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In this issue

IEO on fiscal adjustment, see page 262.

Annual Meetings 2003

Top financial leaders to weigh global economy's strengths and risks

With hopes rising that an uncertain global economic recovery may have gained traction in recent months, the world's finance ministers and central bank governors will gather in Dubai on September 23–24 for the Annual Meetings of the IMF and the World Bank. Preceding this plenary session, the International Monetary and Financial Committee (IMFC)—the IMF's principal advisory body—will meet on September 21 to take up a wide-ranging agenda that is expected to examine the outlook for the global economy and world financial markets, especially what needs to be done to lend breadth and momentum to growth prospects and what further steps are needed to help identify and address potential vulnerabilities.

The IMFC session, which will be chaired by U.K. Chancellor of the Exchequer, Gordon Brown, will also likely review the IMF's continuing efforts to strengthen surveillance of members' economic policies, bolster crisis prevention and crisis resolution, and accelerate poverty reduction and enhance the prospects for sustained growth in low-income countries. In addition, the IMFC will examine progress reports on IMF quotas and governance, accelerated *(Please turn to the following page)*

DUBAI 2003
UNITED ARAB EMIRATES
ANNUAL MEETINGS
BOARDS OF GOVERNORS
WORLD BANK GROUP
INTERNATIONAL MONETARY FUND

Interview with Agustín Carstens

Latin America needs "back to basics" approach

Carstens: "The IMF has a solid track record in handling crises. Most of the emerging market economies that it has helped in the last decade...are back in the capital markets and doing pretty well."

In early August, Agustín Carstens of Mexico returned to the IMF as a Deputy Managing Director, replacing Eduardo Aninat of Chile. He is the first former Executive Director to join the IMF's management team, having sat on its Executive Board during 1999–2000. In the intervening period, he was Mexico's Deputy Secretary of Finance. Before joining the IMF in 1999, he had a distinguished 18½-year career at the Bank of Mexico, including as Director General of Economic Research and Chief of Staff in the Governor's office. He spoke with Laura Wallace about the new post, Mexico's economic ups and downs, and crisis prevention and resolution.

IMF SURVEY: Can you give us more insight into your background and how it will help you in the job of Deputy Managing Director?

CARSTENS: Given that my professional life has been concentrated in three institutions—Mexico's central bank, its finance ministry, and the IMF—I have been exposed to a wide array of issues related to public finance, monetary policy, exchange rates, and financial systems, which pretty much cover the core business of the IMF. In addition, Mexico's economic history over the past 23 years has been extremely rich from a learning point of view. Often, Mexico has *(Please turn to page 251)*

measures to combat money laundering and the financing of terrorism, and the work of the Independent Evaluation Office.

The following day, the joint World Bank–IMF Development Committee is scheduled to discuss the role of adequate and appropriate financing in supporting sound policies in developing countries and in helping them achieve the UN Millennium Development Goals. Also likely to be taken up are possible steps to enhance the voice and participation of developing and transition countries in the Bretton Woods institutions.

As is customary, a number of other events and country group meetings will take place in advance of the plenary proceedings. On September 18, Kenneth Rogoff, the IMF's Economic Counsellor and head of its Research Department, will brief the press on the economic projections contained in Chapter 1 of the September 2003 *World Economic Outlook*. This briefing will be followed by press conferences on September 19 by World Bank President James Wolfensohn and IMF Managing Director Horst Köhler, and on September 20 by, among others, the chair of the Group of 24 developing countries, Fouad Siniora, Lebanon's Minister of Finance.

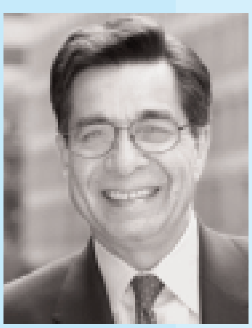
In addition, the World Bank and the IMF are jointly sponsoring, on September 20–22, a seminar series on issues related to regional and global prosperity. The annual Per Jacobsson lecture on international finance, which was established to encourage a dialogue between the private sector and officials in national governments and international agencies, will this year examine "The Arab World: Performance, Challenges, and Prospects." The address will be given on September 21 by Dr. Abdlatif Y. Al-Hamad, Director General and Chair of the Board of Directors of the Arab Fund for Economic and Social Development.

Transcripts for all Annual Meetings communiqués, speeches, and press conferences will be available on the websites of the IMF (www.imf.org) and/or the World Bank (www.worldbank.org). ■

Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF; and Government of the Democratic Republic of the Congo, pages 258–59.

Abbas Mirakhor and Mohsin Khan named joint winners of IDB prize


Abbas Mirakhor


Mohsin Khan

The Islamic Development Bank (IDB) has awarded Abbas Mirakhor, IMF Executive Director, and Mohsin Khan, Director of the IMF Institute, the 2003 prize in Islamic economics. Given in alternate years for achievement in Islamic banking and Islamic economics, the award honors the individual or institution that has made the most significant contribution to the field.

The award recognizes Mirakhor and Khan's seminal research, starting in the mid-1980s when the two worked in the IMF's Research Department, on the special challenges posed by banking systems operating under Islamic principles, which proscribe the charging of interest. While Islamic banks have existed since the 1960s, it was only in the early 1980s that economy-wide banking systems began to conform to Islamic practices. The Islamic Republic of Iran was the first country to adopt such a system, and Pakistan followed suit shortly thereafter. With little known about the system's macroeconomic implications, the IMF encouraged research on the topic. Mirakhor, an Iranian national, and Khan, a Pakistani national, took up the issue.

At the time, the writings of legal scholars and theologians dominated the field. Khan and Mirakhor were among the first to apply conventional economic analysis. "What Abbas Mirakhor and I did was unique because we used standard economic tools," Khan said. "We were interested in outlining for Western-trained economists what the system was about, describing it in terms that they understood, while at the same time convincing people in the Islamic world that you could use standard economics techniques to analyze the relevant questions."

Between 1985 and 1995, the two authored—both separately and jointly—a number of theoretical papers, including one that presented a full-scale model for a financial system within an Islamic economic system. "From a theoretical point of view," Mirakhor said, "there are a lot of interesting questions. What would happen, for example, if you had an economy that ran on a stock market arrangement, with equities shared by everyone in society, but that didn't have a financial system with a fixed interest rate that allocated financial resources?"

In addition to citing the scientific rigor of Khan and Mirakhor's studies, the IDB's prize selection committee noted Mirakhor's dedication to encouraging young economists to conduct research on Islamic economic issues. Most of the research on the subject done in the IMF builds on the work of Mirakhor and Khan.

Khan, who will become the head of the IMF's Middle East and Central Asia Department in December, noted that today the literature on Islamic economics is extensive. When working with a country that is contemplating moving to an Islamic banking system, economists now have the means to understand both its benefits and its potential risks and costs, he said.

Carstens praises transparency

(Continued from front page) enjoyed good access to capital markets and led the way in carrying out certain reforms, as it is currently doing in the management of external debt. Yet, at other points, it got into trouble, losing access to the very same markets. Not that this is an honor, but we were the leaders in the debt crisis of the early 1980s and in the financial crises of the 1990s.

My experience on the IMF's Executive Board was also critical in giving me an excellent idea of different countries' needs. As Executive Director for an eight-country constituency, I was responsible for promoting the interests of countries ranging from heavily indebted poor ones (Nicaragua and Honduras) to emerging market economies (Costa Rica, El Salvador, Guatemala, Mexico, and Venezuela) to an industrial country (Spain) that is a major member of the European Union. I got to know how the institution functioned—and, frankly, it is extremely well run. I also came to appreciate the importance of the Board as the main decision-making organ of the IMF.

