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NEWS: Annual Meetings preview

The global economic expansion has been remarkably tenacious, but sharply higher oil prices and a continued widening of global imbalances will likely top the list of concerns for policymakers gathering in Washington, D.C. on September 24–25 for the Annual Meetings of the IMF and the World Bank. Also likely on the agenda are the IMF's medium-term strategic direction and efforts to strengthen the IMF's support for poor countries.

Denio Zara/IMF

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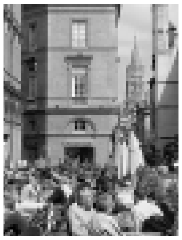
REGIONAL FOCUS: Tough love for Europe

High unemployment, widening fiscal deficits, and population aging are sapping people's confidence in the welfare state, and this, says Michael Deppler, head of the IMF's European Department, is leading Europeans to save rather than spend. The tonic? Encouraging higher labor force participation, balancing the budget, and introducing more competition. And while it is appropriate for countries to take ownership of their own problems, policymakers should not lose sight of the synergies that come from acting together.



Maurizio Gambarini/NewsCom

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RESEARCH: Institutions can change

The search for effective tools in the fight against poverty is intensifying. High and sustained economic growth is essential, and it is increasingly clear that improving the quality of basic economic institutions, such as property rights and governance, plays a crucial role in achieving that. What spurs institutional improvements? And can these changes occur quickly? The September 2005 *World Economic Outlook* takes stock of what is known and suggests several factors that appear to enhance institutional quality.

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RESEARCH: IMF says financial markets are resilient

Recent economic and market developments have produced a favorable environment for the global financial system and reduced near-term risks, according to the IMF's latest *Global Financial Stability Report*. But these benign forces are adding to potential vulnerabilities over the medium term, notably with regard to large global imbalances and high debt levels in many mature markets' household sectors. The report highlights policy measures that could help mitigate these risks and trends that could create self-stabilizing forces.

Justin Sullivan/Getty Images

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What's on

September

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

20 Official opening of second IMF Headquarters building, Washington, D.C.

21 IMF's fall 2005 *World Economic Outlook* (Chapter 1) released

22–23 Global Forum on Tax Treaties and Transfer Pricing, OECD Center for Tax Policy and Administration, Paris, France

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

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

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

October

5–8 National Council on Economic Education Annual Meeting, San Antonio, Texas

15–16 Meeting of Group of Twenty Finance Ministers and Central Bank Governors, Beijing, China

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

November

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

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

8–11 Series of IMF forums on regional economic developments for academics, legislators, NGOs, and media in Guatemala, El Salvador, Nicaragua, and the Dominican Republic

18 APEC Joint Ministerial Meeting, Busan, Korea

16–18 World Summit on the Information Society, Tunis, Tunisia

24 IMF forum on regional economic developments for academics, legislators, NGOs, and media, San José, Costa Rica

27–29 World Economic Forum, India Economic Summit, New Delhi, India

December

13–18 The Sixth WTO Ministerial Conference, Hong Kong SAR

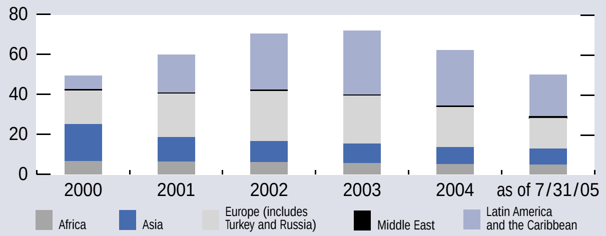
IMF Executive Board
For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp*.

At a glance

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



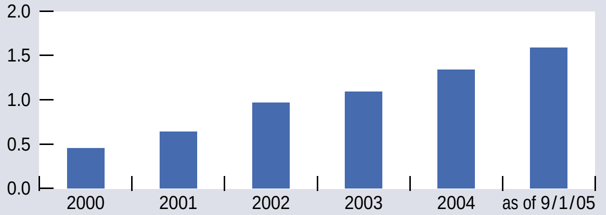
Largest outstanding loans

(billion SDRs, as of 7/31/05)

Nonconcessional		**Concessional**	
Turkey	11.97	Pakistan	1.02
Brazil	10.79	Congo, Dem. Rep. of	.53
Argentina	7.59	Zambia	.49
Indonesia	5.85	Ghana	.31
Uruguay	1.67	Tanzania	.26

HIPC debt relief[1]

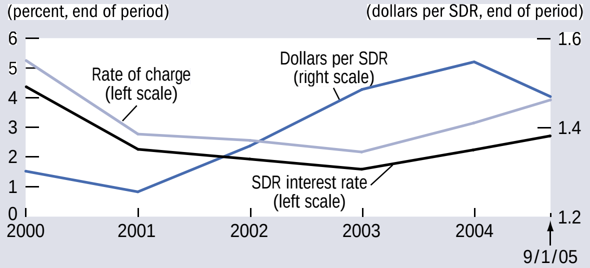
(billion SDRs, end of period)



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

Related rates

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



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

Annual Meetings 2005 preview

Oil, global imbalances likely to take center stage

With the world economy continuing to exhibit a gritty resilience, the world's finance ministers and central bankers meeting in Washington, D.C. on September 24–25 are set to debate ways to keep the global economic expansion on track. Sharply increased oil prices, thin energy reserves, and the ramifications of large global imbalances over the medium term are likely to be among the chief concerns at the IMF–World Bank Annual Meetings.

2005
Annual Meetings
Boards of Governors
Washington, DC
World Bank Group
International Monetary Fund

On September 24, the IMF's chief advisory body—the International Monetary and Financial Committee (IMFC)—is expected to examine prospects and risks for the global economy, the IMF's medium-term strategic direction, and proposals to strengthen IMF support for low-income countries. The session will be chaired by U.K. Chancellor of the Exchequer Gordon Brown.

IMF Managing Director Rodrigo de Rato is expected to provide the IMFC with updates on the IMF's work—including in the areas of surveillance and crisis prevention, crisis resolution, the use of IMF resources, IMF governance, and efforts to combat money laundering and the financing of terrorism.

The IMFC's exchange of views on the global economy will be informed by the latest *World Economic Outlook* (WEO) projections and the related analysis by IMF staff of economic policies around the globe. The projections, contained in the first chapter of the *WEO*, will be released on September 21 at a press conference by IMF Economic Counsellor and Research Department Director Raghuram Rajan.

The joint World Bank–IMF Development Committee, chaired by Trevor Manuel, South Africa's Finance Minister, will meet on September 25. It is expected to follow up on recent initiatives designed to strengthen the development partnership and financing for achieving the Millennium Development Goals, with a special focus on Africa. Also likely to be taken up are the Doha Development Agenda and aid for trade.

Eugene Salazar/IMF

U.K. Chancellor of the Exchequer and IMFC Chair Gordon Brown addresses the world's finance ministers and central bank governors at the opening ceremonies of the 2004 Annual Meetings.

The Joint Annual Meeting of the IMF's and World Bank's Governors, in plenary session, will begin on September 24 and conclude on September 25.

The Annual Meetings will be preceded on September 23 by gatherings of finance ministers from the Group of Twenty-Four developing countries and the Group of Seven advanced economies. A two-day program of seminars on September 22–23 will take up topical economic, financial, and development issues. The seminars are open to the public.

