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IMF reaffirms vital role in low-income countries

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Stephen Jaffe/IMF

The IMF continues to have a vital role to play in low-income countries, Managing Director Rodrigo de Rato said at the Center for Global Development. The Fund has moved swiftly to forgive the debt of 19 poor countries, and now, in the context of its Medium-Term Strategy, it will be helping low-income countries avoid a build-up of new debt and use increased aid to promote growth. It is also seeking fair representation of low-income countries in the IMF.

United Kingdom outlines efforts to end global poverty

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John Harrington/IMF

In a follow-up to the 2005 Gleneagles Summit and its ambitious commitment to reinvigorating the fight against global poverty, the U.K. Department for International Development released a new policy paper that sets out the steps the United Kingdom will take to deliver on those promises. An IMF Economic Forum and panel discussion spotlighted the policy paper's key areas of concern: good governance, growth and aid, climate change, and reform of the international system.

How Latin America has tamed macroeconomic volatility

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Latin American countries have a history of macroeconomic instability, including boom-bust cycles and high inflation. But, over the past three years, they have registered good macroeconomic performance. Anoop Singh, Director of the IMF's Western Hemisphere Department, finds that the region has made steady progress in advancing market-based reforms and entrenching sound macroeconomic policy frameworks. That said, there is scope for further progress, and the region's top priorities will be continued policy and institutional reforms to reduce public debt and strengthen fiscal frameworks.

Is home equity withdrawal depleting U.S. savings?

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Justin Sullivan/Getty Images

The U.S. personal saving rate dipped into negative territory in 2005 as household wealth, and the use of innovative methods of tapping that wealth, expanded dramatically. Was a sharp rise in home equity withdrawal the driver behind the slumping saving rate? And, potentially more ominously, is a slowdown in the housing market now likely to translate into a substantial drop in consumption? A new IMF Working Paper takes a closer look at these linkages.

IN THIS ISSUE

What's on

August

13–18 XVI International AIDS Conference, Toronto, Canada

14–25 "Achieving the Millennium Development Goals: Poverty Reduction, Reproductive Health, and Health Sector Reform," World Bank Global Course, Bangkok, Thailand

24–26 2006 Economic Policy Symposium, Jackson Hole, Wyoming, United States

27–September 1 International Disaster Reduction Conference, Davos, Switzerland

September

7–8 13th Asia Pacific Economic Cooperation Finance Ministers' Meeting, Hanoi, Vietnam

10–11 IMF High-Level Seminar on Financial Taxation, Singapore

10–11 China Business Summit 2006, Beijing, China

12 Organization of the Petroleum Exporting Countries Conference, Vienna, Austria

14–15 Raffles Forum on Good Governance and the Wealth of Nations, Singapore

19–20 IMF–World Bank Annual Meetings, Singapore

19–20 United Nations General Assembly, High-Level Meeting on the Review of the Brussels Program of Action for the Least Developed Countries, New York, United States

25–26 World Trade Organization Public Forum, "What WTO for the 21st Century?" Geneva, Switzerland

October

23–27 IMF High-Level Seminar on Current Issues in Monetary and Financial Law, Washington, D.C., United States

November

6–7 IMF Symposium on Integrity Supervision of Financial Sector Firms, Washington, D.C., United States

9–10 Jacques Polak Seventh Annual Research Conference, IMF, Washington, D.C., United States

17–18 Rio 6: World Climate and Energy Event, Rio de Janeiro, Brazil

18–19 14th Asia Pacific Economic Cooperation Economic Leaders' Meeting, Hanoi, Vietnam

23–24 World Economic Forum, "Connecting Regions—Creating New Opportunities," Istanbul, Turkey

26–28 World Economic Forum, "India: Meeting New Expectations," New Delhi, India

January 2007

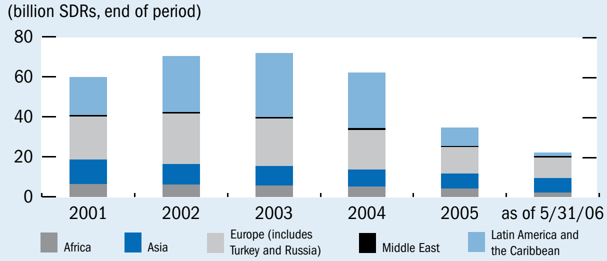
24–28 World Economic Forum Annual Meeting, Davos, Switzerland

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.*

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



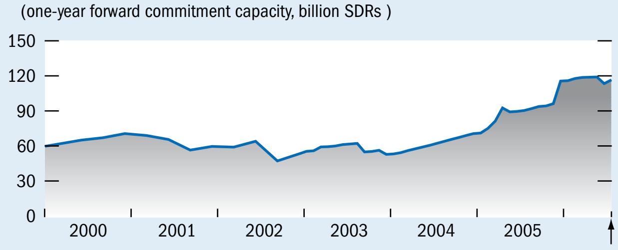
Largest outstanding loans

(billion SDRs, as of 6/30/06)

Nonconcessional		**Concessional**	
Turkey	7.77	Pakistan	0.96
Indonesia	2.47	Congo, Dem. Rep. of	0.55
Uruguay	1.35	Bangladesh	0.28
Ukraine	0.69	Yemen, Republic of	0.16
Serbia and Montenegro	0.49	Georgia	0.16

Available IMF resources

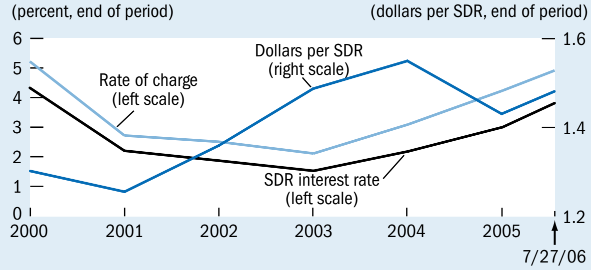
(one-year forward commitment capacity, billion SDRs)



Related rates

SDR interest rate, rate of charge on IMF nonconcessional loans outstanding, and dollars per SDR

(percent, end of period)
(dollars per SDR, end of period)



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

IMF will continue to play vital role in low-income countries

The hard-won gains from debt relief may be lost if countries take on new debt to finance expenditures that do not spur growth, IMF Managing Director Rodrigo de Rato cautioned in a July 31 appearance at the Center for Global Development (CGD) in Washington, DC. In fact, he said, one of the tasks before the IMF is "to ensure that there is not another debt crisis." In outlining the Fund's strategy for low-income countries, de Rato stressed that the IMF is "strongly committed to our low-income country members and to the international effort to reduce poverty." He highlighted the Fund's long advocacy of higher aid and its effective use, and the importance of protecting the voice and representation of poor countries in the IMF.

Joining him for a debate on the IMF's work in low-income countries were Kemal Dervis (Administrator, United Nations Development Program), Ricardo Hausmann (Director of Harvard University's Center for International Development), and Dennis de Tray (Vice President, CGD). CGD's Liliana Rojas-Suarez served as moderator.

IMF perspective

De Rato said that the IMF made an important contribution to reducing the debt of low-income countries when, under the Multilateral Debt Relief Initiative, it moved quickly to cancel the debts owed to it by 19 poor countries. But there are signs that new private and official lenders are rushing to provide new lending to these same countries. To help mitigate the risk of debt buildup, he said, the IMF and the World Bank have designed a forward-looking debt sustainability framework for low-income countries to assist them in their financing decisions. "We can also sound the alarm to official creditors when debt or debt-service levels are likely to become a problem," he added.

As for alternative sources of finance, de Rato noted, the international community also needs to offer sufficient grants and highly concessional loans—with donors providing early and predictable commitments of support to allow low-income countries to plan successfully. The IMF can help improve the effectiveness of aid "by ensuring that macroeconomic frameworks are sound and that adequate public expenditure systems are put in place, so that scaled-up resource flows reach their targets," he explained.

On the fiscal side, "the Fund is also strongly committed to making sure that countries have the 'fiscal space' they need to expand social programs, especially in health and education," he said. Contrary to what some nongovernmental organizations assert, the Fund does not advocate cutting back on spending in these areas, even in times of fiscal restraint, he said. Indeed, many Fund-supported programs include floors on poverty-related spending.