IMF Survey: You are the only member of the current management team from a developing country, although these days Mexico is usually referred to as an emerging market. Do you see yourself as being a voice of developing or emerging market countries?
Carstens: Undoubtedly, the fact that I come from Mexico and from an emerging market has had an impact on me, personally and professionally. I hope that my background and experience will help the IMF deal more effectively with problems in developing and emerging market economies. However, I will be very careful not to let that perspective bias my work, because my obligation now is to all of the IMF's member countries.

IMF Survey: What was particularly important in your economics training, and which areas of economics do you consider your specialty?
Carstens: Ever since I was an undergraduate, I've been especially attracted to issues relating to international finance and monetary policy. In fact, my graduate dissertation at the University of Chicago was on international finance. This education was extremely valuable in that once you start working in a central bank or a ministry of finance or the IMF, you find that you often need to go back to basic economic principles to come up with a solution or a policy recommendation. I was also fortunate to have spent a good 18 years at the Mexican central bank, where there was great emphasis on improving the human capital of its staff. This meant not only that I had hands-on experience in learning central banking and financial issues but also that I was allowed to continue to do research and debate issues with very skilled people from Mexico and other countries.

IMF Survey: Most of your career has been spent helping to guide Mexico's economy. Were you involved in the management of the 1994–95 crisis, and how did Mexico manage to recover so well from it?
Carstens: In 1994, I was chief economist of the central bank and head of its research department, and I was appointed to the team negotiating the financial packages with the IMF and the U.S. Treasury. How did Mexico manage to recover so well from that major crisis? As is well known, Mexico's crisis was a twin crisis, involving both the balance of payments and the banking sector. The solution centered on working out a strong program with the IMF on fiscal and monetary policy, adopting a floating exchange rate regime, increasing transparency with private sector creditors, and facing head on the problems in the banking system. The program was supported by the IMF. In addition, when Mexico signed the North American Free Trade Agreement in 1993, it was encouraged to take actions that would enable it to take as much advantage as possible of globalization. This led to key reforms in a number of sectors, a process that continued after the crisis. These structural changes enabled the economy to grow quickly again once the main macroeconomic and financial problems were addressed.

IMF Survey: You mentioned transparency, and Mexico has been known for its efforts to boost the transparency of its central bank and institutions generally. It now has, for example, one of the best and most current statistical systems in the world. How important is transparency?
Carstens: It's a key issue for all countries. As Mexico has become a more modern, democratic country, it has become clear that good, timely information is an essential ingredient for making sound decisions in both the public and private sectors. For that reason, the Mexican authorities have embraced this big push for transparency, and they are encouraging the private sector to do the same.

IMF Survey: You were heavily involved in the 1994 package. Do you have any thoughts on how the IMF should engage with countries in similar straits?

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—Agustín Carstens

The adoption of CACs should benefit both borrowers and lenders and thus has the potential to really improve the workings of the financial system.
—Agustín Carstens

CARSTENS: I think that the IMF team we dealt with was very professional, and we reached a positive agreement. In the end, neither side got everything it wanted, but that's probably an indication of good negotiating on both sides. And history has proved that it was a good program because Mexico recovered from the crisis very quickly—just five months later, it managed to tap the markets again. Since that crisis and since Mexico repaid the IMF in 2000, without following up with a precautionary or staff-monitored program, Mexico's relationship with the IMF has been very frank and smooth. I think that Mexico learned a lot from interacting with the IMF in those difficult years, and the IMF learned a lot from its engagement with Mexico.

IMF SURVEY: Has Mexico's recent adoption of CACs [collective action clauses] in bond issues set a new market standard?

CARSTENS: I would say so. The adoption of CACs should benefit both borrowers and lenders and thus has the potential to really improve the workings of the financial system. Of course, the need for CACs was recognized for a long time, but emerging market countries were concerned that the markets would penalize them for including these clauses. Mexico decided to be the first one because it was in a unique position. It was an emerging market that had been granted an investment grade rating, and it had a very strong balance of payments position with a floating exchange rate regime. As a result, the probability that the markets would read the adoption of CACs as a preemptive move by Mexico to deal better with a future bankruptcy was extremely low. Reality proved Mexico right. It managed to break the ice without being penalized. Now the markets feel comfortable with CACs, and this has enabled other countries to follow through.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
August 18	1.52	1.52	2.01
August 25	1.53	1.53	2.02
September 1	1.55	1.55	2.05

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2003).

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

Data: IMF Finance Department

IMF SURVEY: How is Latin America doing after the late 1990s financial crises, as it tries to find its way in an increasingly globalized world? Is there a danger that it will retreat to old populist formulas? And where does the Washington Consensus fit in?

CARSTENS: To some extent, I'm glad that a reevaluation of the Washington Consensus is appearing in different forums. Ultimately, the Consensus is a set of policy recommendations, and, overall, they remain valid. Latin America ran into trouble not because it tried to follow the Consensus but because many countries didn't follow the prescribed measures or didn't implement them fully. So I don't think we should judge the Washington Consensus from Latin America's experience, at least not on the assumption that Latin America implemented its recommendations. That would be like failing to follow the prescribed dose of an antibiotic and then blaming the medicine for the problem. We are passing through a period in which many Latin American countries are facing major political and economic challenges. At this stage, extreme prudence is required to fend off the temptations of populist measures. The challenge for international financial institutions—the IMF included—is to engage in a meaningful dialogue with the governments of these countries and help them return to the path of sustainable growth. The key is for them to adopt policies that facilitate growth while preventing debt unsustainability, balance of payments problems, or financial system distress. If we were to put a label to this, it would be a "back to basics" approach.

IMF SURVEY: Should the IMF have handled the 1990s financial crises differently?

CARSTENS: The IMF has a solid track record in handling crises. Most of the emerging market economies that it has helped in the last decade—like Brazil, Indonesia, Korea, Mexico, Russia, and Thailand—are back in the capital markets and doing pretty well. Without the IMF, those countries wouldn't be where they are now. Moreover, the policy initiatives and principles that the IMF has been pushing as a result of its diagnosis of what went wrong, not only in the countries themselves but also in the international financial system, are the right ones and have helped make the international financial system more resilient. These include improving transparency in policymaking and implementation—mostly through the Reports on the Observance of Standards and Codes and the Financial Sector Assessment Programs—and making adjustments in the IMF's lending instruments. The main message is that the IMF constantly needs to watch for vulnerabilities through its bilateral and multilateral surveillance. But, in the end, there will be crises, no matter what the IMF does. Take, for example, a recent Latin American crisis that stemmed from fraud in the banking sector—something the IMF couldn't have foreseen or prevented.

IMF Survey: What will be the new sources of growth in the region, and, on the trade front, can it compete effectively with countries like China?

Carstens: In many Latin American countries, the export sector can become a very important engine of growth, but countries first need to make more decisive progress with their structural reforms to become more competitive. When that is done, they will be better positioned to compete with countries like China.

IMF Survey: What has NAFTA done for Mexico, and can it be translated into a future free trade agreement for the region? Wouldn't it be better if countries focused on global trade liberalization?

Carstens: A coordinated move toward global trade liberalization would be optimal, but realistically, progress will probably be faster on the regional level. As long as regional openness provides the right incentives and increases access to markets in the region, it will improve welfare. But policymakers need to be sure that they can eventually redirect the regional openness toward a wider opening. NAFTA has been a good example for the region because it has shown that a small emerging market economy such as Mexico can successfully take advantage of open trade with a large industrial economy such as the United States.

IMF Survey: Are you hopeful about the Doha trade round under way?

