

## De Rato nominates new Deputy Managing Director

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IMF Managing Director Rodrigo de Rato nominated a former Executive Director from Brazil, Murilo Portugal, to replace Agustín Carstens as a Deputy Managing Director. Portugal, who until recently was a deputy minister of finance in Brazil, said he hopes his government experience and his seven years as an IMF Executive Director will help him “engage the Fund even more effectively with its entire membership.” Carstens resigned to join the transition team of Mexican President-elect Felipe Calderon.



Stephen Jaffer/IMF

## Indonesia repays IMF debt four years early

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Because of its recent good economic performance, Indonesia was able to pay back in October the remaining \$3.2 billion of the \$11.1 billion it borrowed from the IMF during the Asian financial crisis that began in the late 1990s. Indonesia, along with Korea and Thailand, was among the Asian countries hardest hit by the crisis. Indonesia had been scheduled to make its final payment in 2010.



Jewel Samad/AFP/Getty Images

## Flexicurity: Danish for all?

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A new buzzword is gaining popularity—*flexicurity*. It’s derived from the Danish social model that combines flexibility to hire and fire with a strong safety net and programs to help unemployed people find new jobs. This unique mix has brought down unemployment to a 30-year low and is being studied closely by other European countries. But IMF staff caution that while flexicurity may help reduce unemployment, it could be costly to implement in other countries.

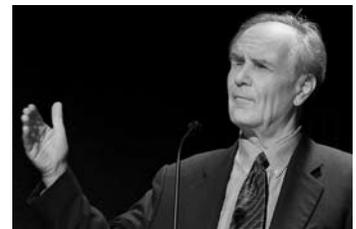


Index Stock Imagery

## What gets measured gets done

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Competition among countries and comparative data are spurring reform. A recent Cato Institute event featured two publications that assess the quality of business environments and rank country performance. James Gwartney (see photo) and Simeon Djankov—coauthors of, respectively, *Economic Freedom of the World* and *Doing Business*—presented the most recent findings and highlighted progress in many African countries.



Eugene Salazar/IMF

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## NOVEMBER

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

**6–7** Organization for Economic Cooperation and Development Policy Dialogue with Nonmembers on Aid for Trade: From Policy to Practice, Doha, Qatar

**9–10** Jacques Polak 7th Annual Research Conference, IMF, Washington, D.C., United States

**10** IMF Economic Forum, How Does Capital Account Liberalization Affect Economic Growth? IMF, Washington, D.C., United States

### 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](http://www.imf.org/external/np/sec/bc/eng/index.asp).

**11–15** Energy Future in an Interdependent World, 20th World Energy Congress, World Energy Council, Rome, Italy

**13–14** 2nd International Conference on Migrant Remittances: Remittances and Access to Finance, World Bank and U.K. Department for International Development, London [see [www.financelearning.org/remittances2006](http://www.financelearning.org/remittances2006)]

**15** IMF Book Forum, *Handbook on Fiscal Federalism*, IMF, Washington, D.C., United States

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

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

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

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

## DECEMBER

**7–8** 1st Meeting of the Organization for Economic Cooperation and Development Forum on African Public Debt Management, Amsterdam, Netherlands

**14** 143rd (Extraordinary) Meeting of the Organization for Economic Cooperation and Development Conference, Abuja, Nigeria

## JANUARY 2007

**5–7** Annual Meeting, American Economic Association, Chicago, Illinois, United States

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

### New Perspectives on Financial Globalization Call for Papers IMF, Washington, D.C., April 26–27, 2007

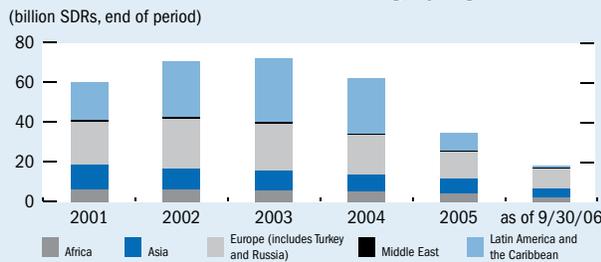
The conference, sponsored by the IMF's Research Department and Cornell University, aims to provide a forum to present recent theoretical and empirical research on the macroeconomic implications of financial globalization.