On the trade front, he called the recent collapse of the Doha Round of trade talks "very painful," saying that he hoped negotiators would try to preserve gains already made.

De Rato also stressed that the Fund's legitimacy as a global institution demands that all its members have fair representation and a voice that can be heard. This issue will be taken up at the September IMF–World Bank Annual Meetings in Singapore.

The Fund is also strongly committed to making sure that countries have the 'fiscal space' they need to expand social programs, especially in health and education.

—Rodrigo de Rato

Debating the Fund's role

A lively debate among the panelists and de Rato followed. Dervis welcomed de Rato's remarks on the voice and representation of poor countries in the IMF Executive Board. It worried him, however, that the IMF seemed less concerned with real exchange rate appreciation that sometimes results from capital inflows into middle-income countries than with real exchange rate appreciation that can result from aid inflows into low-income countries, calling the former a policy of "benign neglect." Rojas-Suarez noted that the multilateral organizations have not been very good in the past at preventing the buildup of unsustainable debt in low-income countries, and wondered what would make the future different and whether aid dependency was now replacing overindebtedness.

In Hausmann's view, the international community's strategy for low-income countries focuses too much on achieving the Millennium Development Goals and not enough on economic growth. He asked why, if Tanzania counts as a success story, is there so little investment, infrastructure, or nontraditional exports? De Rato stressed that macroeconomic stability is part of a growth strategy—economies cannot grow with high inflation and unsustainable debts. All economic policymaking involves tradeoffs, he said, and decisions on these tradeoffs must be made by the countries themselves.

De Tray expressed the view that the IMF has been very successful in crisis management—he saw this first-hand in Indonesia in the late 1990s—and promoting macroeconomic stability. But he questioned whether the Fund was flexible and open enough at the country level to contribute significantly to long-term development. It seemed to him that changes in the IMF's culture were needed and that these would take a long time. ■

Buoyant Japan now needs to bolster longer-term prospects

IMF Managing Director Rodrigo de Rato said on August 3 in Tokyo that he was "very optimistic about Japan's economic prospects" for the near future but that the economy's longer-term fortunes depended on boosting its economic potential as its population aged. With deflation, by most measures, ended, there is reason for optimism.

Speaking at the Foreign Correspondents' Club, de Rato cited the IMF's recent upbeat assessment of the country's economy, which projects output growth at close to 3 percent this year, underpinned by rising employment, and financial and corporate sectors "in their best shape in over a decade." He was in Japan for meetings with Prime Minister Junichiro Koizumi, Finance Minister Sadakazu Tanigaki, Bank of Japan Governor Toshihiko Fukui, and other senior officials.

Toshiyuki Aizawa/Reuters

Japan has much to gain, de Rato said, from an orderly unwinding of global imblances.

Challenges ahead

Looking ahead, de Rato noted that Japan will need to remain mindful of significant policy challenges, notably:

Regaining sustainability in public finances. Thirteen years of deficits have left Japan with a legacy of uncomfortably high public debt and limited resources to meet the demands of an aging society. The IMF's recent review of the Japanese economy commended the authorities for their commitment to address the fiscal imbalances but urged more ambitious steps in the upswing.

Boosting potential growth. To safeguard its living standards, Japan must boost productivity to offset a shrinking population. Japan has made much progress to date—notably in charting a course to scale down the role of government financial institutions in the economy. But more reforms will be needed, in particular to encourage more women, marginalized youth, and older workers to participate in the work force. Further efforts to strengthen competition in product markets can enhance the benefits of these labor market reforms.

Implementing a post-deflation monetary strategy. Given the limited risk of a surge in inflation and the costliness of any recurrence of deflation, de Rato cited the importance of a gradual return to more normal interest rate levels. He commended the Bank of Japan for adopting a new framework that helps anchor inflation expectations and brings a "risk management" approach to the conduct of monetary policy. Careful attention to the longer-term risks of financial or macroeconomic imbalances can also help avoid a recurrence of asset price bubbles.

The IMF and Japan have had a long and constructive relationship, de Rato noted, citing the country's significant role in IMF lending, technical assistance, and policy initiatives. He expressed confidence that this role would continue as the IMF adapts its work, through its Medium-Term Strategy, to meet the needs of its members and the demands of the twenty-first century.

Tackling imbalances

In his review of IMF initiatives, de Rato made note of a newly launched mechanism for addressing global financial issues—the multilateral consultation process—and efforts to ensure fair representation for all IMF members in the institution. Japan, along with China, the euro area, Saudi Arabia, and the United States, is participating in the first multilateral consultation, focused on how coordinated action in several countries may help narrow global current account imbalances. Japan has much to gain, de Rato said, from an orderly unwinding of these imbalances, and it can play a key role, with other participants, in contributing to a smooth resolution.

Ensuring fair representation

On the issue of quotas and voice in the IMF, de Rato outlined a "two-year program of action" designed to ensure fair representation. It is now time, he said, to recognize the rising economic weight of some of the largest emerging market economies, including some in Asia, by increasing their relative quotas and voting shares. He envisaged a process that would start with key decisions on ad hoc quota increases for the most underrepresented members at the IMF's Annual Meeting in Singapore in September.

The process would include immediate action on increases for a few countries whose quotas are clearly out of line but also agreement on the pursuit of more fundamental changes. These changes would include a further round of ad hoc quota increases for underrepresented members (following a review of the formula used to calculate quotas) and measures to protect the voice and representation of low-income countries that borrow from the IMF but have a limited share of its voting. De Rato favored an increase in the "basic votes"—the minimum and equal number of votes accorded to all members—which have declined in relative weight over time. ■

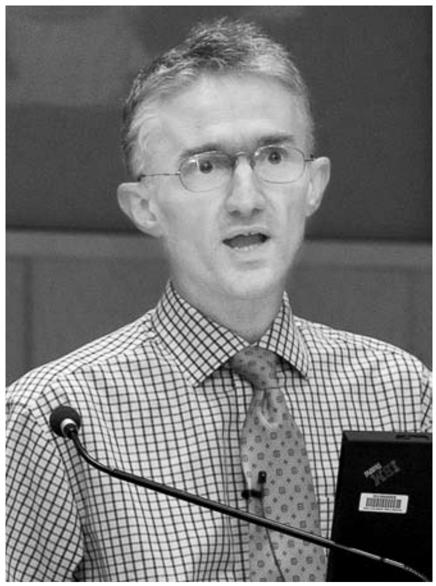
Promises to keep: the United Kingdom outlines its efforts to eliminate global poverty

At the Group of Eight (G8) Summit at Gleneagles in 2005, ambitious commitments were made to reduce the debt of poor countries, deliver more and better aid, pursue fairer trade, encourage improved governance, and foster more coherent policies in support of development. Roughly one year later, at a July 20 IMF Economic Forum, Mark Lowcock of the U.K.'s Department for International Development (DfID) outlined the country's newly launched policy statement, "Eliminating World Poverty: Making Governance Work for the Poor." The paper sets out how the United Kingdom intends to play its part in delivering on the promises made last year. Joining Lowcock to discuss the paper were Dennis de Tray (Center for Global Development), Abdoulaye Bio-Tchané (IMF), and Jim Adams (World Bank).

The policy paper highlighted four areas that the United Kingdom sees as critical in the fight against poverty—good governance, growth and public services, climate change, and reform of the international system.

Good governance. From the U.K. perspective, Lowcock noted, effective states and better governance (at the national and international levels) are essential for promoting growth and poverty reduction. To monitor governance and to inform the choices that the United Kingdom will make regarding the distribution of its aid resources, the country plans to adopt a new quality-of-governance assessment. But how, asked Andy Berg (IMF), will the United Kingdom resolve the tension between making aid available to countries on a predictable basis and withholding aid from poorly governed countries? Lowcock agreed this was indeed one of the most difficult challenges facing donors. The United Kingdom would not want to "punish the poor for the failings of their government;" nor does it want to support regimes that govern poorly. Ultimately, Lowcock said, decisions will be made case by case, and DfID will look for ways to support basic services in problem cases.