Carstens: Yes. But it's like moving a big stone. If the international community can move it even just a few inches, that's good.

IMF Survey: Turning back to the IMF as an institution, do you think it needs to shift direction at all to keep up with the changing world—with the greater emphasis on financial markets and financial sectors—and the changing international agenda, now heavily focused on reaching the UN Millennium Development Goals?

Carstens: In recent years, the IMF has increased its outreach to financial markets and nongovernmental organizations, resulting in smoother communications and more productive relationships. This should be continued and even stepped up. Second, the IMF should continue to enhance its technical assistance, which, for many countries, is the IMF's main calling card. Third, the institution has to continuously strive for excellence in two other key activities—surveillance and financial assistance to countries. The bottom line is that the IMF will always need to adapt to new challenges, and I think that we have what it takes to do so. ■

Latin America ran into trouble not because it tried to follow the [Washington] Consensus but because many countries didn't follow the prescribed measures or didn't implement them fully.
—Agustín Carstens

IMF, World Bank to help developing countries adjust to more open trade

On August 21, IMF Managing Director Horst Köhler and World Bank President James D. Wolfensohn sent a letter to Supachai Panitchpakdi, Director-General of the World Trade Organization (WTO), reiterating the importance of a successful round of multilateral trade talks for developing countries. They also reaffirmed the two institutions' commitment to helping developing countries adjust to a more open trading environment.

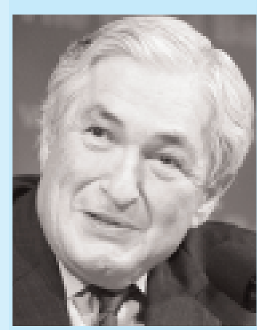
A successful conclusion of the Doha Round, the two men wrote, "is essential for the world economy and will benefit all countries." It can also contribute significantly to the efforts of the international community to meet the UN Millennium Development Goals. Developing countries have much to gain from a more open multilateral trading system, but adjusting to a more liberal trade environment could impose costs on some member countries.

Köhler and Wolfensohn described what the two institutions were doing to help these countries. In addition to a variety of instruments to address concerns about the impact of trade liberalization, the IMF–World Bank plan, still under consideration, would have three dimensions: work closely with members to assess the nature and magnitude of any adjustment need; assist in designing policies, institutional reform, and investment programs to address obstacles to trade expansion and to managing the impact on affected groups; and examine how to use and tailor the two institutions' lending authority to respond to the specific challenges posed by the Doha Development Agenda.

Finally, Köhler and Wolfensohn reiterated that they were fully committed to helping ensure the successful completion of the Doha Development Round. "Given the substantial promise for the world's poor," the letter ended, "we should work together to address the short-term adjustment problems. As you embark on the crucial WTO ministerial meetings in Cancún, we would like to assure you that both our institutions stand ready to support our members in taking full advantage of these opportunities."

For the full text of Press Release No. 03/140, see the IMF's website (www.imf.org).


Horst Köhler


James Wolfensohn

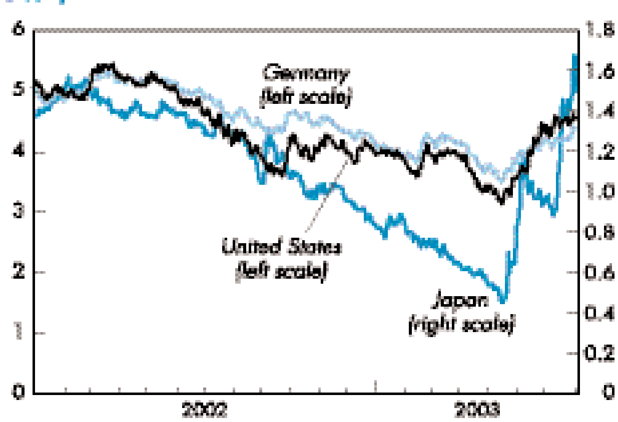
Global Financial Stability Report

Resilience continues to characterize world's financial system

Low interest rates in the major financial centers have allowed the global financial system to continue to make steady progress in overcoming the aftereffects of the bursting of the equity price bubble, according to the latest issue of the IMF's Global Financial Stability Report. *Financial markets have remained resilient during 2003, despite continued lackluster economic growth, geopolitical uncertainties, and high market volatility. While prospects for a stronger economic recovery appear to be improving, the report urges caution about two potential major risks: a further increase in bond yields from relatively low levels and a failure of corporate earnings to match expectations for a rebound in profitability.*

In the months since the March 2003 *Global Financial Stability Report* was issued, the world economy has made further progress in addressing the lingering effects of the bursting of the equity price bubble. Facilitated by interest rates that approached post–World War II lows, household and corporate balance sheets have continued to improve gradually, and corporate default levels have declined. Faced with the prospect of a protracted period of low short-term interest rates and armed with ample liquidity, investors sought higher yields and ventured out along the risk spectrum. In response, emerging market economies increased their issuance of new bonds in the first half of 2003, and corporate issuance rebounded as borrowers extended the maturity of their obligations and took steps to manage their liabilities.

Bond yields rebound from postwar lows
(Percent)



Data: Bloomberg L.P.

More robust conditions

Since mid-June, mature markets have seen a rebound in their government bond yields, and the rally in equity markets that began in March continued in the third quarter (see charts). Bond yields could rise further, the report observes, if there are convincing signs of a strong economic recovery and an increased supply of government securities. The U.S. Federal Reserve has indicated that the Fed funds rate will be kept low for a sustained period, which would likely further steepen the U.S. treasury yield curve. Given the historically high correlation among government bond markets, yield curves in other major financial centers can be expected to do likewise. Ultimately, a combination of a steep yield curve and stronger growth would contribute to more robust global financial conditions.

The transition period, however, would entail risks that need to be carefully managed. More recently, price volatility has risen due to the unwinding of "carry trades" and the hedging of the holdings of mortgage-backed securities. Volatility, however, should not necessarily be of concern to policymakers unless it reaches a point where it triggers financial instability. Potential amplifying factors include dynamic hedging techniques, rigid risk limits, weak corporate governance, lack of transparency by market participants, benchmarking, and index tracking.

Fostering stability

Against this background, the *Global Financial Stability Report* underscores the importance of achieving the appropriate balance between market discipline and regulation. It urges authorities in major market financial centers to persist in reforms to strengthen market foundations while calling on regulators to monitor market innovations. Corporate governance also needs to be strengthened further to restore investor confidence. And, given the increased participation of insurance companies in financial markets and their correspondingly important role in systemic stability, the report calls for improvements in the regulation and supervision of insurance companies.

The report also warns that continued lackluster corporate profitability and weak economic growth could pose another serious risk. The report cautions that lower-than-expected earnings growth in the second half of 2003 could lead to an equity market sell-off, as the recent rally was built on an inflow of funds from low-yielding alternatives and encouraged by expectations of better earnings. If a renewed equity decline were substantial, it could undo some of the financial improvements to date and thereby weaken the global financial sector. Nevertheless, recent corporate earnings reports suggest that the probability of this happening, while not negligible, is low.