On September 25 at George Washington University's Marvin Center, former IMF Managing Director Michel Camdessus will deliver the 2005 Per Jacobsson Lecture on "International Financial Institutions: Dealing with New Global Challenges."

For more information about the IMF–World Bank Annual Meetings, including the full text of the IMFC and the Development Committee communiqués as well as transcripts of the speeches and press conferences, see the IMF's website (*www.imf.org*). ■

Bangladesh's economy is robust, but external shocks pose challenges

Underpinned by a stable macroeconomic environment and progress in implementing structural reforms, Bangladesh's economy has continued to expand at a healthy rate, the IMF said in its annual economic review. Real GDP growth is estimated at 5.2 percent for the fiscal year ending June 30 (FY2004/05), down slightly from 5.5 percent in FY2003/04, partly reflecting the impact of devastating floods in July 2004. Although inflation surged in late 2004, owing to crop damage from the floods and an upswing in oil and other commodity prices, consumer price rises have since moderated and annual average inflation is projected to fall from 6.5 percent in FY2004/05 to 6.0 percent in FY2005/06. The fiscal stance has remained prudent in recent years, with the overall budget deficit estimated at 4.2 percent of GDP in FY2004/05 and projected to continue at this level in FY2005/06.

Bangladesh's external position strengthened in 2003–04, but export earnings have moderated since November 2004, mainly reflecting sharp price declines ahead of the elimination of the Multifiber Arrangement (MFA) quotas on January 1, 2005. At the same time, imports have risen rapidly as a result of higher oil and other commodity prices, increased food imports, and stronger demand for investment goods. The external current account is expected to move into the red to the tune of nearly $1.1 billion in FY2004/05, after recording a small surplus of $176 million in FY2003/04.

Bangladesh	FY2002/03	FY2003/04	FY2004/05	Projections FY2005/06
		(percent change)		
Real GDP	5.3	5.5	5.2	6.0
Consumer price index	4.4	5.8	6.5	6.0
		(million U.S. dollars)		
Imports of goods and services	8.7	9.8	11.6	12.3
Current account balance	76.0	176.0	-1.1	-1.4

Note: Bangladesh's fiscal year ends June 30.
Data: Bangladesh authorities and IMF staff estimates.

The IMF Executive Board welcomed Bangladesh's buoyant economic growth, moderate inflation, and increased international reserves over the past year, and commended the authorities' efforts to maintain economic stability and advance structural reforms. Looking ahead, however, the Board noted that Bangladesh faces key challenges of accelerating growth and maintaining macroeconomic stability while overcoming the potentially significant impact of the MFA phase-out. To this end, the Board urged the authorities to continue implementing core reforms in tax administration, banking, and the energy sector, while improving governance, to enhance the business environment, promote export diversification, and facilitate economic recovery and poverty alleviation. ■

Successful first year in EU for Poland, but growth impediments remain

Poland's economy expanded by 5.4 percent in 2004, although the growth surge in the run-up to European Union (EU) accession dissipated in the second half of the year, the IMF said in its annual economic review. Slowdowns in both domestic and net external demand contributed to the slowdown, although export demand had picked up again by end-2004. This recovery in export growth was especially impressive given weaker demand in western Europe and the zloty's appreciation during the second half of the year. The IMF credited policymakers with successfully coping with EU accession-related price and demand shocks, but noted that domestic demand remained flat into the first quarter of 2005—largely because of declines in highly import-intensive investment and inventories.

The IMF Executive Board congratulated the Polish authorities on a successful first year in the EU but said that the recently stalled growth momentum dampened hopes that the country had entered a period of substantially higher investment and output growth that would accelerate a decline in its high unemployment rate. Poland's 52 percent employment rate is now the lowest in the EU, reflecting structural rigidities and demographic pressures. Of particular concern are unemployment rates for young workers and long-term unemployment rates.

Poland	2002	2003	Prel. 2004	Proj. 2005
		(percent change)		
Real GDP	1.4	3.8	5.4	3.7
Domestic demand	0.8	2.6	5.0	2.6
	(percent of labor force; registered year-end)			
Unemployment	16.2	16.7	19.0	19.4
		(billion U.S. dollars)		
Exports	46.7	61.0	81.6	94.9

Data: Polish authorities and IMF staff estimates. Data projections were prepared in June 2005.

On the fiscal side, the Board encouraged the authorities to take further steps to set the government deficit and debt on downward paths, while protecting public investment plans envisaged in the convergence program for euro adoption. The period immediately following the September 25 elections offers a window of opportunity for fiscal consolidation and spending reform, the Board said, noting that the next government's most important macroeconomic challenge will be to successfully pursue clear medium-term fiscal goals. A well-formulated fiscal strategy would be needed to achieve these goals and enhance growth potential, the Board noted. ■

For more information, please refer to IMF Public Information Notices No. 05/90 (Bangladesh) and No. 05/93 (Poland) on the IMF's website (*www.imf.org*).

Mapping a strategy for recovery in the euro area

Low growth. Persistent high unemployment. "No" votes in referenda on a new European constitution and failure to agree on a new European Union (EU) budget. The news out of Europe these days seems to signal deep-seated uncertainty about how to move forward. At the heart of these problems is an economy caught in a difficult adjustment and needing direction, says Michael Deppler, head of the IMF's European Department. In an interview with Camilla Andersen of the IMF Survey, *he cautions that as long as people feel uncertain, particularly about the viability of their social model, they will save rather than spend. The solution? Restore confidence by setting out a comprehensive, forward-looking strategy that strengthens growth while safeguarding the social model. The elements of such a strategy are well known but politically challenging: increase employment, balance the budget, and introduce more competition in labor, goods, and services markets.*

Henrik Gschwindt De Gyor/IMF

Deppler: "Unfortunately, what we are seeing right now is people questioning whether the euro area and the EU are part of the answer or part of the problem."

IMF Survey: Why has the euro area not benefited from the global expansion?

Deppler: Growth has certainly been disappointing—more disappointing than we had anticipated. This reflects short-term developments, such as the price of oil, and medium-term ones, such as cyclical adjustments in Europe's corporate sector. More fundamentally, however, there are the long-term issues: the low employment rates inherited over the past three decades, the aging of the population that is poised to happen over the next four decades, and uncertainty about what governments intend to do about these problems. All these factors have come together to produce disappointing growth.

That said, the euro area is making progress. Although growth will not be buoyant any time soon, the situation is not as bad as it is sometimes portrayed. In the near term, we think growth will gradually pick up from 1¼ percent this year.

IMF Survey: Have high oil prices and an expensive euro been impeding economic recovery?

Deppler: Oil prices and the euro have certainly played a role. Oil has probably slowed growth cumulatively by about 1 percent over the past two years, and the euro has probably taken off another ½ percent. That is not negligible when you are only growing by 1¼ percent! But the rise in oil prices has reflected strong global growth, which in turn has been good for euro area exports, so the area's weak growth cannot simply be blamed on external developments. The real drag on growth is the domestic setting.

IMF Survey: Why is business sentiment still so weak in many countries?