Growth and public services. "Growth is the exit strategy for aid," stated Lowcock—a sentiment Adams shared. Too often, Adams noted, the importance of growth is lost in the discussions on aid. Many low-income countries, Lowcock noted, will be unable to increase their tax base fast enough by 2015 to finance the public services (for example, schools, clinics, and clean water) necessary to achieve the Millennium Development Goals (MDGs). These countries will need donor support, and the United Kingdom, Lowcock said, is prepared to do its part. De Tray cautioned, too, that many countries will remain dependent on aid for a long time to come—implying the need for a long-term engagement by DfID and other donors.


John Harrington/IMF

Lowcock: "Growth is the exit strategy for aid."

Climate change. Why should a paper focusing on poverty reduction take up the issue of combating global warming? The DfID paper makes a persuasive case for why climate change jeopardizes the development of poor countries, said Bio-Tchané. Desertification in the Sahel and the spread of malaria caused by long rainy seasons in parts of Africa have had devastating effects on the poor, he noted. Lowcock agreed, warning that climate change was the most serious long-term threat to development and the achievement of the MDGs. Developing countries will need to be part of the solution and receive support to adapt.

International challenges, international solutions. In DfID's view, international institutions must also be reformed so that they can deliver better results for development and be more responsive to the needs of poor people. In particular, Lowcock said, developing countries must have a stronger say in the governance of institutions like the IMF and the World Bank. And the heads and top managers of these global institutions should be selected by transparent, competitive processes that are not driven by nationality or tradition.

Sustaining public support for aid

Development is a lengthy process that will require a resolute commitment to aid in donor countries. In the United Kingdom, Lowcock observed, the constituency for development has grown—one person in six was involved in some way in the "2005 Make Poverty History" campaign. Strong support for public spending on international development can be sustained, he said, but only if people see and believe that this use of their tax payments is making a difference. The challenge is to demonstrate that it is. ■

Sabina Bhatia
IMF External Relations Department

Better investment climate would help Palau achieve sustained growth

After several years of slow or negative growth, economic activity has picked up in the Republic of Palau, while inflation has remained low, according to the IMF's latest economic review. Real GDP, driven by higher visitor arrivals and externally funded government projects, grew by 5 percent in FY2004 and 5½ percent in FY2005. Palau, a small island economy in the Pacific, relies heavily on tourism and on external assistance from its 50-year Compact of Free Association with the United States and grants from Japan and Taiwan Province of China to finance budget expenditure and infrastructure projects.

Better economic management has encouraged private sector activity. Fiscal performance was improved by capping nonwage current expenditure while strengthening revenue collections, allowing public debt to remain low. Although investment impediments remain, Palau ranks high on several indicators of the cost of doing business, and local private firms are undertaking a growing share of foreign-financed projects.

Palau	2002/03	2003/04	Prel. 2004/05	Proj. 2005/06
		(percent change)		
Real GDP growth	–1.3	4.9	5.5	5.7
Consumer prices (period average)	–0.6	5.8	2.7	3.0
		(million dollars)		
Compact Trust Fund balance	136.3	141.6	152.5	155.8
Tourism receipts	75.6	96.9	97.2	97.5
		(percent of GDP)		
External public debt[1]	15.9	14.0	13.2	11.3
Current account balance (including grants)	7.9	9.6	10.6	2.5

[1]Does not include public enterprise debt, which is not guaranteed by the government.
Data: Palauan authorities and IMF staff estimates and projections.

Near-term economic prospects are upbeat, with tourism and infrastructure projects playing major roles. In the longer term, however, Palau's prospects are more uncertain and will depend on the direction of economic policies and whether U.S. Compact assistance is renewed beyond 2009.

IMF Executive Directors welcomed Palau's improved economic performance. They commended the authorities for managing foreign aid judiciously and for reducing public sector spending, while noting that further efforts are needed to meet the long-run goal of covering current spending from domestic revenue generation.

Noting that Palau has a large banking sector relative to its size, the Directors stressed the importance of passing pending financial regulations and enhancing the capacity and resources of the new supervisory agency.

To establish a sound foundation for sustained growth, the Directors underscored the need to improve the investment climate and labor and land policies. They were encouraged by the ongoing domestic debate over reducing foreign investment restrictions and welcomed progress made on land titling and leasing, but warned against raising the minimum wage so as to safeguard job opportunities for Palauans. ■

Lithuania should focus on medium-term fiscal pressures

Lithuania's GDP grew by 7.5 percent in 2005, with declining unemployment, high capacity utilization, and buoyant asset prices, according to the IMF's recent economic review. But rising inflation has exceeded the Maastricht inflation reference rate, delaying euro adoption. The economy has continued to be stimulated by fiscal and European Union (EU) expenditures.

The IMF Executive Board welcomed Lithuania's economic performance, attributing it to strong macroeconomic policies, wide-ranging structural reforms, and EU integration. But, the Directors cautioned, imbalances are emerging. Rapid growth of consumption and of investment in property and construction have contributed to inflation and new financial vulnerabilities. Over the longer term, challenges are likely to arise from international tax competition, demand for public goods, emigration, and pressures on international competitiveness.

Lithuania has a sizable current account deficit but low external indebtedness, and the risks from accumulating external short-term debt will need close monitoring. Rapid credit growth has supported households' increasing appetite for mortgages and corporate demands in nontradables sectors. The Directors saw no need to slow the pace of credit growth directly, but encouraged the authorities to conduct forward-looking supervision, cool the property market, and encourage the disclosure of bank fees, among other measures.

Lithuania	2003	2004	2005	Proj. 2006
		(percent)		
Real GDP growth	10.5	7.0	7.5	6.8
Consumer price inflation (12 months to end-year)	–1.3	2.8	3.0	3.5
Unemployment rate (end-year)	12.4	11.3	8.3	4.2
		(percent of GDP)		
Current account balance	–6.9	–7.7	–7.0	–7.5
External general government debt	13.8	13.7	13.2	12.8

Data: Lithuanian authorities and IMF staff projections.

On the export side, growth has been sound but faces capacity constraints in the oil-refining industry and increased international competition in labor-intensive goods.

According to the Directors, a year's delay in Lithuania's adoption of the euro is unlikely to concern financial markets: the currency board, fiscal policy, and trade and financial integration with Europe can be expected to stay on course. But they stressed that a more ambitious fiscal goal would help contain rising prices and suggested reducing the projected 2006 budget deficit. Expressing concern that the planned personal income tax cuts would weaken the revenue base from 2008 onward, the Directors called for measures to address medium-term fiscal pressures stemming from population aging and public sector wage increases. ■

Ethiopia: inflation and balance of payments pressures on the rise

In 2004/05, Ethiopia experienced a second successive year of rapid economic growth, at close to 9 percent; growth of 5 percent is projected for 2005/06. But the country continues to face political uncertainties including unresolved tensions stemming from the May 2005 national elections, which have adversely affected donor support. Ethiopia's largely agricultural economy also remains vulnerable to variations in weather, which have resulted in wide swings in output that have had severe effects on the poor, the IMF said in its most recent annual economic review.

As a result of a shortfall in revenues and aid inflows, the government's domestic borrowing in 2004/05 was higher than budgeted by 2 percent of GDP. The stock of government domestic debt remained high, the external current account deficit widened as imports rose by 40 percent, and the year-end rate of inflation rose.

Ethiopia	2002/03	2003/04	Est. 2004/05	Proj. 2005/06
	(annual percent change, unless otherwise indicated)			
GDP (at constant factor cost)	–3.3	11.1	8.8	5.2
Consumer prices (period average)	15.1	8.6	6.8	10.8
External debt (including to Fund, percent of GDP)	85.4	75.7	53.9	47.4
Overall balance of payments (million dollars)	275.0	227.0	–101.0	–357.0

Note: Data pertain to the period July 8–July 7.
Data: Ethiopian authorities and IMF staff estimates and projections.

Executive Directors welcomed the recent strong growth performance but emphasized the importance of containing inflation and emerging pressures on the balance of payments. They agreed that improving Ethiopia's infrastructure would enhance growth prospects, but cautioned that scaling up domestically financed investment could jeopardize macroeconomic stability. The Directors also stressed the importance of accelerating structural reforms, particularly to raise agricultural productivity and boost private sector growth.