Emerging market financing

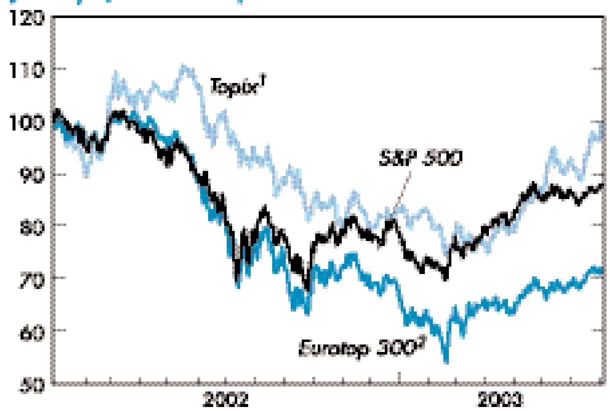
Although the external financing climate for emerging market economies has improved, the report notes that public sector debt in these countries remains high, and there is no room for complacency by borrowers. The report urges countries to take advantage of enhanced market access to press ahead with the implementation of sound policies and improve the structure of their liabilities, including by extending maturities and reducing their dependence on dollar-linked debt. The report also welcomes the use of collective action clauses in recent bond covenants.

Changes in the composition of the investor base for emerging market assets have increased the volatility of overall capital flows, and the report expresses concerns about the persistence of boom-bust cycles for such flows. While some volatility of capital flows is inevitable, sound economic policies and increased transparency could help to make flows more stable.

There is also much that emerging market economies could do to shield themselves from the effects of volatility. These steps should include strengthening asset and liability management, adopting exchange rate arrangements appropriate to the degree of capital account openness, strengthening domestic financial institutions, enhancing supervision and regulation, and developing local securities markets. Such self-insurance efforts might also be complemented, in some cases, by increased holdings of international reserves. The potential volatility of external flows, particularly private debt flows, makes it especially important that emerging market economies continue to deepen their reform efforts and broaden the investor base for emerging market securities. ■

Jürgen Odenius
IMF International Capital Markets Department

Equity market rally continues during third quarter
(January 1, 2002 = 100)



¹Broad-based index of Japanese equities.
²Three hundred euro stocks.

Data: Bloomberg L.P.

Copies of *Global Financial Stability Report*, September 2003, are available for $49.00 ($46.00 for academics) each from IMF Publication Services. Please see page 263 for ordering details. The report is also available on the IMF's website (www.imf.org).

World Economic Outlook

Is public debt in emerging markets too high?

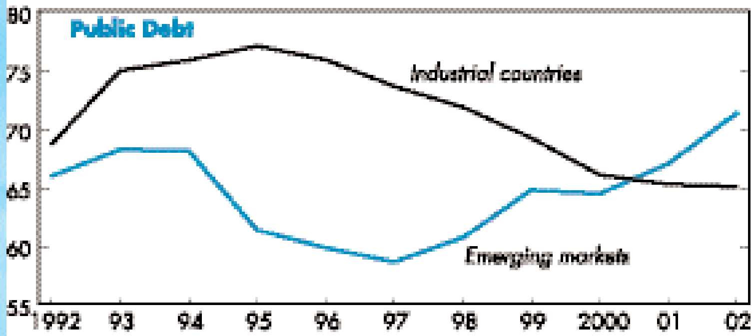
The potential risks of high public debt are once again causing some concern. Following a period of relative decline in the first half of the 1990s, public debt across a broad range of emerging market economies has increased sharply. Argentina, Ecuador, Pakistan, Russia, Ukraine, and Uruguay have undergone high-profile and costly debt defaults or distressed debt restructurings. Other countries—Turkey, for example—have experienced severe fiscal difficulties. Do these developments suggest a repeat of the 1980s debt crisis? Chapter 3, one of the analytical chapters of the September 2003 World Economic Outlook*—the IMF's biannual survey of economic developments, policies, and prospects in its member countries—addresses this question and asks: when does public debt become too high, and what policies are needed to reduce high public debt?*

Public sector debt in emerging market economies has risen markedly since the mid-1990s and currently averages about 70 percent of GDP. Strikingly, after being well below industrial country levels during the 1990s, the average public debt ratio in emerging market economies is now higher than in industrial countries and it is much higher as a percent of government revenues (see chart, page 256).

The increase in debt has more than reversed the decline that took place in the first half of the 1990s, despite the Brady debt restructuring initiative and large-scale privatization programs in many emerging market economies. It has been concentrated in Latin America and Asia and has partly been due to the recognition of contingent liabilities related to financial sector restructuring. Movements in interest rates and exchange rates have also contributed to the increase in debt. In contrast, public debt ratios in the transition countries in Europe have fallen sharply because a number of these economies have implemented significant economic and fiscal reforms as they move toward accession to the European Union. In the Middle East and Africa, debt has remained broadly unchanged but at very high levels (see chart, page 257).

Emerging market public debt is on the rise

(Percent of GDP)



Note: The figures for public debt are unweighted averages.

Data: IMF staff estimates

Legacy of crises gives rise to concerns

Large public debt can significantly hamper economic activity. High taxes are required to finance the debt, which puts upward pressure on real interest rates, crowding out private investment and thereby affecting long-term growth. When a government is no longer able to finance its deficits, it is forced to contract spending or raise revenues, often at a time when fiscal policy needs to be focused on stabilizing the economy. When the government cannot take these actions, a debt crisis ensues and the government is forced to default or inflate the debt away (an implicit default). Both responses entail large economic and welfare costs.

While not all emerging market economies have experienced debt crises, the long history of debt crises in many of these countries suggests that concerns about a recurrence of the 1980s debt crisis are not unfounded. The default experience of many emerging market economies stands in stark contrast to that of industrial countries, which have not explicitly defaulted on their public debt since World War II (although inflation in many industrial countries eroded the real value of debt, particularly during the 1970s). These divergent default histories have given rise to the view that because of the characteristics of emerging market economies—including their inherent volatility, weaker institutions, and poor credit histories—the level of public debt that they can sustain is much lower than in industrial countries.

Debt sustainability

Certainly, a number of features of the fiscal structure in emerging market economies have an important bearing on the level of public debt that they can sustain. For example, many emerging market economies have difficulty running the budget surpluses needed to ensure the sustainability of public debt. This is because government revenues in these economies are quite low, reflecting a large informal sector and significant tax exemptions—for example, effective income tax rates in emerging market countries outside of eastern Europe are often only around 10 percent (compared with 30 percent or more in industrial countries)—and are volatile because of a high reliance on revenues from commodity exports. Emerging market economies also have difficulty controlling noninterest expenditures, particularly during economic upswings, when government spending tends to expand at the same pace as the overall economy. Moreover, interest expenditures in these economies are high and volatile.

According to the *World Economic Outlook*, the current level of public debt in many emerging market economies is not sustainable—that is, a continuation of past fiscal policies will not be sufficient to enable these debts to be repaid in the future. While the sustainable level of public debt varies among countries, for the typical emerging market economy it is often quite low. The *World Economic Outlook* estimates that, based on past fiscal performance, the sustainable public debt level for a typical emerging market economy may be only about 25 percent of GDP, while estimates of fiscal policy reaction functions indicated that emerging market economies as a group have failed to respond in a manner consistent with ensuring fiscal solvency once public debt exceeds 50 percent of GDP. There are, however, regional and country differences, reflecting growth and interest rate differences as well as different capacities to adjust the primary balance. Indeed, the *World Economic Outlook* shows that if a country has low and variable government revenues, it will not be able to sustain as high a public debt level as a country with a higher and more stable revenue base.

Reducing high public debt levels

What can policymakers do to reduce public debt and cushion themselves against the risks of high debt? The example of Chile—where public debt has been reduced to quite low levels—shows that strong fiscal and structural policy reforms, sometimes in combination with an initial debt restructuring, can put public debt on a firm and lasting downward path. To be successful, however, a broad and sustained package of reforms is needed and it should encompass the following features.

