest in remittances and their impact on developing economies is rapidly growing, whether in policy circles including the Group of Eight, in the research community, or indeed among potential remittance-service providers. Remittances are increasingly viewed as a relatively attractive source of external finance for developing countries, one that can help foster development and smooth crises. At the same time there are concerns, including that remittances can be abused to launder money and finance terrorism.

To date, there has been little systematic cross-country research on remittances. To begin to remedy this, the *WEO* took a detailed look at the effects of remittances. Based on an analysis of their determinants, it also examined options available to policymakers to encourage remittance flows while ensuring that they are properly regulated.

Maximizing the benefits of remittances

Overall, the *WEO* found clear evidence that remittances can play an important role in boosting growth, contributing to macroeconomic stability, mitigating the impact of adverse shocks, and reducing poverty in developing countries. Remittances allow households to maintain, or indeed step up, expenditure on basic consumption, including food and housing. They are often used to finance children's education and to set up small businesses. Also, unlike aid or natural resource revenues, remittances typically do not have serious systematic adverse effects on a country's competitiveness.

Given these considerable benefits, what can recipient-country authorities do to seize salient opportunities and meet attendant challenges? The *WEO* identified several key

Miguel Salguero/Fort Worth Star-Telegram

Dollar exchange stores, such as this one, are common in Jrez, Zacatecas. Mexico currently receives about $15 billion annually in worker remittances.

policy challenges that need to be tackled—notably, reducing transaction costs, ensuring that macroeconomic and exchange rate policies do not discourage remittances, reducing barriers to entry into the remittance market, and making certain that regulatory and supervisory frameworks are adequate but not onerous.

Lower transaction costs. Significant benefits could flow from measures that reduce the cost of sending remittances. While transaction costs have declined in recent years, they remain variable and are, in several cases, still high—often amounting to 5–10 percent or more of the amount transferred. To the extent possible, measures must be undertaken to reduce such costs, including removing barriers to entry and encouraging competition in the remittance market. One possible step, the *WEO* suggests, is publicizing information about available options for money transfers and the associated costs.

Ensure appropriate macroeconomic and exchange rate policies. In some cases, macroeconomic and exchange rate policies may both discourage remittances and shift them outside the formal financial system. The authorities must take this potential effect into account, particularly in those countries where remittance inflows (actual or potential) are significant. The *WEO* analysis provides additional grounds to be wary of exchange restrictions, such as constraints on personal payments or the presence of multiple exchange rates, and other economic restrictions. It also finds that, to some extent, unstable macroeconomic policies and exchange rate misalignments (overvalued currencies in potential recipient countries) may deter remittances.

Reduce barriers to entry. Remittance receipts can be leveraged by households to obtain better access to banking and financial services. This is more likely if formal financial intermediaries, including banks and microfinance institutions, enter the remittance market more actively. Here, as with the reduction of transaction costs, governments can help by reducing entry barriers.

Be vigilant, but not heavy-handed. It is vital to ensure that remittance-service providers are appropriately regulated and supervised to minimize the potential risks of money laundering, terrorist financing, or consumer fraud. But a balancing act is needed. Regulatory frameworks must take into account, and where possible minimize, any adverse impact on the cost of sending remittances and on the incentive to provide remittance services. Excessively onerous regulations could paradoxically drive remittance flows further underground.

In addition, remittances, like any other foreign exchange inflow, carry a potential for "Dutch disease"-type problems. In general, this does not appear to have been a major problem, but this consideration does suggest that, in the presence of significant changes in remittance inflows, authorities may need to accept a greater degree of exchange rate flexibility than would otherwise be the case in order to avoid instability in domestic inflation.

The *WEO* study acknowledges that better information is still needed on the magnitudes and sources of remittances, including both inflows and outflows. Without such information, other challenges—such as regulating remittances and developing new financial products to serve the needs of remittance senders and recipients—will remain extremely difficult.

Finally, it is important to remember that remittances are just one of the many channels through which rising global migration flows affect developing-country welfare. While workers' remittances may be beneficial, the loss of labor, especially specialized human capital—the "brain drain"—may hamper the development prospects of those left behind, including by affecting the tax base. But on the positive side, migrants themselves often find better opportunities in their destination countries, and may learn skills and gain experience that will prove valuable if they repatriate. And, more broadly, emigration may encourage the development of commercial networks, promote trade and investment flows, and lead to significant diaspora philanthropy. ■

Copies of the April 2005 *World Economic Outlook* are available for $49.00 each ($46.00 academic price) from IMF Publications Services. The full text of the latest issue of the *World Economic Outlook* is also available on the IMF's website (*www.imf.org*).