Deppler: Investment boomed in the period up to 2000, but has since disappointed. This is true for much of the world, including the United States. In Europe, the corporate sector overinvested at the height of the stock market and became overleveraged as a consequence, particularly in Germany. As a result, companies are seeking to improve their balance sheets rather than invest. But the situation is stabilizing, and there are signs that business sentiment is improving.

IMF Survey: What about consumers and households?

Deppler: The wage moderation that is needed to generate employment over the longer term, together with sticky inflation, means real incomes are increasing only slowly. More fundamentally, the aging of the population, which is set to accelerate in the next few years, points to an underlying fiscal unsustainability throughout much of western Europe. As the population gets older, benefit payments will start increasing just as the workforce that helps pay for them will start shrinking. For the most part, governments have not yet mapped out in any convincing fashion how they intend to manage these challenges. This helps explain why consumers and investors are being careful.

IMF Survey: So what can policymakers do?

Deppler: First, let me say that we view the problems as fundamentally structural rather than cyclical—as long term rather than short term. To worry about the short term when there is no credible vision of the future is to no lasting purpose.

Instead, policymakers need to define, with a sense of purpose and vision, a strategy encompassing both fiscal and structural policies that strengthen employment and growth and make the social model sustainable. Let me give you an example. If governments deal with aging-related expenditure pressures by raising taxes and cutting pensions, labor supply and growth will suffer, as will demand, because households will then save to compensate. But if they raise retirement ages, this will increase labor supply and leave consumption relatively unaffected. What's needed is a strategy that puts more people to work and makes work more productive.

IMF Survey: What has been done so far?

Deppler: Much has been done in terms of wage moderation and ending early retirement. We have also seen some labor market reforms over the past decade, and even though changes have been on the timid side, there are results to show for it. Despite what many think, the employment performance of the euro area from 1996 to 2004 was on a par with that of the United States—roughly 12 million new jobs were created. And there has been recent progress as well. I would single out Agenda 2010 in Germany and the pension reform in France as two reforms that have significantly strengthened incentives to work and reduced these two countries' underlying fiscal unsustainability. That said, much more needs to be done.

> What's needed is a strategy that puts more people to work and makes work more productive.
>
> —Michael Deppler

IMF Survey: Does this emphasis on reform mean there is no role for monetary policy?

Deppler: No. There is a role for monetary policy, but it is not a primary one because the problems are essentially structural. So monetary policy should be as supportive of the transition process as possible, but within a framework that maintains price stability.

In our view, monetary conditions have been supportive and interest rates broadly appropriate. The difficulty faced by the European Central Bank is that, while growth has been weak, inflation has been and is very stubborn. After five years, headline inflation remains slightly above the "close to, but below, 2 percent" target, and it will likely persist at those levels for some time yet because of the pressure from oil prices. Since growth is expected to recover, we don't see a case for cutting interest rates at this point. However, there would be a case if the recovery were to falter once again and underlying inflationary pressures remained contained.

IMF Survey: The IMF is calling on euro area countries to aim for fiscal balance. Is this realistic during a time of slow economic growth and rising demands on the welfare state?

Deppler: The bottom line is that policies must be consistent to be credible. One cannot on the one hand speak of reforms to make the social model sustainable and on the other have budgets that imply increases in public deficits and debt ratios ahead of accelerating population aging. Any short-term "relief" that is expected to result from higher deficits will be negated by people's justifiable fear that this is simply postponing the inevitable.

Consistency requires a clear view on how to deal with medium- to long-term trends, which means a balanced and reinforcing mix of fiscal and structural adjustment. The mix varies across countries, but for the euro area as a whole we see a need for fiscal policy to move to a roughly balanced position by 2010, which implies adjustment of ½ percent of GDP a year. This goal stands in rather sharp contrast with actual fiscal positions, which have been drifting badly.

IMF Survey: The Stability and Growth Pact [SGP] doesn't seem to be doing a very good job at getting countries to live up to their commitments. What can be done to encourage more fiscal discipline?

Deppler: This has been a difficult period for Europe, and many of the difficulties came to a head in the context of the implementation of the SGP. The response has been a reform that made the euro area's fiscal framework more flexible. Technically speaking—that is, forgetting about the policy context—there is nothing particularly wrong with what has been done. Indeed, if governments buy into the reform fully, it would represent a step forward. We will then have ownership of the SGP, which we didn't really have before.

However, fiscal discipline in a monetary union with decentralized fiscal policies is a chancy business. You need to guard against free riders. This is a real concern in a situation where fiscal policies in most countries are already in trouble. The proof of the reformed SGP, therefore, is going to be in the eating—in how the European Council of Finance Ministers applies the new rules. If they follow through with vigorous implementation, then the new SGP will be a step forward. If they don't, one has to worry about what will happen.

IMF Survey: What will it take to create more jobs?

Deppler: The employment rate in the euro area is, on average, only about three-quarters of the level in the United States. This is the euro area's main problem—fewer workers will have to pay for more benefits—but it is also its main opportunity. There are, potentially, enough workers to sustain the social model. Although politically difficult, the policies needed to encourage job creation are well known: more flexibility in hiring and firing, continued wage moderation, and improving incentives for finding a job for those who are out of work.

Indeed, Europe has been practicing wage moderation and reforming its labor markets for more than a decade, and has more to show for it than is often realized. While this needs to continue, the challenge now is also to strengthen the payoff in terms of growth.

For this to happen, countries must improve their productivity, which has been lagging. Unfortunately, we know a lot less about increasing productivity than about increasing employment, but one instrument that does seem to work—on both fronts—is to increase competition in the domestic economy. This forces companies to become more efficient and, hence, more productive. Moreover, by disciplining pricing behavior, increased competition strengthen real incomes and consumption and thus helps offset the dampening effects from wage moderation alone. This should yield more "bang for the buck" in terms of translating wage moderation into jobs and output growth.

What is needed, therefore, are strategies that are more comprehensive than in the past—strategies that combine labor and product market reforms. The revised Lisbon strategy provides avenues for doing so.

IMF Survey: Do you think the euro area will manage to move forward again, given the reluctance in many countries to undertake reform?

Deppler: There is considerable dissatisfaction with the economic performance of the euro area, and I have no doubt that governments are keen to address the problems facing their societies. Once current political uncertainties get resolved—elections will be held in Germany later this month, in Italy next year, and France is gearing up for presidential elections in a year and a half—there will be a renewed momentum. But the question is whether the initiatives will once again be piecemeal and partial instead of decisive and comprehensive.

Alexandra Winkler/Reuters

Germans protest the government's "Agenda 2010" reforms in March 2004.

IMF Survey: There is a lot of talk about political differences within the EU and the euro area—between large and small countries, between old and new members, and between "liberals" and those wedded to protecting Europe's social model. Do these differences threaten Europe as we know it?

Deppler: Unfortunately, what we are seeing right now is people questioning whether the euro area and the EU are part of the answer or part of the problem. There is a pause for reflection. And as part of that media-heavy reflection, there has been a polarization of views. But in my experience, there is a broad consensus among policymakers on what needs to be done, with the differences being second order. The challenge is for governments to come up with the credible visions to make it happen.