Interested authors should submit either a draft of the paper or a detailed abstract by December 1, 2006, to [globconf@imf.org](mailto:globconf@imf.org).

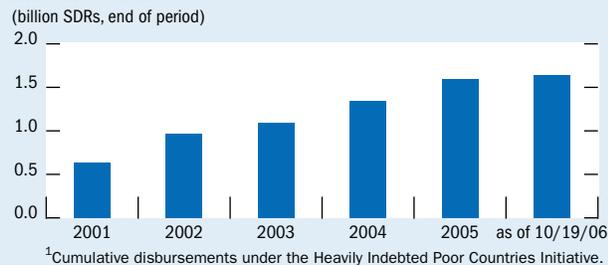
For details, see [www.imf.org/external/np/seminars/eng/2007/finglo/042607.htm](http://www.imf.org/external/np/seminars/eng/2007/finglo/042607.htm).

## IMF financial data

### Total IMF credit and loans outstanding, by region



### HIPC debt relief<sup>1</sup>



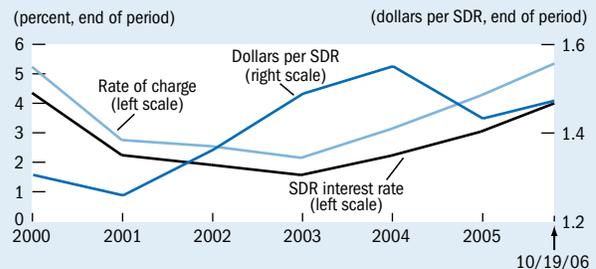
Note: Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also

### Major currencies, rates per SDR

	October 16, 2006	Year ago (October 14, 2005)
Euro	1.172	1.202
Japanese yen	175.706	165.255
U.K. pound	0.789	0.824
U.S. dollar	1.467	1.443

### Related rates

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



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.

## Brazil's Murilo Portugal set to replace Carstens

**M**urilo Portugal has been nominated to succeed Agustín Carstens as a Deputy Managing Director of the IMF. In announcing the proposed appointment, Managing Director Rodrigo de Rato said Portugal, until recently the deputy minister of finance in Brazil, "is ideally qualified to succeed" Carstens, who resigned October 16 to join the transition team of Mexico's President-elect Felipe Calderon.

De Rato said that Portugal, 58, "possesses economic skills and rich experience in the government of a major emerging market economy and, in addition, knows the Fund extremely well, having served as an Executive Director for seven years" between 1998 and 2005. He also was an Executive Director of the World Bank Group between 1996 and 2000.

In accepting the proposed appointment, Portugal said he was delighted at "the prospect of coming back to work at the Fund, an institution with a superb staff and a fine tradition of consensus building. I regard this as a rare opportunity to serve the IMF's 184 country members at a time of great importance for the Fund as it implements its Medium-Term Strategy." He said he hoped his experience as a member of the Executive Board for seven years and as a policymaker in Brazil would allow him "to engage the Fund even more effectively with its entire membership."

Portugal, who has degrees in both law and economics, was educated at Universidade Federal Fluminense in Rio de



De Rato greets Murilo Portugal (right) during a visit to Brazil earlier this year. Portugal was an Executive Director at the IMF during 1998–2005.

Janeiro and at the universities of Cambridge and Manchester in the United Kingdom. He has held a number of senior positions in the Brazilian government. He has been Secretary of the National Treasury, and a member of the board of Banco do Brasil, as well as serving in important posts in the Office of the President and at the Finance and Planning Ministries.

Before nominating Portugal, de Rato consulted with the IMF's Executive Board about the qualities needed for the post. The Board, which must approve the appointment, is expected to take up Portugal's nomination in the coming days. ■

## Carstens leaves to take transition post in Mexico

**A**gustín Carstens resigned as IMF Deputy Managing Director on October 16 to join the transition team of Felipe Calderon, the President-elect of Mexico, who is scheduled to take office on December 1.