Beating the business cycle

Why do economic forecasters do such a poor job predicting growth? One crucial reason, argues Anirvan Banerji, Director of Research of the independent, New York-based Economic Cycle Research Institute (ECRI), is that they fail to predict the turning points of the business cycle. At a June 23 IMF book forum, Banerji presented his new book, *Beating the Business Cycle: How to Predict and Profit from Turning Points in the Economy* (coauthored with Lakshman Achuthan), and offered a spirited defense of the "leading indicator approach" to predicting growth.

"The record of failure to predict recessions is virtually unblemished," the IMF's Prakash Loungani concluded in a 2001 study of private sector forecasts. That dismal record makes it all the more remarkable that one organization has constantly bucked the trend. According to *The Economist*, ECRI is "the only organization to give advance warning of each of the past three recessions; just as impressive, it has never issued a false alarm."

Henrik Gschwindt de Gyor/IMF

From left: Anirvan Banerji (Director of Research of the ECRI), and discussants Robert Lenzer (National Editor, Forbes), and Fred Joutz (Associate Professor of Economics, George Washington University).

What accounts for ECRI's success? Banerji credits first and foremost the organization's reliance on an elaborate system of leading indicators to predict turning points in the economy. This approach has often been belittled as "measuring without theory," but Banerji went to some length to counter this assertion. He claimed that formal econometric models are not sufficiently flexible to capture turning points of the economic cycle—as illustrated by the work of two well-known econometricians. In the late 1980s, they created a sophisticated recession probability index, which immediately failed to predict the 1990 recession. Queried as to the reasons why the index had failed, one of the authors replied: "parameter drift."

A better tool kit

Thus, a more robust approach was needed, as the correct projection of turning points of the business cycle could provide crucial information to policymakers and markets. Banerji insists that ECRI's analysis lives up to this claim. Back in 1950, Geoffrey Moore—one of ECRI's intellectual fathers—created eight leading indicators of revivals and recessions for the U.S. economy from 1870 to 1938. Forty years later, he repeated this exercise for various industrial countries in the second half of the 20th century. To Moore's own surprise, he found that the leading indicators identified in 1950 were still holding up! That is, the same indicators that forecast turning points in the post-Civil War U.S. economy worked also for late 20th century Germany, the Republic of Korea, New Zealand, and the United States itself.

Staying the course

Away from the academic mainstream, Moore and a small band of researchers have stayed their course for decades, refining the scope and accuracy of their forecasting tools. Rather than relying on one-dimensional leading indicators, today most ECRI projections are based on a long index, a weekly leading index, and a short-term index. When the business cycle turns, these indices turn sequentially, providing increasing confidence about where the economy is headed.

This refined approach has permitted ECRI to make correct calls even when everybody else went wrong. For example, in March 2001, 95 percent of U.S. economists forecast that there would not be a recession, while ECRI emphasized that a recession was unavoidable. At mid-June, ECRI's analysis pointed to a slowing of U.S. growth, even though a slight uptick in the long index gave some reason for hope of a reacceleration. Also, ECRI produces separate leading indicators for growth, inflation, and employment. As a consequence, its projections can better handle nonstandard phenomena, such as the recent jobless recovery or inflation-free growth. ■

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IMF Policy Development and Review Department

The full transcript of the June 23 book forum is available on the IMF's website (*www.imf.org*). *Beating the Business Cycle: How to Predict and Profit from Turning Points in the Economy*, by Lakshman Achuthan and Anirvan Banerji, is published by Doubleday and Company.