But there is one unfortunate byproduct of the current skepticism. There has been a narrowing of the focus on national solutions, including a tendency toward protectionism. In one sense, this narrowing is healthy. Since many of the problems can only be solved at the national level, it is certainly appropriate for countries to get out from hiding behind Brussels and start taking ownership of their problems.

But policymakers should also not lose sight of the considerable added value that comes from acting together. Our view is clear—amid its various ebbs and flows, postwar European integration has been beneficial overall. What's more, the benefits of cooperation are especially marked in a decentralized monetary union such as the euro area. I expect people will once again come to appreciate the benefits of working closely together once this difficult moment has passed. ■

Copies of IMF Country Reports 05/265 and 05/266, *Euro Area Policies*, and *Euro Area Policies: Selected Issues*, are available for $15.00 each from Publication Services. See page 280 for ordering information. The full text of the reports is also available on the IMF's website (*www.imf.org*).

Regional integration and WTO accession: What's the right sequencing for the CIS?

Regional trade integration is neither a substitute for, nor necessarily a hindrance to, multilateral trade liberalization. With regional agreements continuing to be a prominent part of many countries' trade policy agendas, it is likely that regional integration and multilateral trade reform will continue to coexist. A new IMF paper explores the appropriate sequencing of joining a regional customs union and the World Trade Organization (WTO). It looks specifically at whether joining the Eurasian Economic Community (EAEC) customs union—a regional arrangement that includes five members of the Commonwealth of Independent States (CIS)—facilitates or delays WTO accession for some of these countries. It finds good reasons for smaller economies with relatively liberal trade regimes to join the WTO first.

Although economically inferior—from a global perspective—to nondiscriminatory trade liberalization on a most-favored-nation (MFN) basis, regional trade agreements continue to proliferate. Regional trade integration can serve as a vehicle for dialogue and coordination on regional issues that are not part of the multilateral agenda. Also, regional agreements are not inconsistent with membership in the WTO. The WTO allows members to participate in preferential trade agreements as long as trade barriers are eliminated on "substantially all trade" among the members. The appropriate sequencing between WTO accession and regional trade integration—in particular, customs unions—remains an important consideration, however.

Two considerations

The sequencing of WTO accession and membership in a customs union should be evaluated carefully by any country considering a customs union. The welfare implications of joining the WTO before joining a customs union, or vice versa, may vary considerably across member countries, depending on the individual country's trade preferences and bargaining power. There are two key considerations in evaluating the appropriate sequencing: how it may affect a country's leverage in regional trade negotiations and, thus, the resulting structure of protection; and whether first pursuing regional integration might lead to delays in the WTO accession process.

By joining the WTO early, small open economies can obtain leverage over the trade policies of larger and possibly less open economies that are still in the process of accession. In fact, by acceding earlier, small countries may be able to extract concessions from regional members within the WTO framework that would be impossible to obtain bilaterally or in a regional trade agreement, given disparities in economic influence among the members. Such leverage could be especially valuable when forming a customs union where the common external tariff represents a negotiated compromise between producer and consumer preferences in the member countries.

Delays in the accession process can result when customs unions are negotiated before WTO accession, because members of a customs union need to coordinate positions and reconcile future commitments with "common terms of accession" for WTO membership. This delay will tend to be particularly costly to small open economies, which have proportionately more to gain from trade integration. Larger economies might be more concerned with the terms than with the speed of accession. Furthermore, while it might be argued that joint negotiation over accession increases the collective bargaining power, it is not obvious, a priori, that the outcome would reflect the preferences of a customs union's smaller members.

Moreover, if one of the members of the customs union is already a WTO member, this may create incompatibility between WTO and customs union commitments. In this case, the common external tariff should be set to the lowest rate

The CIS's long road to the WTO

The EAEC regional customs union, which supercedes the CIS customs union, may be delaying members' accession to the WTO.

CIS members	WTO application	Current status
EAEC members		
Belarus	September 1993	Ongoing negotiations
Kazakhstan	January 1996	Ongoing negotiations
Kyrgyz Republic	February 1996	Joined in 1998
Russia	June 1993	Ongoing negotiations
Tajikistan	May 2001	Ongoing negotiations
EAEC observers		
Armenia	November 1993	Joined in 2003
Moldova	November 1993	Joined in 2001
Ukraine	November 1993	Ongoing negotiations
EAEC nonmembers/ nonobservers		
Azerbaijan	July 1997	Ongoing negotiations
Georgia	July 1996	Joined in 2000
Turkmenistan	Not yet applied	...
Uzbekistan	December 1994	Ongoing negotiations

Note: CIS is the Commonwealth of Independent States; EAEC is the Eurasian Economic Community; WTO is the World Trade Organization.
Data: World Trade Organization.

Attending the Eurasian Economic Community's June 2005 summit in Moscow are (from left) Presidents Robert Kocharian of Armenia, Alexander Lukashenko of Belarus, Vladimir Putin of Russia, and Imomali Rahmonov of Tajikistan. The community envisages a regional customs union and, eventually, a common economic area.

among members. This also minimizes the risk of trade diversion and of an overall increase in protection.

The Eurasian Economic Community

In October 2000, Belarus, Kazakhstan, the Kyrgyz Republic, the Russian Federation, and Tajikistan signed the EAEC agreement, which came into force in May 2001. The agreement, which supersedes the CIS customs union of the 1990s, envisages the implementation of a customs union and, eventually, a common economic area, implying a deeper economic integration and cooperation beyond the harmonization of external tariff rates. An agreement on the common external tariff, signed in February 2000, envisaged finalizing and implementing the common tariff in stages over a period of five years from the time it came into force, to be prolonged, if necessary, by mutual agreement. In fact, the common external tariff still has not been implemented.

In the mid-1990s, when most of the CIS countries applied to join the WTO, each country approached accession independently. A coordinated approach to pursuing WTO membership in accordance with EAEC commitments was, however, explicitly endorsed in May 2003 by the non-WTO members of the EAEC and was reiterated in Almaty, Kazakhstan, in June 2004. This coordinated approach may further complicate the WTO accession process; it can lead to considerable delays that can be detrimental for small open economies, which would benefit from more rapid accession. This is because the EAEC countries must harmonize their common external tariff commitments with, de facto, common terms of accession under the WTO by reconciling very different interests in the region. These delays may also impose costs on the more open economies in terms of missed opportunities to extract concessions from the customs union's more protectionist members. The prospect of fully implementing the EAEC has already increased the region's overall rate of protection as it complies with the customs union commitments.

An analysis of the EAEC tariff structure suggests that the level of trade protection of Kazakhstan, the Kyrgyz Republic, and Tajikistan will increase once the customs union is fully implemented because its members will need to harmonize their current tariff structures to that of the EAEC. In particular, consumers in Kazakhstan, the Kyrgyz Republic, and Tajikistan would bear the costs of joining the EAEC customs union, because these countries may have to increase their tariff rates to meet EAEC commitments.

Simulation of the two sequencing paths shows that joining the WTO before implementing the EAEC customs union (in contrast to delaying WTO accession) is welfare-improving from the standpoint of consumer welfare in member countries whose tariff rates were initially low. Moreover, net trade diversion differs across members because of the difference in their current levels of trade protection.