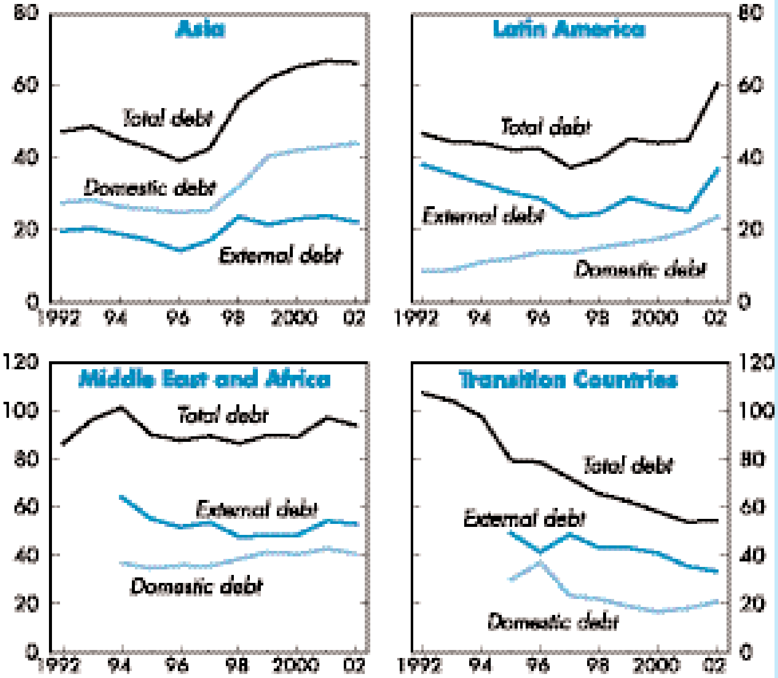
• *Tax and expenditure reforms.* Reforms to strengthen and broaden the tax base are needed to give governments access to higher and less volatile revenues. The low effective tax rates in emerging market economies suggest that tax avoidance—through either legal or illegal means—and weak tax administration are serious issues that need to be addressed. The continued reliance on taxes and transfers related to commodity exports is a weakness of many current tax systems, and efforts are needed to broaden the tax base to reduce its variability. Better control of expenditures during economic upswings is also essential to ensure that periods of strong revenue growth result in higher primary surpluses rather than increased spending.

• *Steps to improve the credibility of fiscal policy.* Governments need to be able to demonstrate that their overall debt burden is manageable and likely to remain so under most circumstances. Building this credibility requires not only implementing effective fiscal reforms but also adhering to these reforms through upturns and downturns. The strengthening of fiscal institutions has a very important role to play in this regard. Fiscal rules—broadly defined as a permanent constraint on fiscal performance—may play a useful role in strengthening fiscal policy credibility if appropriately designed and obeyed. For example, Brazil's Fiscal Responsibility Law introduced in 2000 appears to have helped strengthen the government's credibility in financial markets. The law established policy rules consisting of limits and targets for selected fiscal indicators for all levels of government, including debt ceilings and transparency requirements.

• *Steps to reduce exposure to exchange rate and interest rate movements.* Given the structure of their public debt, many emerging market economies are exposed to considerable interest rate and foreign exchange risk. Steps will need to be taken to reduce the reliance on domestically issued foreign currency and short-term debt. Policies to promote more open economies would help reduce the risks from external debt because exchange rate depreciations would then provide more of a boost to exports and government revenues and would mitigate the impact on the budget of higher debt-servicing costs.

• *Structural reforms to boost growth prospects.* Experience suggests that it is difficult to bring public debt ratios down without robust economic growth. In this context, the implementation of a broad-based agenda of structural reforms is a crucial complement to fiscal consolidation efforts. As was emphasized in the April 2003 *World Economic Outlook*, the strengthening of institutions could be expected to provide a significant boost to growth over the medium term. Addressing corporate and financial sector weaknesses will also be key, while further steps to liberalize trade and promote long-term foreign investment will have lasting growth benefits.

Public debt has grown most in Latin America and Asia
(Percent of GDP)

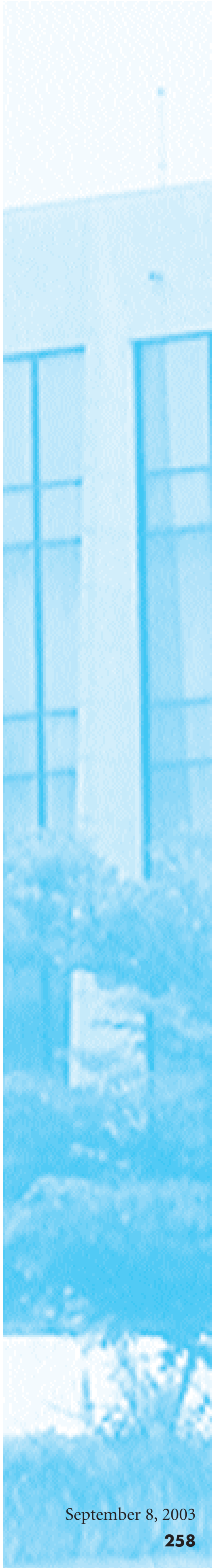


Note: The figures for public debt are unweighted averages. Only countries for which continuous data are available are included.

Data: IMF staff estimates.

• *Addressing the risks from contingent and implicit liabilities.* Governments must also act to minimize the risks they face from contingent and implicit liabilities. This applies not only to countries trying to reduce high debt levels but also to those that currently have relatively low debt. The experiences of many countries in recent years have shown that the recognition of such liabilities can significantly add to public debt and quickly raise questions about sustainability. The recapitalization of banking systems, in particular, has proved costly, while government guarantees on private sector projects are a further source of risk. Improving financial sector supervision is an essential step toward this goal. ■

Copies of the full *World Economic Outlook*, September 2003, will be available in late September for $49.00 ($46.00 for academics) each from IMF Publication Services. See page 263 for ordering information. Chapters 2 and 3 of the *World Economic Outlook* are now available on the IMF's website (www.imf.org).



Democratic Republic of the Congo

An optimist's agenda for economic revival and poverty alleviation

Decades of political infighting and gross mismanagement of public resources have devastated economic and social conditions in the Democratic Republic of the Congo. At the end of 2000, ravaged by a vicious regional war and beset by security and governance problems, the country appeared incapable of repairing its economy or taking credible steps to alleviate poverty. But an early 2001 improvement in the political situation paved the way for the government to introduce, in May 2001, an ambitious and far-reaching reform program, supported by the IMF and the World Bank. This staff-monitored program called for bold measures and has produced surprisingly good results, especially in 2002. Now, two years after launching the program, the authorities are looking to maintain the reform momentum and address the public's high expectations. The country must tackle these goals as it approaches what could potentially be its first truly democratic elections since the death of Prime Minister Patrice Lumumba in February 1961. Recent developments suggest that these goals are within reach.

During much of its existence as a sovereign state, the Democratic Republic of the Congo has suffered poor economic performance and widespread poverty. In the 1990s and 2000, the country experienced large macroeconomic imbalances and negative economic growth. Its gross domestic product contracted by about 50 percent over the period, while its population grew by 3 percent a year. With per capita annual income of less than $100, the Democratic Republic of the Congo is one of the poorest countries in the world.

As the country's expenditures—essentially to maintain the political elite under Mobutu Sese Seko and sustain the war effort in the late 1990s— mounted, its revenues plummeted. The government systematically monetized the resulting fiscal deficits, causing the money supply to balloon and triggering hyperinflation. With the real effective exchange rate appreciating, especially in the late 1990s, and large external interest payments falling due, the external current account deficit rose as well. With several of its key export commodities hit hard (see table this page), the country accumulated sizable external payments arrears, including, by the end of 2001, $503.4 million to the IMF and $317.6 million to the World Bank in unpaid debt service.