Significantly larger external assistance will be required to sustain growth at rates that would reduce widespread poverty and meet the Millennium Development Goals. The Directors stressed the need to complement donor efforts with a sound development strategy and strong governance systems, and to strengthen public expenditure management to ensure that aid and resources freed up by debt relief under the Multilateral Debt Relief Initiative are used efficiently.

The Directors said that fiscal policy should support monetary policy in containing inflation and be focused on limiting domestic bank financing and ensuring debt sustainability. A tighter fiscal stance might be required to contain demand and to stabilize the balance of payments. The Directors also saw a need to better prioritize expenditures to strengthen pro-poor spending and establish an effective social safety net, while improving public expenditure management. ■

Continuing structural reforms, monitoring stock market are priorities for Kuwait

Kuwait's economy strengthened further in the past two years, with real GDP growth of 6.4 percent in 2004 accelerating to 8.5 percent in 2005, thanks to higher oil production and buoyant non-oil activity. The overall fiscal surplus increased to an estimated 24 percent of GDP in 2004/05. Nonetheless, fiscal policy was expansionary as the non-oil primary deficit increased to 61 percent of non-oil GDP because of higher subsidies, transfers, and capital outlays. As a result of buoyant non-oil activity and the delayed effect of the dinar's depreciation against the euro and the yen, inflation edged up to almost 4 percent in 2005. The stock price index more than tripled during 2003–05. Progress with structural reforms continued, albeit slowly, and private sector participation expanded, particularly in telecommunications, airlines, and infrastructure development.

The IMF Executive Board commended the authorities for Kuwait's strong macroeconomic position and their constructive role in support of oil price stability. The Directors encouraged the authorities to further improve the structure of the budget by gradually increasing capital expenditure and achieving a better balance between productive expenditure and fiscal savings,

Kuwait	2003	2004	Est. 2005	Proj. 2006
		(percent change)		
Real GDP	13.2	6.4	8.5	6.2
Consumer price index	1.0	1.3	3.9	3.5
		(percent of GDP)		
Current account balance[1]	33.1	30.7	26.0	25.1
Overall fiscal balance[1]	17.4	24.4	–11.6	40.4
Total expenditure[1]	37.8	35.2	31.2	30.1

[1]Fiscal year ending March 31.
Data: Kuwaiti authorities and IMF staff estimates and projections.

and to develop a comprehensive and transparent medium-term strategy to manage fiscal surpluses. They welcomed steps taken to further strengthen banking supervision and open the sector to foreign banks and noted that the continuing increase in the stock price index should be carefully monitored to assess its potential impact on the financial sector. In this regard, it will be important to implement the Financial Sector Assessment Program recommendations, including passing capital market and insurance laws and establishing comprehensive oversight of the stock exchange, investment companies, and insurance sector. ■

For more information, please refer to IMF Public Information Notices Nos. 06/23 (Palau), 06/51 (Lithuania), 06/48 (Ethiopia), and 06/35 (Kuwait) on the IMF's website (*www.imf.org*).

How Latin America has tamed macroeconomic volatility

After experiencing another decade of turbulence, Latin America has registered good macroeconomic performance over the past three years. Although there are large differences among countries, the region as a whole is estimated to have expanded at an average annual rate of 5 percent during 2004–05, the fastest two-year growth rate in two and a half decades. It has done so while generally maintaining low inflation and recording current account and primary fiscal surpluses. Moreover, 2006 is expected to be another strong year. A recent IMF Working Paper considers whether the region's recent performance marks a distinct break from the past.

Over the past century, countries in the Latin American region have tended to experience macroeconomic instability, with boom-bust cycles, bouts of hyperinflation, devaluations, failed currency reforms, banking sector collapses, and debt defaults. Periods of strong growth have tended to be relatively short-lived, often ending in deep recessions, financial instability, and crisis. Output volatility has been higher and average growth lower than in many other regions (see chart, this page), contributing to persistent economic inequality and high poverty.

Roots of instability

What explains this history of recurrent macroeconomic instability? To be sure, external shocks have played a role, especially given the region's dependence on commodity exports and foreign capital. Terms of trade volatility and global capital market conditions have indeed weighed on the region's macroeconomic performance. At the same time, however, recent IMF research finds that more than 70 percent of the volatility of real GDP per capita growth in Latin America is due to country-specific shocks, including those stemming from volatile macroeconomic policies.

Monetary and exchange rate policies have tended in the past to amplify rather than dampen the cycle in the region. An important underlying factor has been the pressure to finance large budget deficits, which has often forced monetary policymakers to provide excessively easy access to central bank credit. The resulting inflationary bias, coupled with the tendency of the region's central banks to act procyclically (loosening during upswings and tightening in the face of negative shocks) and the predominance of pegged exchange rate regimes, left the region highly prone to macroeconomic and financial instability.

However, the primary driver of macroeconomic instability in the region has been fiscal policy and frequent changes in the fiscal stance. Indeed, Latin America's fiscal volatility during 1960–2000, as measured by discretionary changes in government spending, was considerably higher than in other regions of the world over the same period. Fiscal volatility has been triggered partly by the tendency of fiscal policymakers to act in a procyclical manner—overextending the public sector during boom times and sharply curtailing spending during downturns—and has amplified cyclical instability in the wider economy. That tendency, coupled with heavily dollarized economies, fixed exchange rates, and weak central banks, has created cycles characterized by a ratcheting up of public debt, monetary accommodation, accelerating inflation, and eventual crisis.

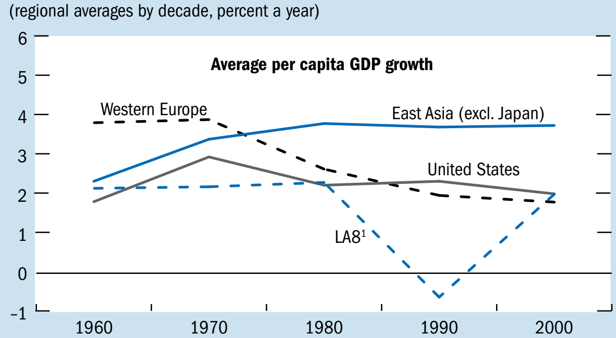
Changing course

Encouragingly, though, there has been steady progress in advancing market-based reforms and entrenching sound macroeconomic policy frameworks, which seem to have

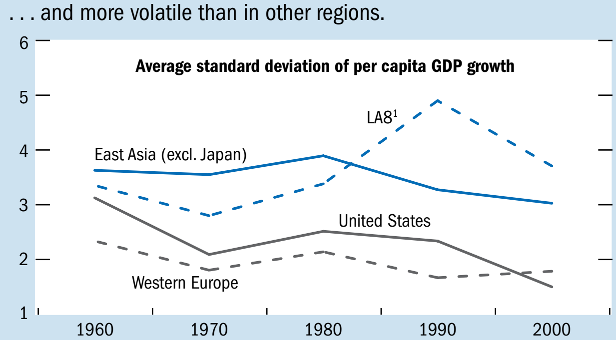
Turbulent times

On average per capita, growth in Latin America, has been lower . . .

(regional averages by decade, percent a year)



. . . and more volatile than in other regions.



[1]Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay, and Venezuela.
Data: Angus Maddison (2001), *The World Economy: A Millennial Perspective* (Paris: Organization for Economic Cooperation and Development).

begun bearing fruit. In recent years, a number of countries have made concerted efforts toward fiscal consolidation and have exhibited a willingness to tackle inflationary pressures at an early stage. This more favorable policy implementation appears to reflect a strengthened political commitment to macroeconomic stability, especially low inflation.

Accordingly, these countries have implemented a range of institutional and operational reforms to improve central bank autonomy, adopt inflation targeting, and allow for much greater exchange rate flexibility than they did in the wake of the exchange rate stabilization plans they initially followed in the 1990s. Countries have also instituted improvements to make financial systems more resilient and, while more work remains to be done, the decline in nonperforming loan ratios and strengthened capital adequacy ratios illustrate the strides made in this area.