Managing Director Rodrigo de Rato said that Carstens, who was Deputy Secretary of Finance in Mexico before joining the IMF's management team in 2003, has made an important contribution to the Fund. De Rato said that Carstens was a "driving force" for "making our technical assistance work more effective. He clearly understood that good policy in surveillance and lending programs needed to be backed up by providing robust technical assistance to strengthen institutional frameworks."

De Rato also said that Carstens was a "tireless advocate for keeping in close contact with our membership" and was



Carstens championed IMF technical assistance.

a "superb ambassador for the Fund who carried high credibility with policymakers." De Rato credited Carstens with having strengthened the IMF's work on financial sector issues, noting that he "has consistently brought to the attention of the international community the importance of well-functioning financial systems. He has emphasized both the economic and fiscal costs of bank failures and the importance of financial systems in promoting growth and development."

In addition to serving as Deputy Secretary of Finance, Carstens held a number of positions at Mexico's central bank, Banco de Mexico, and in 1999–2000 was an IMF Executive Director.

In a statement, Carstens, 48, said he had intended to stay at the Fund for five years. "It is, therefore, with great regret that I have to say goodbye today in order to work in the service of my country." ■

## IMF declares the Kyrgyz Republic eligible for debt relief

The Kyrgyz Republic has been declared eligible for assistance under the joint IMF–World Bank enhanced Heavily Indebted Poor Countries (HIPC) Initiative, the IMF announced. In February 2005, the IMF approved a loan of about \$13 million under its Poverty Reduction and Growth Facility (PRGF) to support the Central Asian country’s economic program. The Kyrgyz Republic, with a population of 5.3 million, is eligible for 100 percent grant funding under the World Bank’s International Development Association (IDA) for FY06/07.

Making the announcement on October 13, Agustín Carstens, then Deputy Managing Director of the IMF, said “Executive Directors agreed that the Kyrgyz Republic is eligible for debt relief under the enhanced HIPC Initiative based on its heavy external debt burden—even after application of traditional debt relief mechanisms—and its status as a PRGF-eligible and IDA-only country.” Its external debt, as of end-2004, exceeded the sustainability thresholds established under the HIPC Initiative.

The prospective debt relief is expected to create fiscal space to allow the Kyrgyz Republic to further reduce poverty over the coming years and to achieve the Millennium Development Goals, especially by boosting social spending and high-quality public investment. The IMF has already approved debt reduction packages for 29 countries, 25 of them in Africa.

Despite a difficult political environment, the Kyrgyz authorities are preserving macroeconomic stability and pressing ahead with reforms, which the IMF sees as essential for creating a stronger foundation for improving living standards and significantly reducing poverty in a low-inflation environment. Growth in the Kyrgyz Republic is projected

at 4–5 percent in 2006, recovering from a small output contraction last year.

### Central Asia’s outlook

In the Central Asian region (Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan), growth this year is expected to average about 8 percent, said David Owen of the IMF’s Middle East and Central Asia Department, presenting the findings of the IMF’s latest regional economic outlook on October 16 in Almaty, Kazakhstan. Macroeconomic performance for the region remains very good, although the report highlights the need for policies to guard against rising inflation and excessive borrowing. “This will be the seventh year in a row of growth at this pace or higher—a sustained strong performance that has nearly doubled the region’s GDP in real terms over the past decade,” Owen said.

Growth in the region is set to remain high in 2007, at 7–8 percent, on average, and inflation is expected to ease slightly. But there are still risks to the outlook. In particular, the region is heavily dependent on oil and other commodities whose prices are volatile. Performance could also deteriorate if global growth were to slow or global financial market conditions were to tighten, which could significantly reduce external flows into the region.

According to the report, the four countries’ progress in building reserves and reducing debt has improved the region’s position, but they should continue to pursue policies that will make them more resilient. For example, they could limit inflationary pressure by tightening monetary policies and allowing more nominal exchange rate appreciation in response to continued foreign inflows.

Governments in the region need to be vigilant about the risk of a new cycle of excessive external borrowing, either public or private. Kazakhstan may need to adopt tighter prudential measures to limit banks’ external borrowing, which is financing rapid credit growth. The Kyrgyz Republic and Tajikistan need to avoid accumulating excessive debt while they invest to improve infrastructure.