Stand-By, EFF, and PRGF arrangements as of June 30

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina	September 20, 2003	September 19, 2006	8,981.00	4,810.00
Bolivia	April 2, 2003	March 31, 2006	171.50	60.00
Bulgaria	August 6, 2004	September 5, 2006	100.00	100.00
Colombia	May 2, 2005	November 2, 2006	405.00	405.00
Croatia	August 4, 2004	April 3, 2006	97.00	97.00
Dominican Republic	January 31, 2005	May 31, 2007	437.80	385.26
Gabon	May 28, 2004	July 31, 2005	69.44	27.78
Paraguay	December 15, 2003	September 30, 2005	50.00	50.00
Peru	June 9, 2004	August 16, 2006	287.28	287.28
Romania	July 7, 2004	July 6, 2006	250.00	250.00
Turkey	May 11, 2005	May 10, 2008	6,662.04	6,106.87
Uruguay	June 8, 2005	June 7, 2008	766.25	735.60
Total			**18,277.31**	**13,314.79**
EFF				
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Serbia and Montenegro	May 14, 2002	December 31, 2005	650.00	187.50
Total			**794.40**	**311.23**
PRGF				
Albania	June 21, 2002	November 20, 2005	28.00	4.00
Armenia	May 25, 2005	May 24, 2008	23.00	19.72
Azerbaijan	July 6, 2001	July 4, 2005	67.58	12.87
Bangladesh	June 20, 2003	December 31, 2006	400.33	251.83
Burkina Faso	June 11, 2003	August 15, 2006	24.08	10.32
Burundi	January 23, 2004	January 22, 2007	69.30	35.75
Cape Verde	April 10, 2002	July 31, 2005	8.64	0.00
Chad	February 16, 2005	February 15, 2008	25.20	21.00
Congo, Republic of	December 6, 2004	December 5, 2007	54.99	47.13
Democratic Republic of the Congo	June 12, 2002	October 31, 2005	580.00	53.23
Dominica	December 29, 2003	December 28, 2006	7.69	3.48
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	June 4, 2004	June 3, 2007	98.00	70.00
Ghana	May 9, 2003	October 31, 2006	184.50	105.45
Guyana	September 20, 2002	September 12, 2006	54.55	27.79
Honduras	February 27, 2004	February 26, 2007	71.20	40.69
Kenya	November 21, 2003	November 20, 2006	225.00	150.00
Kyrgyz Republic	March 15, 2005	March 14, 2008	8.88	7.62
Mali	June 23, 2004	June 22, 2007	9.33	6.67
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Mozambique	July 6, 2004	July 5, 2007	11.36	8.12
Nepal	November 19, 2003	November 18, 2006	49.91	35.65
Nicaragua	December 13, 2002	December 12, 2005	97.50	41.78
Niger	January 31, 2005	January 30, 2008	6.58	5.64
Rwanda	August 12, 2002	February 11, 2006	4.00	1.14
Senegal	April 28, 2003	April 27, 2006	24.27	13.86
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	19.60
Tanzania	August 16, 2003	August 15, 2006	19.60	8.40
Uganda	September 13, 2002	September 12, 2005	13.50	4.00
Zambia	June 16, 2004	June 15, 2007	220.10	49.52
Total			**2,769.79**	**1,319.49**

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

UN leadership sought for aid coordination

If the world wants to distribute aid more effectively, pursue the Agenda for Sustainable Development, and achieve the Millennium Development Goals, the international architecture for development and environment must be reformed, according to a recent study commissioned by Germany's Friedrich Ebert Foundation. It argues that the current international structure is fragmented and dysfunctional, dominated by institutional and national interests, and characterized by overlapping responsibilities.

The study, "Governance Reform of the Bretton Woods Institutions and the UN Development System," which was authored by experts from German, U.K., and U.S. think tanks, notes that the political, economic, and bureaucratic capacities of developing countries are frequently overwhelmed by aid programs from national and international donor organizations. At the same time, donor countries often see their aid efforts diminished because too many players and institutions are involved. For that reason, the study calls for a core UN group to take charge. "We need to get a leadership group on aid architecture," says Simon Maxwell, Director of the Overseas Development Institute in London, at a July 6 forum on the study in Washington, D.C.

Specifically, the authors call for the creation of a Council of Global Development and Environment—based on a 2004 proposal by a German government advisory group—with a mandate to formulate political guidelines, steer the UN development system, manage a single development budget, and become an equal partner with the Bretton Woods institutions. The authors also call for reform of the governance of the Bretton Woods institutions with recommendations for a better balanced voting structure, a recalibrated quota system, enhanced transparency of Executive Board discussions, and reinforced cooperation with the UN.

Call for stronger coordination

But better coordination between the UN development system and the Bretton Woods institutions requires a leadership group that has the power and the resources to do the job effectively, the study says. The Council would not interfere with the operations of the international financial institutions, but rather issue political guidelines on the direction of international development and environmental policies that would lead to more effective policy coordination and coherence. "Many disagree with the creation of a new management system," Dirk Messner, Director of the German Development Institute in Bonn, concedes. "But they agree with the functions the system should have and admit that it's a step in the right direction."

Henrik Gschwindt de Gyor/IMF

From right: Dirk Messner (Director of the German Institute for Development Policy) and Dieter Dettke (Executive Director, Washington office, Friedrich Ebert Foundation).

Several principles should guide the leadership group, the study says, including keeping the core group small and involved in as many issues as possible; developing trust-building measures from the beginning; encouraging a system that makes it awkward not to cooperate; using positive incentives to effect reform; and setting up appropriate institutions to manage these interactions and relationships. "However the leadership group is constituted, it should set out a vision of a unified and efficient UN development system, large enough and competent enough to provide a realistic alternative to the Bretton Woods system—and then should offer to fund it," the study concluded. ■

A copy of the study can be requested from the Friedrich Ebert Foundation at *www.fesdc.org.*

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