Given that much of the region's past volatility can be attributed to fiscal weakness, it is especially encouraging to see the improvements in government budgets (see chart, this page). A number of countries in the region have undertaken important institutional reforms to help discipline fiscal policy. One welcome sign of success is the significant decline in debt-to-GDP ratios since 2002. Based on a sample of nine countries in the region (namely, Argentina, Brazil, Chile, Costa Rica, Ecuador, Mexico, Peru, Uruguay, and Venezuela, which account for 90 percent of the region's GDP at market exchange rates), the weighted average ratio of public debt to GDP is estimated to have fallen by about 26 percentage points between end-2002 and end-2005, with declines in all nine countries.

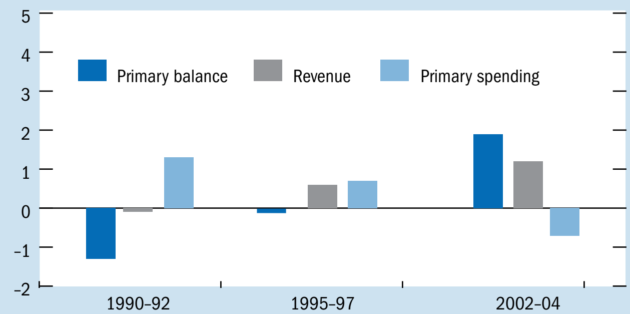
On average, these nine Latin American countries maintained primary fiscal surpluses of 3⅓ percent of GDP during 2003–05, more than twice the average surplus they achieved during the preceding decade and much higher than those of other emerging markets, where primary deficits have been the norm in recent years. Although this improvement partly reflects the boost to revenues that oil and other commodity exporters in the region have experienced, primary balances also improved in other countries, including those with high levels of debt. Combined with solid economic growth, these primary surpluses accounted for most of the decline in the region's debt-to-GDP ratio.

The recent decline in debt has been accompanied by a welcome improvement in debt management. Notably, foreign currency–denominated debt has been reduced, as some countries (Brazil, Chile, Colombia, Mexico, and Peru) have increased their reliance on debt issuance in domestic currencies, including in international markets (Brazil, Colombia, and Uruguay). The decline in the share of foreign currency debt has also benefited from an appreciation of the real exchange rate and from the debt exchange in Argentina, which increased the share of debt in the local currency.

Rewards of fiscal discipline

Primary balances have improved during the current expansion.

(change in percent of GDP between indicated years)[1]



[1]Unweighted averages for 17 countries. Smaller sample used for 1990–92.
Data: IMF staff estimates.

Future priorities

The region has made important strides in addressing the roots of macroeconomic stability and, in a still relatively favorable environment, has scope to make further progress. As for future priorities, the top ones are continued policy and institutional reforms to reduce public debt and strengthen fiscal frameworks. Other related priorities are to solidify the commitment to low inflation; improve the business environment, including by lowering the cost of financial intermediation; and implement labor market and other structural reforms to improve flexibility.

Such an agenda clearly requires a strong social and political consensus. In this regard, the entrenchment of democracy in the region, as exemplified by the continued successful and peaceful conclusion of democratic elections generally, augurs well for consolidating popular support for the market-based reforms and institutions that are needed to support macroeconomic stability and sustain higher growth. ■

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This article is based on IMF Working Paper No. 06/166, "Macroeconomic Volatility: The Policy Lessons from Latin America," by Anoop Singh. Copies are available for $15.00 each from IMF Publication Services. For ordering information, see page 240. The full text is also available on the IMF's website (*www.imf.org*).

Is home equity withdrawal influencing the U.S. saving rate?

The decline in the U.S. personal saving rate over the past decade has coincided with considerable growth in home equity withdrawal. Many analysts suspect there is a link. A new IMF Working Paper by Vladimir Klyuev and Paul Mills explores the factors behind the two phenomena and investigates the extent to which home equity withdrawal has driven the falling saving rate. It also explores the degree to which rising interest rates and a slowdown in the housing market may now pose risks for household saving and consumption.

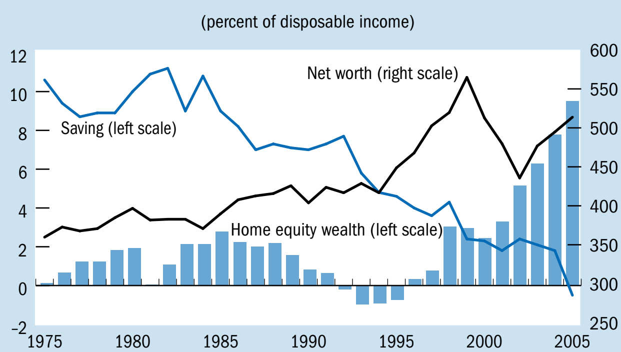
The U.S. personal saving rate, on a downward trend since the mid-1980s, turned negative in 2005. Over the past decade and a half, home equity withdrawal rose from a small negative number in the early 1990s to nearly 10 percent of personal disposable income in 2005 (see chart below).

Many commentators see the increase in home equity withdrawal as a major driving force behind the falling household saving rate. Others, however, attribute the decline in saving to the rapid growth of household wealth created by strong capital gains on financial and real assets; low interest rates, which diminished the reward to saving; and financial innovations, which have reduced the cushion of precautionary savings that households need to smooth consumption over time. In the latter view, home equity withdrawal is a convenient way for households to gain greater access to their accumulated wealth to finance consumption and rebalance asset portfolios. From this perspective, withdrawal is not an independent factor pushing household saving down.

Why worry about household saving and what may be driving it? Because there's a bigger picture: the secular decline in the U.S. household saving rate has contributed substantially to the increase in the U.S. current account deficit and global imbalances. And there are fears that a sharp rebound in the saving rate from historically low levels would contract domestic demand and possibly push the world's largest economy into a recession. Analysts want a better understanding of what may be influencing the saving rate so that they can better forecast its future course, which will have implications for the U.S. and global economies.

Wealth effects

Personal saving declined as household wealth soared and home equity withdrawals accelerated.



Data: Haver Analytics and IMF staff calculations.

Home equity withdrawal

Home equity withdrawal is a generic term for all forms of transactions whereby homeowners reduce the equity in their homes. Examples include refinancing an existing mortgage with a higher principal, taking out a second mortgage or a home equity loan without using the proceeds on home improvement, or selling an inherited house. In any given period, some households withdraw equity through these and other mechanisms, while others inject equity into their homes by making down payments on first-time home purchases, amortizing their mortgages, and so on. The balance of these transactions determines the aggregate level of home equity withdrawal, which can be inferred from flow-of-funds accounts. It may be either positive or negative and varies widely across countries and over time.

The withdrawn funds can also be used for a variety of purposes. Survey evidence from the United States and other countries indicates that about one-third of the funds obtained through home equity loans and mortgage refinancing is used for home improvement, which does not constitute a home equity withdrawal. About one-fourth is used to repay other debts, and one-fifth is used to acquire financial assets. Less than one-fifth is used to finance consumption. Hence, the bulk of home equity withdrawal is used to rebalance portfolios, allowing households to reduce higher-interest (and less tax-advantaged) debts and diversify their wealth holdings, while consuming only a limited proportion.

A number of changes have also made it easier for households to withdraw home equity. Liberalization of deposit and lending markets, increased competition among mortgage providers, mortgage securitization, improved credit-scoring techniques, and other innovations have dramatically reduced the cost of refinancing.

New products and marketing strategies have included nontraditional mortgages that require lower initial down payments and allow for more flexible amortization while expanding the range of eligible borrowers. The growth of home equity withdrawal has been helped particularly by the expansion of home equity loans and lines of credit, which have experienced explosive growth in the past few years, supported by the securitization of these instruments. Finally, "reverse mortgage" loans, which allow older homeowners to access home equity in retirement, have recently become more widely available. The ever-greater ease of accessing home equity and the strong buildup of equity as a result of the fast appreciation explain why home equity withdrawal has risen strongly over the past few years.