Adjustment to higher oil prices remains a challenge. Both oil producers and consumers should quickly pass through changes in world oil prices to domestic product prices and cushion the effect of this adjustment on the poor. Structural and institutional reforms to foster private sector development, increase productivity, and boost countries’ resilience will continue to be necessary. Finally, the report says that increased regional cooperation would promote trade and investment and improve prospects for long-term growth and poverty reduction. ■



Marking the first anniversary of the so-called tulip revolution in the Kyrgyz Republic, riders fight for the body of a goat as they take part in Kok-Boru, the national game.

## Indonesia repays its IMF obligations early

Indonesia's strong economic recovery has enabled it to repay four years early the remaining \$3.2 billion of the \$11.1 billion it borrowed from the IMF in the years after the Asian financial crisis of the late 1990s.

John Lipsky, First Deputy Managing Director of the IMF, said in a statement that Indonesia's ability to repay well ahead of schedule "reflects the strength of Indonesia's economic recovery and its strong balance of payments position." He praised the nation's economic achievements over the past several years.

Indonesia, a country of 225 million, is the last of the three hardest-hit Asian nations—Korea and Thailand being the other two—to repay the borrowings made to support their economies during the crisis. Both Korea and Thailand had repaid their IMF loans by the end of 2003. Indonesia was not scheduled to make its final loan payment until the end of 2010. It repaid about \$3.7 billion last July.

In the IMF's most recent review of the Indonesian economy in July, Executive Directors noted the country's "considerable



A money exchange employee checks dollar and rupiah bank notes for a customer in Jakarta.

achievements since the crisis" and said that it has "continued to make steady economic progress" despite recent severe earthquakes and tsunamis. In particular, Directors noted a return to a precrisis level of real GDP, a declining trend of public debt, and improved creditworthiness. ■

## Saudi Arabia pursues domestic growth and oil market stability

Saudi Arabia is successfully keeping inflation very low despite large surpluses earned from high oil prices. Its external current account surplus is projected to reach 31.3 percent of GDP in 2006, and the central government surplus, 17.2 percent of GDP. Part of the fiscal surplus will be used to pay down the central government debt, which is projected to decline to 17 percent of GDP. The country's growth prospects for 2006 are very favorable in light of the expected sustained increase in global demand for oil, said the IMF in its annual review of the economy.

Steady implementation of structural reforms has improved the investment climate and paved the way for Saudi Arabia's accession to the World Trade Organization in 2005. Privatization is advancing, and numerous mega projects in the non-oil sector are being implemented through public-private partnerships.

IMF Executive Directors encouraged the authorities to sustain the pace of structural reforms and the expansion of the non-oil economy to further increase employment opportunities for the growing Saudi Arabian labor force. This will involve effective use of the growing oil revenues to further promote private sector growth by increasing spending in areas where social and private returns are high.

Directors commended the authorities' support of oil market stability by increasing oil production and implementing an ambitious investment plan to expand production and refining

Saudi Arabia	Prel. 2004	Est. 2005	Proj. 2006	Proj. 2007
	(percent change)			
Real GDP	5.3	6.6	4.7	6.5
Real oil GDP	6.7	5.9	-1.6	4.2
Real non-oil GDP	4.6	6.8	6.8	7.6
Consumer prices (end of period)	0.4	0.7	1.0	1.0
	(billion dollars)			
Current account balance	52.0	90.8	98.1	82.1
Gross official reserves	87.9	153.2	166.8	188.1

Data: Saudi Arabian authorities and IMF staff estimates and projections.

capacity. They encouraged the country's growth-promoting initiatives, noting that these are helping to moderate global current account imbalances. They also welcomed the plan to further increase resources for social sector and infrastructure priorities while emphasizing the importance of efficient resource use. The authorities' use of oil revenues to increase spending while using the fiscal surplus to reduce public debt will strengthen private sector confidence, the Directors said.