Caution advised

There are reasons to be cautious about the implementation of the customs union envisaged by the EAEC. First, there could be welfare losses for some countries as a result of trade diversion owing to an increase in the rate of protection. Second, the harmonization process could benefit certain countries more than others. And, finally, even though a customs union does not, in principle, limit the scope for future multilateral liberalization, it can delay decision making because of the need to coordinate positions. This extended timetable gives protectionist lobbies in some countries leverage over the trade policies of other more liberal countries, and it may indeed slow the WTO accession process. ■

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IMF Asia and Pacific Department

This article is based on IMF Working Paper No. 05/94, "Regional Trade Integration and WTO Accession: Which Is the Right Sequencing? An Application to the CIS." Copies are available for $15.00 each from IMF Publication Services. Please see page 280 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Research

What changes institutions?

With one billion people in developing countries living on less than $1 a day, the elimination of extreme poverty remains high on the policy agenda of the international community. Sustained high rates of economic growth are critical to poverty reduction, and improved growth performance in many cases requires improvements in the quality of basic economic institutions such as property rights and governance, including a reduction in corruption. But what spurs institutional improvements? Can better institutions be built quickly? The September 2005 *World Economic Outlook (WEO)* takes stock of existing knowledge and identifies several factors that appear to enhance institutional quality.

Many developing countries have made considerable progress toward a stable macroeconomic environment, but another key precondition for sustained high growth and higher standards of living is good institutions. The April 2003 *WEO* estimated that if the overall quality of sub-Saharan Africa's institutions could rise to that of developing Asia's, African per capita GDP would nearly double over the long term. Improving institutions, however, can be a slow and complex process.

Change is possible

Basic economic institutions reflect rules that have been codified in law as well as informal conventions and traditions. Every country's institutions are thus the product of a complex interaction of economic and political factors, history, and culture, and are often quite persistent (see chart, this page). For example, European centrally planned economies provided only minimal protection of private ownership and lacked the innovation and dynamism of free market economies. In the postcommunist era, these countries have typically adopted western-style legal codes, but improvements in the business climate—reduced corruption, speedy court proceedings, and expeditious business registration procedures—have been slower to develop.

Despite this tendency toward institutional persistence, the experience of the past three decades suggests that rapid institutional change is possible and has, in fact, helped raise living standards in many countries. The *WEO* identified 65 cases of significant improvements in economic institutions ("transitions") since the early 1970s (see chart, page 275).

Analysis of these transitions suggests that several underlying factors may have increased the potential for institutional improvements. First, the earlier collapse of colonial systems altered institutional structures geared toward the systematic extraction of profits. Second, rapid technological improvements helped economies move away from sectors, such as natural resource mining, that are prone to rent seeking. Third, globalization has afforded new economic opportunities amid declining transportation and communication costs. And, finally, the fall of communism radically altered governance in many economies, taking away another major source of institutional persistence.

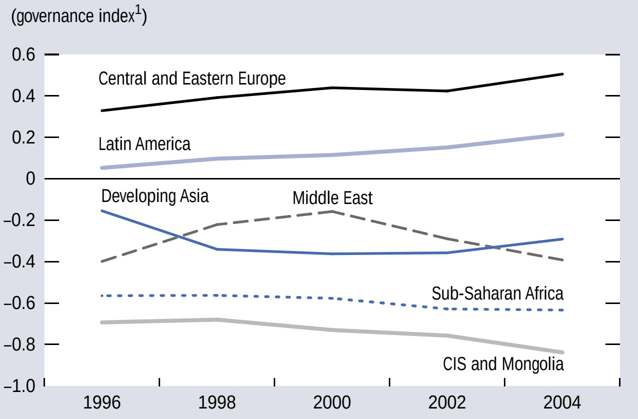
Determinants of change

Using data for 90 countries over 1970–2004, the *WEO* evaluated how various factors influence the probability of large improvements in economic institutions. Several aspects appear to increase the likelihood of such transitions:

- ***Trade openness***. A move from complete autarky to full liberalization increases the probability of institutional transition by about 15 percentage points. Greater openness creates momentum for positive institutional changes because export sectors typically require constant innovation to keep up with international competition. In addition, imports reduce the ability of domestic producers to sustain monopolistic rents, which tend to impede institutional improvement.
- ***Press freedom***. Greater accountability is typically associated with policies that benefit a country's long-term growth prospects rather than the interests of a strong few.
- ***Neighbors with higher institutional quality***. Cross-country competition and the demonstration effects of regional success stories also can spur change.

Institutional quality differs sharply across regions

Over the past decade, institutional quality slowly improved in central and eastern Europe and Latin America, but remained poor in sub-Saharan Africa and the Commonwealth of Independent States (CIS).

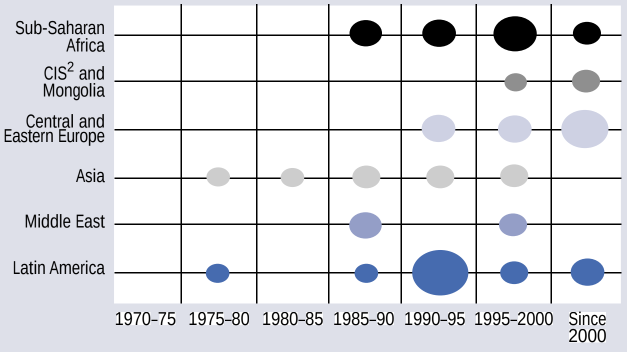


[1]Institutional quality is measured by Kaufmann, Kraay, and Mastruzzi's 2004 aggregate governance index. Regional scores are calculated as simple averages.
Data: Kaufmann, Kraay, and Mastruzzi (2004), and IMF staff calculations.

Institutions are evolving

Most of the identified 65 institutional transitions have occurred after the collapse of communism.

(economic transitions[1])



Note: The bubble size represents the number of transitions in the five-year period.
[1]Only developing economies are included, expect for Asia, which also includes any transitions in the newly industrialized economies.
[2]Commonwealth of Independent States.
Data: Gwartney and Lawson (2004), and IMF staff calculations.

• ***Higher levels of education***. This is consistent with the notion that more educated populations are more effective participants in broader decision making.

In a complementary analysis, the *WEO* examined the factors that determine institutional quality across countries and time. Unsurprisingly, many of the same factors discussed above support good institutional quality more generally. The study also found that a large natural resource sector negatively affected institutional quality in some countries—since performance of these economies is determined largely by global demand and price conditions for the commodities concerned, there were unfortunately relatively few competitive benefits from institutional improvements and innovation.

As for foreign aid, the evidence was ambiguous: in the analysis of transitions, large aid inflows were negatively correlated with the probability of transition to better institutions. However, analysis of the overall quality of economic institutions did not produce any clear-cut result. On balance, any unfavorable effects of aid seemed to be greater in countries with weak institutions. More research is needed to better understand the effects of aid, but it appears that efforts aimed at improving institutions would also improve its effectiveness.

External anchors can help

Various external anchors and international initiatives can promote improvements in institutional quality. An economy's openness, for example, supports positive institutional changes across many dimensions. Unilateral policies that reduce trade barriers as well as multilateral efforts to liberalize trade under the current Doha Round are likely to exert a strong positive effect on institutional transformation.