Incentives to save

Individuals save a portion of their income partly so that they do not have to reduce consumption dramatically when their income falls—for example, when they retire or are unemployed. When household wealth increases as a result of an appreciation of their assets, homeowners are more likely to feel that their stock of wealth is adequate and, accordingly, save less. They may also feel less need for a buffer if there is less uncertainty—when inflation falls, for example.

Incentives to save are also affected by interest rates, with higher rates offering greater reward in the form of higher future consumption for each unit saved today. In the long run, the Working Paper finds that the U.S. personal saving rate is negatively related to household net worth (relative to income) and positively related to the real interest rate and the inflation rate. Each extra dollar of wealth tends to reduce annual household saving by about 2 cents.

Even after accounting for rising wealth and declining interest and inflation rates, the saving rate trends down over time, possibly indicating a reduction in precautionary saving stemming from gradual financial liberalization. Home equity withdrawal is not found to affect the long-run value of the U.S. saving rate. Canada has also experienced a decline in its household saving rate since the early 1980s, apparently reflecting steady growth in the household net worth ratio, along with lower inflation and interest rates. Canadian households have, however, increased their equity in housing.

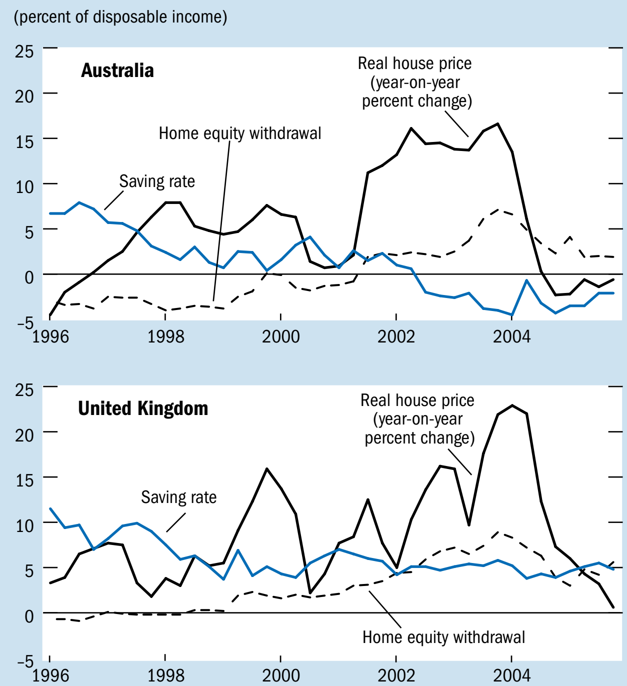
Nevertheless, changes in home equity withdrawal do help to explain short-run changes in the U.S. saving rate, as well as transient deviations of the saving rate from the value implied by its long-run determinants. A 1 percentage point increase in the ratio of home equity withdrawal to disposable income temporarily lowers the saving rate by 0.15–0.2 percentage points.

Effects on consumption and saving

Given the numerous signs that housing market activity and price appreciation are decelerating in the United States, it is useful to assess the effect of that slowdown on household consumption, which is the largest component of GDP. With smaller capital gains on real estate assets, a sharp reduction in home equity wealth can be anticipated. And for those who view home equity extraction as an indispensable source of financing for household consumption, a drying up of this source would imply a severe drop in consumption, with serious consequences for GDP growth.

Modest rebound

As the appreciation of house prices moderated in Australia and the United Kingdom, home equity withdrawals dropped considerably, but the rise in the saving rate was modest.



Data: Haver Analytics and IMF staff.

The Working Paper, however, suggests that a reduction in home equity withdrawal would have only a small and temporary effect on consumption. Even a drop from its current 10 percent of disposable income to its long-run average of 1 percent within one year would temporarily boost the saving rate by about 1½ percentage points of disposable income. A more permanent positive effect on saving would be expected if the growth of household wealth slowed and interest rates rose. Indeed, this is the effect experienced in Australia and the United Kingdom—two countries that went through a major deceleration in house price growth (see chart above). Although home equity withdrawal dropped markedly in these episodes, the rebound in the saving rate in these countries was moderate. ■

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Paul Mills, IMF International Capital Markets Department

Copies of IMF Working Paper No. 06/162, "Is Housing Wealth an 'ATM'? The Relationship Between Household Wealth, Home Equity Withdrawal, and Saving Rates," by Vladimir Klyuev and Paul Mills, are available for $15.00 each from IMF Publication Services. Please see page 240 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Botswana: avoiding the resource curse

It has often been observed that resource-abundant economies tend to grow less rapidly than resource-scarce economies—a phenomenon referred to as the "resource curse." But Botswana appears to be an exception. Although it is one of the most resource-rich countries in the world, it has achieved remarkable economic success. A new IMF Working Paper casts light on the relationship between growth and natural resources in Botswana and suggests that governance may play a catalytic role in transforming resource abundance into economic development. The study finds that good regulation and powerful anticorruption policies are particularly important for resource-abundant developing countries.

For the past 30 years, Botswana has experienced extraordinary growth—about 9 percent a year on average since the mid-1970s (see chart)—raising its per capita GDP, currently estimated at over $5,000 a year (in current prices), from the low-income-country to the upper-middle-income-country level. This strong economic growth has largely been attributable to an abundance of diamonds, of which Botswana is the world's largest producer, with about $3 billion in exports every year. The mining sector (copper, nickel, and coal, as well as diamonds) accounts for about 40 percent of Botswana's total growth. Mineral wealth has also enabled Botswana to register current account surpluses averaging 5 percent of GDP over the past three decades and accumulate over $6 billion of foreign reserves.

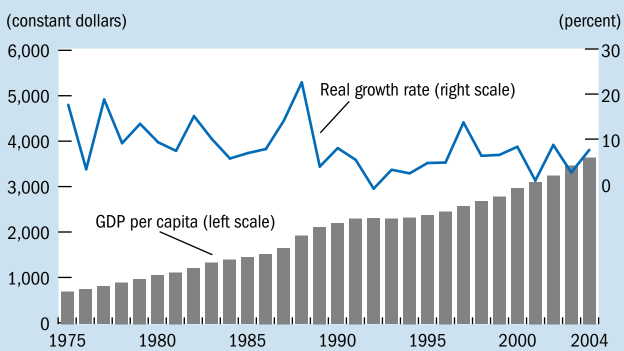
The role of governance

But mineral wealth alone does not account for Botswana's economic growth. Botswana has also been praised for its sound institutions and good governance, which are rooted in the strong political leadership that has prevailed since it achieved independence in 1966. According to the Governance Research Indicator Country Snapshot (GRICS) indices developed by the World Bank, Botswana ranks well above the average of middle-income countries in all aspects of governance and compares favorably even with some high-income countries in several aspects (see table).

Botswana's fiscal management, in particular, has been disciplined and transparent. With an implicit rule that all mineral revenue is used to finance "investment expenditure," the government has, except in several recent years, run surpluses for almost two decades. Investment expenditure is defined as development expenditure and recurrent spending on education and health care; other recurrent spending is funded from nonmineral revenues.

Bucking the curse

Botswana's resource wealth has allowed it to grow at a healthy rate and achieve upper-middle-income status.



Data: Botswana authorities and World Bank, *World Development Indicators,* 2006.

The resource-growth link

Why is the link between resources and growth not automatic? Despite expectations that resource-rich countries can promote growth by using the large revenues they derive from their resources to invest more in economic infrastructure and human capital, economic growth in these countries has often stagnated. Various reasons have been put forward.

From a political economy perspective, natural resource wealth can sow the seeds of discord and conflict among domestic stakeholders, such as politicians, developers, local tribes, and citizens. If monitoring systems and fairness based on the rule of law are not in place, stakeholders may be motivated to seek unfair resource rents—those that exceed economically reasonable profits—quickly depleting natural resources. Sometimes, tribal conflict or an international civil lawsuit results. Resource rents may also bring about corruption, eroding economic efficiency, and undermine sound fiscal management, reducing the pressure on governments to collect taxes and enforce accountability and weakening fiscal discipline.