By the mid-1990s, the country had alienated virtually all of its major external partners, and relations with the international financial community, including the IMF, the World Bank, and the African Development Bank, had been severed.

Reforms stabilize economy

To address the country's deteriorating economic and social conditions and bring the Democratic Republic of the Congo back into the fold of the international community, the government negotiated a staff-monitored program with the IMF in May 2001. The goals were to stamp out raging hyperinflation, stabilize the macroeconomic framework, and lay the foundation for a strong and durable revival of economic growth. Several critical measures were introduced, most in the budgetary and monetary areas:

In public finance, the authorities put in place a tightly executed treasury plan to ensure that monthly spending would not exceed actual revenues; assigned ambitious revenue targets to the fiscal agencies, with performance monitored on a weekly basis; and adopted budget laws for fiscal years 2001 and 2002, signaling their determination to put public finances back in order.

Monetary measures included liberalization of interest rates and better liquidity regulation, with a view to preserving macroeconomic stability. To correct a huge exchange rate misalignment, the authorities devalued the nominal official exchange rate from 50 Congolese francs (CFr) per dollar to CFr 313.5 per dollar, effective May 26, 2001. Concurrently, the foreign exchange market was liberalized and the exchange rate, floated. Since then, the external value of the national currency has been determined by supply and demand in the foreign exchange market.

Together with these measures, the government instituted a comprehensive structural reform pro-

Production of key commodities plunged in the 1990s
(output in metric tons, unless otherwise indicated)

	1989	2000
Copper	442,000	31,000
Cobalt	9,300	3,600
Gold (kilograms)	2,500	100
Coffee	95,000	11,000
Timber (cubic meters)	361,123	16,478
Cement	454,000	161,000
Water (cubic meters)	203,000	182,000

Data: Congolese authorities; and IMF staff estimates gram that called for, among other measures, liberalizing all key sectors of the economy, from the distribution and pricing of petroleum products to public transportation and diamond exports.

Under this program, the Democratic Republic of the Congo has achieved surprisingly good results:

• Monthly inflation declined initially to less than 1 percent, from a preprogram monthly average of 18 percent during January–April 2001. For 2001 as a whole, year-end inflation was held to 135 percent, compared with 511 percent in 2000. But GDP growth remained negative, at –2 percent in 2001.

• The budget deficit (on a cash basis) was effectively eliminated by 2001, contributing to a hefty reduction in net bank credit to the government.

• The reform measures also helped stabilize the external value of the national currency.

• Finally, with prices liberalized, petroleum products became readily available, ending lengthy waits at filling stations.

The IMF and the World Bank deemed the staff-monitored program broadly satisfactory. This led the country to negotiate its first three-year program under the IMF's Poverty Reduction and Growth Facility (PRGF) in April 2002, ending nearly a decade of isolation from the Bretton Woods institutions and the African Development Bank. (As a prerequisite, the country successfully cleared its arrears to the IMF, which amounted to SDR 403.9 million, or about $522 million, as of March 31, 2002.)

IMF program aims to consolidate growth

The PRGF-supported program seeks to consolidate macroeconomic stability and further improve the business climate. IMF and World Bank financial support for the program amounts to the equivalent of some $750 million and over $904 million, respectively.

The program calls for continued prudent budgetary and monetary policies, with a view to consolidating the gains made under the staff-monitored program, especially the preservation of macroeconomic stability. The three-year arrangement also includes ambitious fiscal, monetary, financial, and structural reform initiatives:

• The creation of a large taxpayers' unit within the tax department is helping to improve private sector dealings with the tax administration, combat fiscal fraud, and make revenue collection more efficient. In early 2003, the import tariff structure was overhauled. The number of import duty rates was reduced from five to three, and the highest import duty rate was brought down to 20 percent.

• Total independence has been granted to the central bank to conduct monetary policy; government borrowing from the central bank has been phased out; and a comprehensive restructuring program for the central and commercial banks has been launched under which three bankrupt state-owned financial institutions are being liquidated.

• The investment, mining, and labor codes have been made more investor-friendly, and the government revenue and expenditure management services have been computerized. In late 2002, a code of ethics and good conduct for public servants was introduced, and, with World Bank support, ambitious programs were introduced to reform public enterprises and develop the private sector. A test case is GECAMINES, the collapsed state-owned mining giant, which is being restructured to trim its workforce by more than 40 percent, at a cost of $45 million in retrenchment benefits.

The Congolese economy began to turn around in 2002

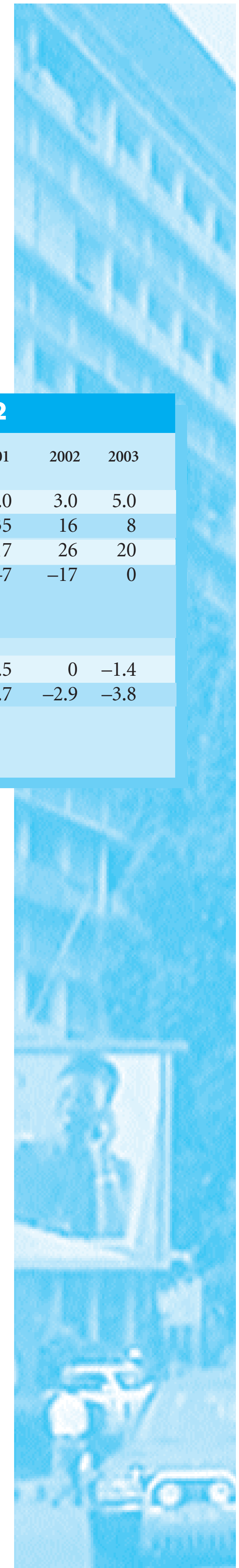
	1996	1997	1998	1999	2000	2001	2002	2003
				(annual percent change)				
Real GDP	–1.1	–5.4	–1.7	–4.3	–7.0	–2.0	3.0	5.0
Inflation (end of year)	693	14	135	484	511	135	16	8
Broad money growth	523	71	160	382	493	217	26	20
Credit to government (percent of broad money, beginning of year)	131	154	104	392	272	–7	–17	0
				(ratio in percent)				
Overall fiscal balance/GDP	–1.6	–3.5	–2.7	–3.4	–4.1	0.5	0	–1.4
Current account balance/GDP	–3.1	–9.0	–2.6	–5.7	–4.6	–4.7	–2.9	–3.8

Data: Congolese authorities; and IMF staff estimates and projections

Performance under the PRGF-supported program has been broadly satisfactory. Year-end inflation plummeted to 16 percent in 2002, and throughout much of the first half of 2003, the annualized rate of inflation was held to around 10 percent. Activity in all major sectors of the economy, with the notable exception of manufacturing, rebounded in 2002—especially mining, telecommunications, and construction. For the first time in more than a decade, real GDP growth turned positive (3 percent) in 2002 (see table this page). As a result of the authorities' efforts, on July 23–24, 2003, the country reached its decision point under the enhanced Heavily Indebted Poor Countries Initiative. Over time, the country will qualify for debt-service relief from all creditors of about $10 billion in nominal terms.

The way forward

Over the past two years, the Democratic Republic of the Congo, against great odds, has restored macroeconomic



stability and put in place key structural reforms. If maintained and reinforced, these reforms should help revive the economy and, in time, make it possible to reduce poverty. Toward this end, the authorities are focusing on several deepened reform initiatives in tax administration, the judiciary, and the financial and public enterprise sectors. To improve the country's chances of realizing its ambitious growth objectives, it needs substantial inflows of financial resources. With foreign private investors expected to return only slowly, the country must maintain good relations with the donor community, in particular by remaining on track with the implementation of its PRGF-supported program.