Other external anchors can play important roles, too. The process of European Union (EU) accession has supported institutional changes in central and eastern European countries. In nonmember countries, improvements could be stimulated through the recently launched EU Neighborhood Program. Similarly, the World Trade Organization has promoted positive institutional changes in accession candidates, notably China. In Africa, the New Partnership for Africa's Development could become, through its Peer Review Mechanism, an important platform for diagnosing institutional weaknesses, formulating country-specific recommendations, and attracting investment to countries that have successfully implemented reforms.

Furthermore, the international community has taken on an important role in promoting transparency in developing countries and has recognized that in some areas, such as corruption, developed countries also need to take corrective steps. The OECD Convention on Combating Bribery in International Business Transactions obliges its signatory countries to treat corruption of a foreign public official just as they would corruption of a national public official. The U.K. Extractive Industry Transparency Initiative encourages both governments and companies operating in natural resource– exporting countries to disclose revenues and payments, thereby improving data quality and reducing the scope for misallocation of funds.

For their part, the IMF, the World Bank, and other international agencies have supported greater transparency through a variety of means, including through their lending conditions. In Uganda, public expenditure tracking surveys helped dramatically increase the ratio of actual primary education spending to the centrally budgeted allocation. The IMF's fiscal transparency code promotes government accountability. Likewise, its transparency code for monetary and financial policies can help reduce noncompetitive practices in the financial sector.

On aid flows and their effects on institutional quality, the *WEO* analysis does not provide the definitive word. In the coming years, a number of countries are likely to see a large increase in aid flows in relation to government expenditures. Therefore, both donors and individual recipient countries need to carefully consider the potential institutional implications and try to structure aid delivery—and accompanying policy measures—to minimize risks of any adverse effects. Improving institutions can be seen as also improving the effectiveness of aid in helping to reduce poverty. ■

Martin Sommer and Angela Espiritu
IMF Research Department

Are saving and investment trends fueling global imbalances?

Global saving and investment rates have fallen, current account imbalances are at unprecedented levels, and yet real long-term interest rates in most countries remain low. What's going on? The September 2005 *World Economic Outlook (WEO)* argues that important changes in investment and saving patterns have had significant implications for global imbalances and long-term interest rates.

Global saving and investment rates are near historic lows, having dropped to under 22 percent of world GDP in 2004 from around 26 percent in the early 1970s. The recent decline appears to have been driven by global as well as country- and region-specific developments. Easily available credit and rising asset prices have lowered saving in many industrial countries, but fiscal deficits in the United States and aging populations in Japan and Europe have also been major factors. As for investment, rates have fallen noticeably in Japan, the euro area, and some emerging market regions, particularly Asia (excluding China). As a result, the industrial country share of global saving and investment has dropped to 70 percent in 2004 from about 85 percent in 1970.

These trends have had significant implications for current account imbalances across the world. In particular, with saving falling sharply in the United States, its current account deficit (the excess of investment over saving) has reached an unprecedented level—a projected 6.1 percent of GDP, or $760 billion, in 2005. Elsewhere, rising saving in China and oil-producing countries, and weaker investment in Japan and emerging Asia with the exception of China, have resulted in an excess of saving over investment (a current account surplus).

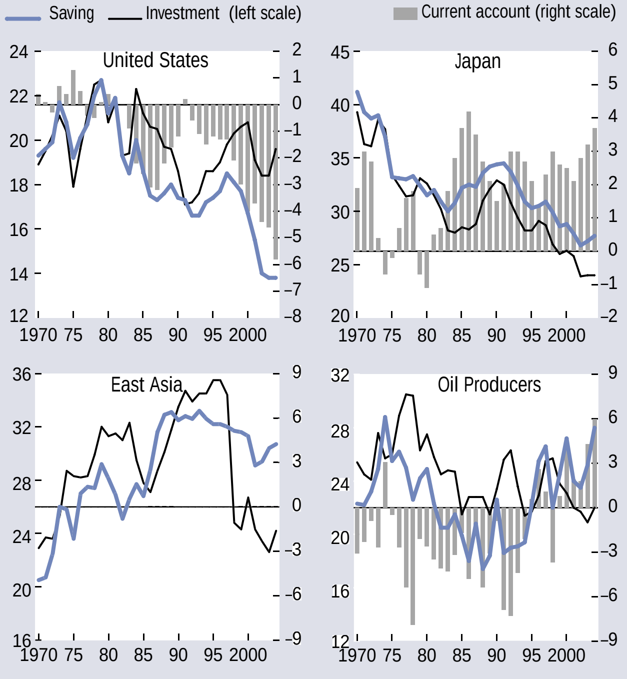
The current constellation of current account imbalances around the world, involving a large and diverse group of countries including many emerging market and oil-producing economies as well as industrial countries (see chart), stands in strong contrast to the mid-1980s, when large current account imbalances were principally concentrated in the United States, Japan, and Europe (mainly Germany). The current episode appears to be a result of a number of country-specific events rather than a single global event.

The other piece of the puzzle—persistently low real interest rates—seems to be largely the result of the unusually low investment rates for this stage of the economic cycle. Investment levels are low despite strong corporate profit growth, mainly because corporations in many countries have continued to strengthen their balance sheets by paying down debt. In emerging Asia, in particular, there is evidence that a number of countries are currently "underinvesting."

Saving and investment trends have fueled imbalances

Developments in both industrial countries and emerging market economies have contributed to the current global imbalances.

(percent of GDP)



Data: OECD Analytic Database; World Bank, *World Development Indicators*; and IMF staff calculations.

What it all means

Going forward, two important implications of these findings stand out. First, there is no "silver bullet" to address the imbalances of the large and diverse group of countries currently involved. Urgent action needs to be taken on many fronts, notably accelerated fiscal consolidation in the United States, reforms to boost growth in Japan and Europe, and measures to raise investment in Asia (including completing ongoing financial and corporate restructuring) and in oil-exporting countries.

Second, the evolution of investment will be a critical factor in determining the path of long-term interest rates going forward. A revival of global investment would almost certainly send long-term interest rates higher. ■