From an economic point of view, Dutch disease is another possible reason that resource wealth doesn't automatically promote growth. In resource-exporting countries, sectors other than natural resources (typically manufacturing) are likely to suffer from the real appreciation of the national currency, because resource earnings are absorbed, in part, by the domestic nontradables sector, raising the country's income level. Some have attributed Africa's slow growth in recent decades, in part, to the Dutch disease syndrome. The lack of positive spillover effects associated with natural resource extraction, which is generally capital-intensive and location-

High score

On all measures of governance, Botswana compares favorably with averages for middle-income developing countries and is not far below those for high-income (developed) countries.

	Botswana	Sub-Saharan Africa	Low-income countries	Middle-income countries	High-income countries
Voice and accountability	0.75	0.42	0.38	0.57	0.82
Political stability	0.78	0.45	0.40	0.59	0.82
Government effectiveness	0.66	0.30	0.27	0.42	0.77
Quality of regulation	0.72	0.38	0.34	0.51	0.85
Rule of law	0.67	0.33	0.29	0.47	0.84
Control of corruption	0.62	0.29	0.25	0.39	0.76

Note: The indicators range from zero (representing worst-possible governance) to 1 (best-possible governance).
Data: *Governance Matters III: Governance Indicators for 1996–2002*, D. Kaufmann, A. Kraay, and M. Mastruzzi (Washington: World Bank, 2003).

specific, may also limit vigorous development in the agglomeration of nonmineral industries.

Resource abundance should be advantageous to any economy whose government has a sound long-term plan for extracting natural resources and an effective mechanism for investing revenues in the social and economic infrastructure needed for sustained growth and economic diversification. However, if governance is poor, resource earnings are liable to be unevenly distributed and unfairly dissipated, and the country may be doomed to economic stagnation.

Explaining the relationship

Is good governance essential for resource richness to lead to growth, as it has done in Botswana? To explore this relationship, the Working Paper uses a growth regression approach that takes into account all relevant macroeconomic conditions: natural resource richness measured by per capita natural resource exports (such as oil, metals, and precious stones, but not agricultural products), governance, average tax rate, trade openness, and population growth. The study analyzes 89 countries—60 developing countries and 29 high-income countries—between 1998 and 2002.

To measure governance, the study uses the GRICS indices. By introducing an interactive coefficient between resource abundance and each of these six governance indices into the estimation equation, it examines which dimension of governance is most crucial to helping ensure that resource endowment contributes to producing economic prosperity.

The study finds that natural resources tend to affect economic growth negatively. However, the interactive effects of resource abundance and governance are systematically positive for growth, meaning that if a country has good governance, resource wealth is conducive to economic development. Thus, resource abundance itself does not prevent faster growth, as implied by the resource curse hypothesis. Rather, with proper government management, resource richness can generate growth.

The right policies

For any country to manage its natural resources beneficially, good governance is important in four dimensions: voice and accountability, government effectiveness, the quality of regulation, and anticorruption policies. The study's regression results indicate that for developing countries, the last two are particularly important.

The policy implications are straightforward. First, voice and accountability refer to civil liberties and political rights and represent the ability of a democratically accountable government to discipline those with the authority to extract resources. Without monitoring by citizens and a process for selecting and replacing those in power, resource rents will tend to be dissipated unfairly. Second, government effectiveness, as measured by the quality of public services and the competence of civil servants, also needs to be high. If the government cannot produce and implement adequate resource and revenue management policies, resource wealth will be overexploited.

Third, because natural resource development necessarily involves a long-term relationship with private parties, market-unfriendly policies like price controls, excessive regulatory burdens, and arbitrary political interventions in mining transactions, are undesirable. Finally, anticorruption policies are essential to ensure that resource benefits are distributed fairly and transparently. To prevent corruption, the budgetary and procurement process needs to be transparent; an independent anticorruption authority may have to be established to ensure that this is the case.

Other factors still matter

A remaining question is whether good governance is sufficient for resource-rich countries to avoid the resource curse. Good governance alone may not prevent Dutch disease, especially given that resource-dependent counties—including Botswana—are often not economically diversified. Despite its income prosperity, Botswana is lagging behind in terms of employment and social development. It is clear that, in addition to good governance, other supporting policies, including structural reforms, are necessary to ensure that natural resource benefits are effectively channeled into sustainable growth and social development. ■

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This article is based on IMF Working Paper No. 06/138, "Did Botswana Escape from the Resource Curse?" Copies are available for $15.00 each from IMF Publication Services. See page 240 for ordering information. The full text is also available on the IMF's website (*www.imf.org*).

Making India's tax system pro-growth

Over the past 15 years, India has substantially revamped its tax structure. The central government has cut customs and excise duties, lowered income tax rates, extended a form of value-added tax (VAT) to some industries, and broadened the tax base to include some services. After a 10-year delay, all but two state governments have recently introduced a VAT. Despite these reforms, however, relatively high tax rates for some firms and sectors continue to coexist with pervasive exemptions. The result is a patchwork tax system and low revenues. How, asks Hélène Poirson in a new IMF Working Paper, can India raise its tax revenues to address its critical infrastructure and social needs without compromising growth? The answer may lie, she says, in closing gaps in the tax base and removing tax-induced distortions to savings and investment decisions.

India's ratio of tax revenue to GDP is low by international standards. This is partly due to extensive exemptions, which also cause the burden of taxation to fall disproportionately on some sectors. High tax rates affect the business climate and may have contributed to the growth of the country's "shadow economy," which carries costs in terms of forgone tax receipts and lower productivity growth.

Since 1991, the Indian authorities have undertaken a series of tax reforms, the main thrust of which has been to lower statutory rates and broaden the tax base. While these reforms have succeeded in boosting India's openness—through large tariff reductions—and lifting the share of direct taxes in total revenue, the overall ratio of tax revenue to GDP has not risen significantly. India is left facing familiar but difficult choices. Years of large fiscal deficits have left the government with a heavy debt burden, and the government has increasingly been competing with the private sector, recently booming, for resources. At the same time, growing infrastructure constraints and critical social needs require higher government spending.

High and low

What should India do? Further tax reform has the potential to boost revenue and support continued rapid economic growth. After declining to below 14 percent of GDP in 2001–02, India's general government tax revenue rebounded to 16¾ percent of GDP in 2005–06 (see chart). Revenues declined during the 1990s as major tax reforms were implemented. Direct tax revenues increased, but indirect tax collections declined, mainly because of tariff reductions. Recent reforms—namely, the addition of new services to the tax base, the introduction of a state-level VAT in 2005, and a modernized tax administration—helped reverse the decline in revenues. The tax take in India now exceeds the average for other Asian emerging countries by 3¾ percentage points of GDP but is 3½ percentage points below the average for all emerging countries.

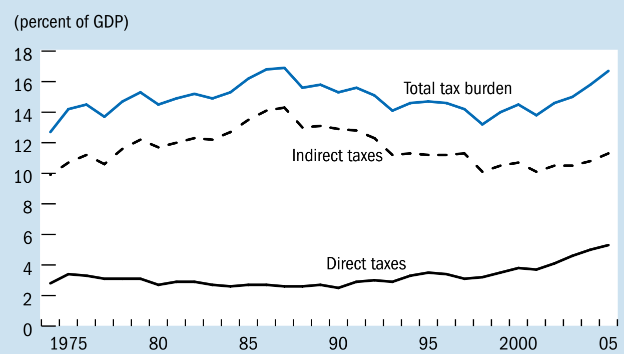
To assess the effective burden of taxation in India on different categories of income and consumption, the study calculated the average effective tax rate (AETR). This standard indicator summarizes various tax effects, including statutory tax rates, the effective tax base (taking into account tax evasion, exemptions, and the extent of informal activity), and the quality of tax administration. It is measured as the ratio of tax revenue to the notional tax base derived from national accounts.

The results show that AETRs on labor and capital in India are broadly in line with those in other low-income countries but well below AETRs in the more mature emerging markets in Asia. The latter is attributable partly to the relatively narrow taxpayer base, the absence of social security and associated payroll taxes, pervasive tax incentives, low personal capital gains taxes, and a large informal sector. In contrast, India's AETR on consumption is broadly in line with that in other Asian countries, despite a tax base that excludes many services.