Its continued success with economic reforms may, however, be hampered by risks associated with, notably, the public's pressing demands for rapid improvements in living standards and difficulties in securing lasting peace in the context of the political normalization that is under way. While the Congolese people are well aware of the harmful impact of political instability and war on growth, there has been little public debate of the risk to long-term growth of delayed reforms.

Indeed, in the face of the country's extreme poverty, the government's ability to respond effectively to pressing social demands while maintaining macroeconomic stability will be limited over the next several years. Broad recognition of this reality is essential if the authorities are to maintain reform momentum and program ownership.

Over the last three decades, the Congolese authorities have historically favored inflation-prone financial policy responses when faced with difficult policy choices. This has prevented the country from generating strong, private sector–led economic growth and allowed poverty to expand steadily. But the past two years have proved that the country can successfully deal with the difficult demands it is facing, and it should commit itself to doing so. ■

Mbuyamu Ilankir Matungulu
IMF African Department

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NBER Summer Institute

Is the United States becoming more egalitarian?

Most measures of human well-being in the United States show an upward trend over the past century, and inequalities in well-being across race and gender have declined, according to Clayne Pope, an economic historian. Pope was one of about 1,000 economists participating in the Summer Institute organized annually in Cambridge, Massachusetts, by the National Bureau of Economic Research. Prakash Loungani summarizes Pope's findings.

U.S. President Ronald Reagan famously asked: "Are you better off today than you were four years ago?" Economic historians often investigate a variant of that question: "Are you better off today than if you'd been born a hundred years ago?" The answer—at least in the United States—is an unequivocal yes, according to Clayne Pope, a professor at Brigham Young University. Not only do most measures of human well-being show an upward trend over the past century, inequalities in well-being have also declined.

Consider life expectancy, often argued to be the single-best indicator of human well-being. Over the past hundred years, there has been a steady increase in the length of life for both genders and across races (see top chart, this page). We've become so used to this upward trend, Pope says, that we forget that it wasn't always so: "From 1750 to the Civil War, there was little increase in U.S. life expectancy, nor was there much change in inequality" of life expectancy across people.

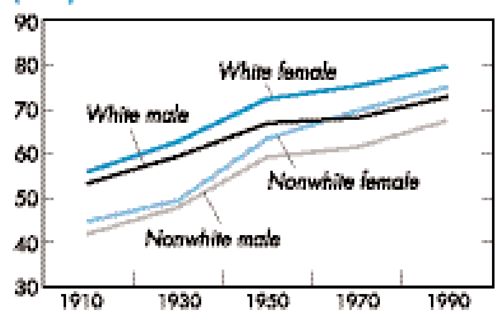
The most dramatic gains have been made by nonwhite females: they now live, on average, longer than white males. In contrast, the gap in life expectancy between white and nonwhite males is "still pronounced and of social concern," Pope says.

More equal lives

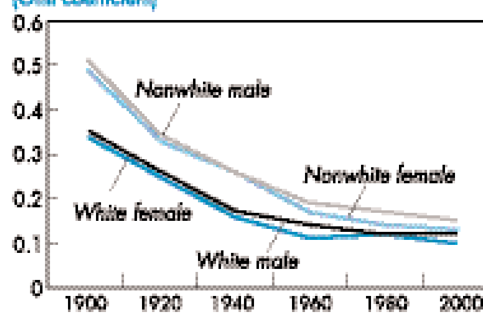
Not only has life expectancy increased, inequality in life expectancy within groups has been steadily declining. Economists commonly measure the degree of inequality using a Gini coefficient, a statistical construct that takes values between 0 and 1; if everyone lived to the same age, the Gini would take on a value of zero. A hundred years ago, the Gini coefficient for life expectancy of white males was 0.35; today, it is down to 0.12, not too far from the value of zero that would indicate perfect equality (see bottom chart, this page). The decline in longevity inequality among nonwhites is even more pronounced.

Other measures of well-being—education, leisure, and consumption—show trends similar to that of life expectancy. Years of education and educational expenditures per pupil are more equal today across people than they were a hundred years ago. So, too, is the distribution of leisure. Pope says that the most important component of the increase in leisure time is the increase in years of retirement, which has occurred for most people regardless of their occupation, income, or wealth. Males are less likely than before to be part of the labor force once they reach 55, while their life expectancy, as noted, has risen. The result, Pope says, is that "males are adding significant years of leisure to their well-being" (though perhaps sometimes to the detriment of their wives' leisure!). Inequality of consumption tends to be lower than that of income thanks to progressive taxation and transfer programs. Moreover, while income inequality has increased in the United States, inequality of consumption does not show any trend.

U.S. life expectancy has increased across race and gender
(Years)



Inequality in life expectancy has steadily declined for all groups
(Gini coefficient)



Data: Clayne Pope, "Measuring the Distribution of Well-Being," working paper presented at NBER Summer Institute, June 2003

Forces for equality

What has produced these egalitarian trends? Pope speculates that the most powerful force has been the rise in per capita income. Rising incomes have been conducive to better health and longer life, better shelter and clothing, and improved household sanitation and medical care. They have supported greater investment in education, allowing children to substitute schooling for labor. Growing incomes have also been the primary influence behind the reduction in hours worked and the acquisition of labor-saving household durables, thereby permitting an increase in leisure.

Another egalitarian force is the availability of public goods. "Discoveries—such as the germ theory of disease and its application in public sanitation, techniques of inoculation and vaccination, the myriad uses of the electric motor, and so on—have produced direct benefit for millions of people," Pope says. Some gains could not have come about without government action that commanded broad political support.
A prime example is the provision of public education.

Equality also comes about because of what Pope calls "natural boundaries." One such boundary is imposed by time: "There are only 24 hours in the day regardless of one's income or wealth. Time is an egalitarian force in the production of well-being." Likewise, the bounded nature of the length of life promotes equality in lifespans. Biology imposes a constraint on consumption. "We can only eat so much"; hence, the distribution of calories consumed tends to be narrow.

Income inequality persists

That income is not limited by natural boundaries may explain why trends in income inequality diverge from inequality in other measures of well-being. "Income distribution is always likely to have a very long right-hand tail"—that is, a few individuals with extraordinarily high incomes. And, over time, the growth of the size of markets through economic development and technological innovations increases the rewards to rare talents and abilities, thereby widening income equalities.

Why does income inequality receive so much attention while the egalitarian trends in other measures of well-being only "evoke responses ranging from mild satisfaction to a sustained yawn"? Partly, Pope says, because people are more interested in reducing the remaining inequities than in reflecting on past achievements. Moreover, remaining inequalities take on a "stronger sense of injustice" when most inequalities have been eliminated. Such differences "become more pressing as society can at least consider the possibility of eliminating or seriously reducing them." ■

Fiscal adjustment in IMF-supported programs

IEO finds no cookie-cutter approach, but some potential contractionary bias

Fiscal adjustment is usually a core element in IMF-supported programs and commonly a controversial one, too. In a recent study that relied on both extensive cross-country analysis and detailed case studies, the Independent Evaluation Office (IEO) examined the record. While it acquitted the IMF on charges of being dogmatic and overly rigid, it did find some evidence of a potential contractionary bias that needs to be addressed. The IEO also called for more forceful and more farsighted IMF surveillance in the fiscal area. And it urged the IMF to play a more active role during surveillance in alerting authorities to the importance of having social programs and budget systems in place that can protect the most vulnerable groups during adjustment programs and in times of crisis. Marcelo Selowsky, Assistant Director of the IEO and head of the team that prepared this evaluation, talks about the study's findings and recommendations.