Marco Terrones and Roberto Cardarelli
IMF Research Department

Stand-By, EFF, and PRGF arrangements as of August 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina	September 20, 2003	September 19, 2006	8,981.00	4,810.00
Bolivia	April 2, 2003	March 31, 2006	171.50	60.00
Bulgaria	August 6, 2004	September 5, 2006	100.00	100.00
Colombia	May 2, 2005	November 2, 2006	405.00	405.00
Croatia	August 4, 2004	April 3, 2006	97.00	97.00
Dominican Republic	January 31, 2005	May 31, 2007	437.80	385.26
Macedonia, FYR	August 31, 2005	August 30, 2008	51.68	51.68
Paraguay	December 15, 2003	September 30, 2005	50.00	50.00
Peru	June 9, 2004	August 16, 2006	287.28	287.28
Romania	July 7, 2004	July 6, 2006	250.00	250.00
Turkey	May 11, 2005	May 10, 2008	6,662.04	6,106.87
Uruguay	June 8, 2005	June 7, 2008	766.25	735.60
Total			**18,259.54**	**13,338.68**
EFF				
Serbia And Montenegro	May 14, 2002	December 31, 2005	650.00	62.50
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Total			**794.40**	**186.23**
PRGF				
Albania	June 21, 2002	November 20, 2005	28.00	0.00
Armenia	May 25, 2005	May 24, 2008	23.00	19.72
Bangladesh	June 20, 2003	December 31, 2006	400.33	184.55
Benin	August 5, 2005	August 4, 2008	6.19	5.31
Burkina Faso	June 11, 2003	August 15, 2006	24.08	10.32
Burundi	January 23, 2004	January 22, 2007	69.30	28.60
Chad	February 16, 2005	February 15, 2008	25.20	21.00
Congo, Democratic Republic of	June 12, 2002	March 31, 2006	580.00	53.23
Congo, Republic of	December 6, 2004	December 5, 2007	54.99	39.27
Dominica	December 29, 2003	December 28, 2006	7.69	3.48
Georgia	June 4, 2004	June 3, 2007	98.00	56.00
Ghana	May 9, 2003	October 31, 2006	184.50	79.10
Guyana	September 20, 2002	September 12, 2006	54.55	27.79
Honduras	February 27, 2004	February 26, 2007	71.20	40.69
Kenya	November 21, 2003	November 20, 2006	225.00	150.00
Kyrgyz Republic	March 15, 2005	March 14, 2008	8.88	7.62
Mali	June 23, 2004	June 22, 2007	9.33	6.67
Malawi	August 5, 2005	August 4, 2008	38.17	32.75
Mozambique	July 6, 2004	July 5, 2007	11.36	6.50
Nepal	November 19, 2003	November 18, 2006	49.91	35.65
Nicaragua	December 13, 2002	December 12, 2005	97.50	41.78
Niger	January 31, 2005	January 30, 2008	6.58	5.64
Rwanda	August 12, 2002	February 11, 2006	4.00	1.14
São Tomé & Príncipe	August 1, 2005	July 31, 2008	2.96	2.54
Senegal	April 28, 2003	April 27, 2006	24.27	13.86
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	February 10, 2006	65.00	9.80
Tanzania	August 16, 2003	August 15, 2006	19.60	5.60
Uganda	September 13, 2002	December 31, 2005	13.50	2.00
Zambia	June 16, 2004	June 15, 2007	220.10	49.52
Total			**2,692.18**	**1,170.74**

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

Global Financial Stability Report

World markets resilient, but medium-term vulnerabilities building

The global financial system has continued to strengthen and become more resilient, according to the IMF's latest semiannual *Global Financial Stability Report (GFSR)*. This trend has again been driven by global economic expansion, together with determined corporate restructuring and cost-cutting efforts, which have led to further improvements in corporate balance sheets in most countries. On the basis of expectations of continued global growth and low inflation, and with generally benign financial markets, the report projects that the global system's resilience will further improve in the short term.

Low bond yields and flat yield curves have continued to encourage investors to move out along the credit risk spectrum in search of yield, further narrowing credit spreads including those in emerging markets. Investors have also been attracted by improving macroeconomic fundamentals in many emerging market countries, which, along with superior long-term risk-adjusted returns, have convinced institutional investors, such as pension funds, to make strategic allocations to this asset class. This, in turn, has had a stabilizing influence on emerging bond markets and has occurred in spite of occasional corrections in mature credit markets and growing political uncertainty in a number of emerging market countries with upcoming elections.

But the benign forces that have helped to underpin global economic growth and buoyant financial markets have also contributed to larger global payments imbalances and debt—particularly household debt. Thus, the recent developments that have reduced risks in the near term have increased potential vulnerabilities for the medium term, including:

Low bond yields, narrow credit spreads, and low risk premiums more generally have increased financial markets' vulnerability to corrections. These could be triggered if investors' appetite for risk declines—for example, because of a deterioration in fundamentals. If economic growth were to slow significantly, corporate balance sheets could deteriorate. Nevertheless, the resilience of the global financial system would likely weaken only gradually.

With the credit cycle likely close to its peak, the robust corporate earnings growth of the past few years is likely to slow. While current indicators are excellent, higher levels of corporate indebtedness—stemming, for example, from more active merger and acquisition activity or higher corporate dividend payments—could weaken credit quality. Indeed, a recent steepening of the U.S. credit curve—that is, an increase in spreads on longer-maturity corporate credits relative to still narrow spreads for shorter maturities—reflected market concerns about a medium-term deterioration. And the flatter yield-curve environment has reduced scope for traditional carry trades—borrowing in a low-yielding market and using the proceeds to invest in a higher-yielding one—which tends to negatively affect financial institutions' earnings outlook.

The household sector in mature markets, especially the United States, has accumulated record levels of debt. Asset price increases, mainly in the housing market, have raised households' net worth, but left the household sector increasingly exposed to the performance of asset markets. Large declines in asset prices would undermine consumer confidence and dampen personal consumption. The credit cycle in the household sector also seems to be peaking across many mature markets. U.K. personal delinquency rates have been on the rise, for example, and U.S. regulatory authorities will need to keep a watchful eye on popular but risky interest-only and negative-authorization mortgages that postpone the debt-service burden into the future.

Growing global imbalances are a serious medium-term issue. The United States has been able to finance its current account deficit easily this year, with the dollar appreciating and thanks to sufficient private capital inflows. But the danger, the report warns, is that investors' willingness to continue to finance global imbalances reduces the urgency for policymakers to take the necessary corrective actions. This raises the specter of a "snap back"—a sharp, significant reallocation of investors' asset holdings away from U.S. dollars—in the future. While the *GFSR* views the probability of this occurring soon as low, the associated costs and dislocation, if it were to occur, would be large in terms of sharp declines in the U.S. currency and hikes in U.S. interest rates—possibly with disorderly financial markets and likely depressing global economic growth.

Corrections in credit derivatives and collateralized debt obligation markets are a more likely risk than is a sharp, abrupt widening in credit spreads. These complex instruments are used in relative-value trades and tend to be used by many investors executing similar strategies. They also depend on relatively untested models and default correlation assumptions for their pricing.

Buffers in times of stress

While not seeking to downplay the seriousness of these risks and vulnerabilities, the *GFSR* argues that they need to be seen in perspective and alongside certain trends that could create "self-stabilizing" forces. Although credit spreads could—and probably will—widen, they are considered likely to do so gradually and moderately. For corporations overall, currently healthy and liquid balance sheets should serve as a "long fuse" that would delay a general credit downturn. Similarly, in mature markets' household sectors, the accumulated increase in household net worth could buffer the immediate impact of any downturn.

Aside from these more cyclical factors, two trends could also help protect against the medium-term risk of abrupt and indiscriminate reversals of capital flows. First, assets under management by institutional investors have been increasing significantly, in line with demographic changes and pension reforms over the past 15 years or so and, given the potential for further development of institutional investors in many emerging and mature markets, are expected to continue to expand. Because these large institutional investors are generally guided in their asset allocation strategies by long-term fundamentals rather than by day-to-day market noise, they will likely continue to have a stabilizing effect on financial markets. Second, the risk of contagion has been reduced in recent years by greater transparency and disclosure in financial markets, including on the part of emerging market borrowers, as well as increased sophistication of the investor base.