Low AETRs on capital and labor, combined with relatively high statutory rates, reflect a tax system that is not very effective in raising revenue. For example, a 35.9 percent corporate income tax rate in India in 2003 generated revenue of 2.3 percent of GDP: Singapore raised 3½ times that revenue with a rate of just 22 percent, and Chile raised twice that revenue with a rate of 17 percent. These results suggest ample room to increase AETRs in India without raising rates and, thus, without hampering competitiveness.

Openness and tax revenue

After the 1990s tax reforms, revenue from direct taxes rose while revenue from indirect taxes fell mainly because of declining tarrifs.



Data: Indian authorities and IMF staff projections.

Forgone investment

Following three years of above-trend growth in GDP, India's investment rate increased to 31¾ percent of GDP in 2005–06. This is similar to investment levels in Korea, Thailand, and Vietnam, but well below that of China (40 percent of GDP). Successive governments in India have lowered corporate and personal tax rates since 1993 to boost saving and investment. However, the corporate tax rate remains high, depressing investment by raising the required pretax rate of return. Moreover, interest deductibility tends to favor finance through debt over equity or retained earnings, potentially leading to higher insolvency risks and discrimination against small companies that face difficulty borrowing. Other tax distortions include the widespread use of rebates, exemptions, and special regimes for specific sectors and regions.

Cross-country studies confirm a negative relationship between the tax burden (tax-to-GDP ratio) and growth across advanced economies, but find no significant association in low- and middle-income countries. In contrast, firm-level empirical studies and simulation results support the view that a high marginal effective tax rate on corporations negatively affects growth.

How does the Indian income tax code affect incentives to invest? To investigate this, Poirson calculated two summary indicators, the marginal effective tax wedge between the pre- and post-tax returns on capital, and the marginal effective tax rates, defined as the ratio of the marginal effective tax wedge to the real required pretax rate of return. The two indicators incorporate not only the corporate income but also personal tax provisions, as well as depreciation allowances and the inventory valuation method. Both indicators measure the potential cost of taxation to investors and are comparable across countries.

Focusing first on the marginal tax burden at the firm level (ignoring any personal tax rates), the estimates show that corporations in India that have only limited access to debt financing, particularly smaller firms, face a high marginal tax burden. Reflecting the relatively high statutory corporate income tax rate, India's marginal effective tax rate for investments financed by equity or retained earnings is nearly 33 percent (as of 2004), compared with an average of 22 percent in industrial countries.

Poirson also estimates the overall marginal tax wedge on capital, taking personal taxes into account. The results suggest that the tax wedge in India, at 1.4 percent, is slightly below the industrial country average, reflecting low personal taxes. However, tax-induced distortions tend to be high. Firms that rely on internal financing are penalized by a marginal tax wedge of 2.6 percent, almost one-third higher than the average in industrial countries. Equity financing is also penalized, although the tax wedge on equity-financed investments of 2½ percent is one-fifth lower than the industrial country average, reflecting lower taxes on dividend and capital income. In contrast, debt financing enjoys a negative tax wedge of 0.2 percent in India, compared with a positive industrial country average of 1 percent.

The wide coverage of tax incentives in India also means that the tax wedge varies greatly across sectors and regions. For example, the study estimates that the tax wedge for a firm that benefits from a corporate tax exemption is less than one-third that of a firm that does not enjoy a tax holiday.

Further reforms needed

A number of measures could help India raise additional revenue over time while generating a tax system that is less distortionary and, arguably, fairer. Many of the options are part of the government's 2004 road map for fiscal consolidation. Key steps could include building on recent success in introducing the state-level VAT to create a comprehensive national goods and services tax (GST). International experience suggests that a GST would help secure gains in economic efficiency and boost investment and exports while generating revenue gains in excess of 1 percent of GDP. Broadening the tax base by lifting exemptions, expanding the taxpayer net, and increasing reliance on information technology to improve tax administration and compliance would also help improve revenue productivity and, in the case of exemptions, help reduce tax-induced distortions.

The study suggests that other 2004 measures—including the elimination of the corporate income tax surcharge and the dividend distribution tax—would decrease the marginal tax wedge by 0.2 percent of GDP and attenuate distortions. However, firms that rely on nondebt financing would be penalized. To address this and mitigate potentially excessive reliance on debt finance, India should consider additional reforms. These include limiting the deductibility of interest to a percentage of net taxable income, limiting debt for the purposes of income tax, limiting interest to a referential rate, and, introducing an allowance for corporate equity. ■

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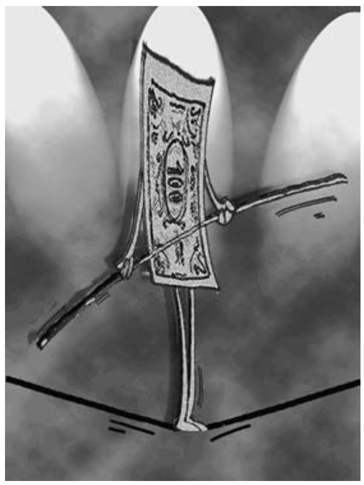
This article is based on IMF Working Paper No. 06/93, "The Tax System in India: Could Reform Spur Growth?" by Hélène Poirson. Copies are available for $15.00 each from IMF Publication Services. Please see page 240 for ordering details. The full text is also available on the IMF's website *(www.imf.org)*.

All that cash: U.S. firms are starting to spend more

Since 2001, U.S. corporations have built up large reserves of cash, prompting many to ask why firms are saving so much and whether it is a temporary or permanent state of affairs. Recently, firms have begun to dip into their cash reserves for accelerated shareholder payouts, cash-financed mergers and acquisitions, and increased investment. How can we better understand the link between cash and investment? On July 18 at the American Enterprise Institute (AEI), Governor Kevin M. Warsh of the U.S. Federal Reserve System gave an address on the recent buildup of corporate cash balances and the state of corporate balance sheets in the United States.



Massoud Etemadi/IMF

The buildup may be abating

After a long period of saving, it appears that U.S. firms are beginning to borrow more and spend their cash holdings, a trend that is likely to continue, Warsh said. A renewed focus on capital spending and on business expansion largely accounts for the recent shift, and this has been driven by growing external pressures to boost shareholder value. Continuation of these developments could lower the liquidity and credit quality of some corporations, but it is unlikely, at least in the near term, he said, to "put at risk their strong balance sheets or impede the solid expansion of business spending."

Still, "should some emerging trends, such as lower required interest coverage ratios, gain traction, they might induce a more pronounced deterioration in credit quality than is currently expected," Warsh said. He expects corporations to keep cash levels historically high as a cautionary measure because of geopolitical and economic uncertainties and a more rigorous legal and regulatory environment. According to Warsh, corporations in the United States have shown a remarkable ability to adapt and thrive in recent years despite these changes. He expects that they will continue to do so.

Increasing role of intangible assets

Could some part of the cash buildup puzzle, the AEI's Kevin A. Hassett asked, be explained by corporate investments in intangible assets—those assets that are not physical—such as intellectual property? If, by pursuing profitable activities, firms are holding more cash, does an investment shortfall exist after all? Hassett argued that "perhaps the composition of investment in the economy has changed dramatically over time and is much more focused on intangibles." He cited recent data showing that investment in intangible assets is now bigger than business fixed investment. If investment is defined more broadly to include intangible assets, then "this current expansion will look more like previous expansions" and will paint a more cyclically normal picture.

Warsh agreed it was "a very important point." Although much of the capital investment in the late 1990s tended to be in business fixed investment, his sense now is that much of current investment—that is, new capital expenditure—is associated with previous investments, making more of technology, systems, and structures that were purchased in the past. Warsh said this could partly explain the productivity improvements we have seen, which "might have even accelerated during the past few years because of intangible investment in process improvement, and productivity investments are the result, boosting profit margins." ■

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For more background on this topic, also see Chapter IV, "Awash With Cash: Why Are Corporate Savings So High?" of the IMF's April 2006 *World Economic Outlook (WEO)*, available on the IMF's website (*www.imf.org*). Published copies of the full *WEO* are available for $49.00 ($46.00 academic rate) each from IMF Publication Services. Please see right for ordering information.

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