IMF SURVEY: Critics frequently argue that the IMF uses a cookie-cutter approach to its fiscal adjustment prescriptions—that regardless of country circumstances, the IMF insists on cuts. True?

SELOWSKY: Some of the extreme criticisms—for example, that the IMF always insists on austerity—are not supported by our study. We find significant variability in the fiscal adjustment in IMF-supported programs. In fact, in about one-third of the cases, current account deficits, primary fiscal deficits, and primary expenditures were programmed to increase as a share of GDP. However, we find that the rationale for the scale of the proposed fiscal adjustment is not made clear. It may not be a cookie cutter, but it is a bit of a black box.

IMF SURVEY: Another charge is that the IMF has been inflexible—that once fiscal targets have been established for programs, they are rigidly adhered to?

SELOWSKY: There, too, reality didn't match perceptions. We found that fiscal targets were often adjusted in the implementation process. If expected output dropped below predictions, fiscal targets were typically relaxed. Ironically, though, the IMF called for greater fiscal tightening less often if output performed better than expected.

IMF SURVEY: Critics have linked the IMF's prescriptions with sharp declines in output.

SELOWSKY: The dramatic output declines that occurred in some capital account crisis countries rightly captured the attention of many observers. It is not the case, however, that there has been a general tendency for output to decline during program years. The real problem is that IMF programs are very optimistic in projecting the recovery of output and private spending, particularly when a program starts in an adverse situation.

IMF SURVEY: Was that genuine optimism or a bit of cheerleading?

SELOWSKY: Both. We did not explore why it happened, but you can speculate that it is very hard for the authorities to sell a program that does not assume

Reluctance to recognize the possibility of further declines in private spending during a crisis or unrealistic expectations of recovery may understate risks and preempt the systematic discussion of the possible role of countercyclical fiscal policy.
—Marcelo Selowsky

things are going to get better—particularly after taking difficult measures. I suspect it is hard, too, for a chief of mission to present to the Executive Board a program that does not incorporate good output performance.

***IMF Survey:* Is this optimism something you would want the IMF to avoid then?**

Selowsky: The key question is whether that optimism influences, analytically or substantively, the design of the program. We believe it does. First, reluctance to recognize the possibility of further declines in private spending during a crisis or unrealistic expectations of recovery may understate risks and preempt the systematic discussion of the possible role of countercyclical fiscal policy.

Second, in a number of programs, countries reduced their current account deficits and boosted accumulated reserves beyond what the programs called for. This overperformance signals a situation where foreign financing wasn't a constraint at the margin, which suggests that a more countercyclical fiscal policy could have been considered. In other words, the economy could have responded at the margin to a demand stimulus.

We recognize, of course, that the fiscal stance cannot be determined solely on the basis of its countercyclical role. Its impact on perceptions of sustainability and debt dynamics also needs to be assessed because it influences confidence and the restoration of private investment demand.

These complex interactions can be assessed only at the individual program level, and the basis for the fiscal stance ought to be clearly explained in program documentation. Our evaluation concludes that this is not done systematically. Executive Board documents generally provide insufficient analysis and justification for the proposed fiscal adjustment path and do not spell out the assumptions driving projections of private spending. This not only reduces the transparency of the program (particularly to the outside world) but also prevents identification of the critical assumptions that ought to be monitored during program implementation to facilitate mid-course corrections if necessary.

***IMF Survey:* On a very basic level, did IMF-supported programs meet their fiscal targets?**

Selowsky: We saw quite a bit of variation, but a large share of countries didn't meet their fiscal adjustment targets, and most of the adjustment that did take place occurred during the first year. What seemed to happen was that the IMF relied on expedient measures to generate quick adjustment, and these instruments quickly exhausted themselves.

Measures like quickly raising the value-added tax, increasing the social security tax, or cutting wages usually didn't produce a lasting impact. Most countries typically have small tax bases, and when programs call for hiking "easy to collect" taxes, extensive tax evasion soon follows. Similarly, when programs

Our evaluation finds that surveillance does not forcefully flag policy inaction—often it is not candid enough.
—Marcelo Selowsky

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call for caps in public sector wages, the authorities soon find themselves under a lot of pressure to re-establish those wage levels after the program ends.

What the IMF needs to do is help countries improve the flexibility and resilience of their fiscal systems so that they can more easily and efficiently generate adjustments when they have to deal with shocks. Much longer term institutional change is needed—countries have to expand their tax bases, curb tax evasion and exemptions, and reform their civil service—but this takes time.

Selowsky: "We recommend that the IMF invite the authorities during Article IV consultations to identify the critical social programs they would like to see protected or activated in a crisis."

IMF SURVEY: Your study suggests the problem is not just a mismatch of short-term program objectives and longer-term institutional development needs but also a question of the IMF's tiptoeing around politically difficult issues, such as tax evasion.

SELOWSKY: Exactly, but we have to be careful here. Capping wages isn't easy politically, but it's easier than civil service reform, which is what should be done. We have to acknowledge that programs have too short a time horizon to tackle long-term institutional reforms. That's where IMF surveillance comes in. We suggest that the surveillance process should be used to build a road map for future reforms and to encourage the authorities to implement these reforms, particularly when their countries aren't in crisis situations. This is the best time to undertake such reforms.

IMF SURVEY: To what extent is the IEO prodding the IMF to be less reactive and do more forward planning—to think less as a fireman and more as an organization that devises and promotes safety regulations?

SELOWSKY: The institution has to think a little more about the long term, but we recognize that it is still going to be called at the last minute when the house is on fire. These two roles aren't incompatible. Once there's a fire, it has to be put out. But let's acknowledge that there were Article IV consultations prior to the crisis, and there will be consultations after the crisis. Surveillance should make strong efforts to learn from the past and set a clear road map of reforms for the future to improve the resilience of fiscal systems. Let's identify these priorities, monitor their progress, and encourage a dialogue with the authorities if progress is slow. Our evaluation finds that surveillance does not forcefully flag policy inaction—often it is not candid enough.

IMF SURVEY: Finally, one widespread concern that we didn't mention earlier is that the IMF's prescriptions for fiscal adjustment are thought to take a toll on social spending in program countries, particularly middle-income countries. Did you find evidence of this?

SELOWSKY: We found that the presence of an IMF-supported program did not, in itself, reduce aggregate spending on education and health care. It may, in fact, have even increased such spending temporarily. But that doesn't mean that vulnerable groups aren't hurt in crisis situations or during periods of budgetary retrenchments. Spending categories that often are the most critical to vulnerable groups come under pressure and are likely to be preempted by other expenditures during these periods. For example, basic medical or primary school supplies may be preempted by personnel expenditures. Protecting very targeted spending is usually not costly, particularly if it is facilitated by some reallocations in the budget. This can be particularly relevant in middle-income countries.

IMF SURVEY: So what can the IMF do?

SELOWSKY: One of the most important recommendations of our evaluation is that the IMF should have a dialogue with authorities during Article IV consultations about the need to have budgetary systems in place that can fund, in real time, critical programs during crises or periods of macroeconomic adjustment.

We recommend that the IMF invite the authorities during Article IV consultations to identify the critical social programs they would like to see protected or activated in a crisis. Selection of these programs would be entirely at the discretion of the authorities, perhaps with assistance from the World Bank. Once these have been identified, the World Bank and the IMF could agree with the authorities on public expenditure management systems geared to protecting critical programs in case of crisis. ■

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