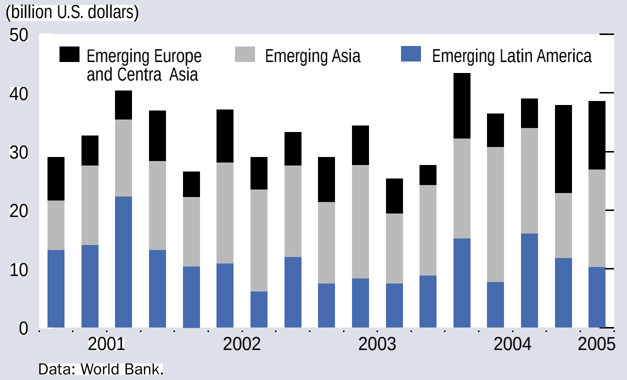
Lines of defense

Policymakers can also take a proactive approach to mitigating medium-term risks, the report points out, through ongoing risk management and market participants' vigilance in carrying out supervisory activities. National monetary authorities face the challenge of striking the right balance, while maintaining low inflation, between encouraging excessive risk-taking and overly constraining financial markets and dampening economic growth. Here, the report commends the U.S. Federal Reserve's gradual tightening of monetary policy since mid-2004 and urges its continuation.

Countering the risk of growing global imbalances, however, will require a cooperative, mutually reinforcing response from the national policymakers in the major economies, albeit with each adopting policies appropriate for its particular circumstances. Among the most critical of these needed measures are greater efforts to raise public and private savings rates in the United States; further progress in implementing key structural reforms to raise the trend growth rates in Europe and Japan; and financial sector reforms and further moves to more currency flexibility on the part of many Asian countries, following the recent welcome lead of China and Malaysia. These sorts of mutually reinforcing policy actions would go some

FDI flows to emerging markets on the rise

In the first quarter of 2005, FDI flows to emerging markets continued their upward trend, after having fallen in 2002–03.



Data: World Bank.

way toward upholding current levels of investor, business, and consumer confidence.

To guard against the future risk of nonperforming corporate loans, it will be important for national financial supervisors to ensure that lending institutions not relax their credit standards. Equally important, financial supervisors, particularly in the United States and other mature markets, will need to remain vigilant on household indebtedness.

Given the more severe risk of a correction in credit derivatives and collateralized debt obligation markets, financial supervisors must ensure that regulated institutions maintain robust counterparty risk management practices—notably guarding against any spillover effects of market corrections should they occur. In view of the complexity of these instruments and markets, financial regulators may need to upgrade their skills to carry out their functions effectively.

Financial supervisors across countries will also need to understand and anticipate the systemic implications of the evolving trends in global asset allocation, the report cautioned. The influence of private capital flows is likely to continue growing, with emerging market economies becoming increasingly important players in the competition for global capital flows (see chart). Moreover, changes in asset allocation decisions by institutional investors may have important effects on capital flows across asset classes and national borders, as well as on asset prices. For this reason, the report urges national financial authorities to develop and revise regulatory and accounting policies with an eye to preserving the diversity in investment behavior of the various financial market players, as well as the long-term orientation of major institutional investors. ■

Jacqueline Irving
IMF External Relations Department

Share of U.S. dollar reserve holdings remains steady

Total international reserves, including gold, increased by 15 percent during 2004, reaching SDR 2.7 trillion ($4 trillion) at year-end, according to the newly released IMF *2005 Annual Report* (available on the IMF's website, *www.imf.org*). Foreign exchange reserves—the largest component of official reserve holdings—grew by 18 percent, to SDR 2.4 trillion ($3.6 trillion). IMF-related assets, which make up the rest of nongold reserves, declined by 12 percent to SDR 76 billion ($113 billion), reflecting the recent decline in outstanding credit to member countries. And the market value of gold held by monetary authorities declined by 1 percent to SDR 254 billion ($377 billion) in 2004.

The report notes that the currency composition of foreign exchange reserves has changed gradually over the past decade (see table), with the share of U.S. dollar holdings rising from 60 percent in 1995 to 71 percent in 1999, and remaining broadly stable in 2000 and 2001. In 2002, the share of U.S. dollar holdings sharply declined to 67 percent, driven by the fall in value of the U.S. dollar and a reduced share of U.S. dollar assets in net purchases. The dollar share declined slightly further in 2003 before stabilizing in 2004. While official reserves held in U.S. dollars picked up strongly over these two years—accounting for more than 80 percent of the increase in official reserve holdings—this was offset by the depreciation of the U.S. dollar vis-à-vis other major currencies.

The euro, which replaced 11 European currencies on January 1, 1999, accounted for 24–25 percent of total foreign exchange reserves in 2002–04, higher than in 1999–2001. Over the past decade, the share of the Japanese yen declined from 7 percent to 4 percent; the share of the pound sterling rose slightly from around 2 percent to around 3 percent; and that of the Swiss franc remained below 1 percent.

The data in this year's *Annual Report* reflect an improved compilation methodology and other data improvements. The aggregate currency shares are calculated based on data reported by the authorities, while unallocated reserves are reported under memorandum items (see *Annual Report* for details).

Given a heightened interest in the currency composition of reserves, the IMF plans to disseminate data on a quarterly basis beginning in December 2005. ■

Currency composition of reserves

	1995	1999	2000	2001	2002	2003	2004
				(percent, end of year)[1]			
U.S. dollar	59.9	71.0	70.5	70.7	66.5	65.8	65.9
Japanese yen	6.8	6.4	6.3	5.2	4.5	4.1	3.9
Pound sterling	2.1	2.9	2.8	2.7	2.9	2.6	3.3
Swiss franc	0.3	0.2	0.3	0.3	0.4	0.2	0.2
Euro[2]	–	17.9	18.8	19.8	24.2	25.3	24.9
Deutsche mark	15.8	–	–	–	–	–	–
French franc	2.4	–	–	–	–	–	–
Netherlands guilder	0.3	–	–	–	–	–	–
Other currencies	4.8	1.6	1.4	1.2	1.4	1.9	1.8
Memorandum items							
Unallocated reserves[3]							
All countries	25.6	22.9	23.6	26.0	28.3	29.8	32.6
Industrial countries	1.0	1.1	0.3	0.3	0.3	0.2	0.3
Developing countries	47.6	37.8	39.4	42.1	45.0	47.2	50.2

Note: Components may not sum to total because of rounding. Country coverage changes marginally every year, but the changes were larger than usual in 1996 (broader coverage) and in 2000 (narrower coverage). The data for 2004 are preliminary.
[1]The currency shares are calculated for the reserves of member countries that report the currency composition of their foreign exchange reserves. The data include minimal estimation undertaken mainly for late reporters. Reserves for which currency composition is not reported are shown under "Unallocated reserves."
[2]Not comparable with the combined share of euro legacy currencies in previous years because it excludes the euros received by euro area members when their previous holdings of other euro area members' legacy currencies were converted into euros on January 1, 1999.
[3]Foreign exchange reserves whose currency composition information is not submitted to the IMF, in percent of total official holdings of reserves.

Data: IMF, *International Financial Statistics*.

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