They expressed approval of sound financial sector policies and encouraged efforts to further deepen the capital market. They welcomed the authorities' decision to participate in the IMF's General Data Dissemination System and encouraged Saudi Arabia, with Fund technical assistance, to address statistical weaknesses. ■

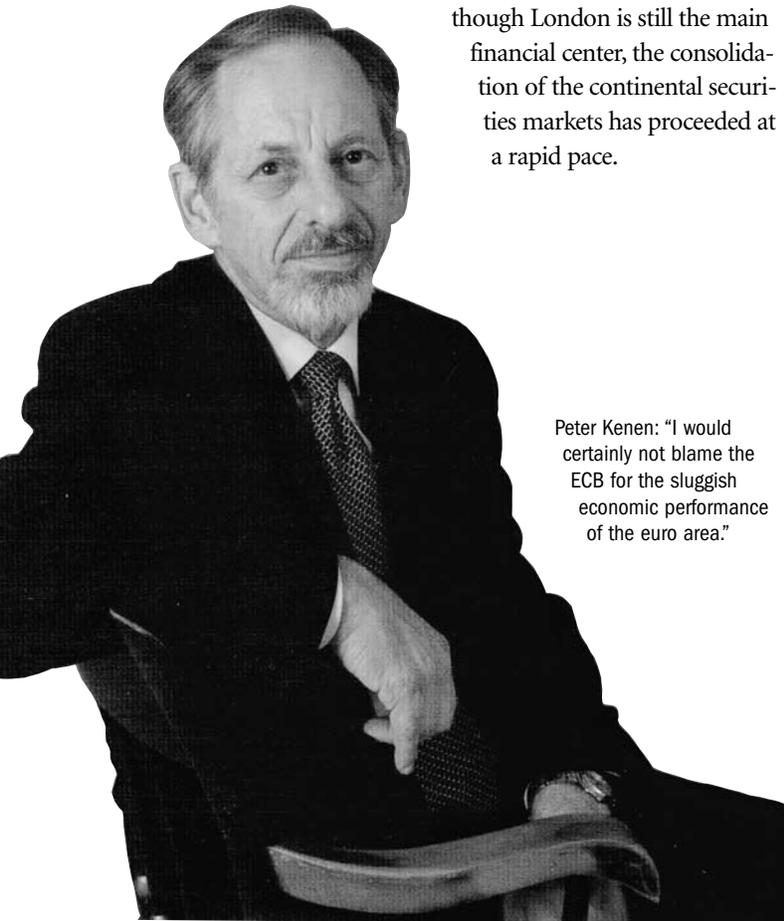
For more information, please refer to IMF Public Information Notice No. 06/108 (Saudi Arabia) on the IMF's website ([www.imf.org](http://www.imf.org)).

### Seven years on: Assessing Europe's central bank

**A**fter five years of almost no growth, the euro area is finally enjoying an economic recovery. But the European Central Bank (ECB), which sets interest rates for the euro area's 12 member states and whose policies are shadowed by many other European Union (EU) countries outside of the monetary union, is worried about inflationary pressures. It has embarked on a tightening of monetary policy, which has led some policymakers to complain that it risks choking off the recovery. Camilla Andersen spoke to Peter Kenen, Senior Fellow at the Council of Foreign Relations, about the role of the ECB.

**IMF SURVEY:** Has the euro been successful?

**KENEN:** The euro is the second most important currency in the world today. For a young institution to have achieved that is a major accomplishment. There is also evidence that the euro has stimulated trade, although on a more modest scale than some of my colleagues, for instance Andrew Rose, had originally predicted. And it has enormously stimulated the growth of European capital markets—to the extent that we are now seeing the unification of European stock markets. Even though London is still the main financial center, the consolidation of the continental securities markets has proceeded at a rapid pace.



Peter Kenen: "I would certainly not blame the ECB for the sluggish economic performance of the euro area."

Pryde Brown Photographs

**IMF SURVEY:** Inflation in the euro area has generally been low. But for the past few years, the ECB has not been able to completely meet its own target of keeping inflation "close to but below 2 percent." What does that say about the ECB?

**KENEN:** That is a difficult question to answer because inflation rates have been falling all over the world since the ECB began operating in 1999. The ECB's track record is good, but not much better than that of the other major central banks, the Bank of England and the U.S. Federal Reserve. As you probably know, its inflation target has been widely criticized. Most central banks have a single target surrounded by an acceptable band of 1 percent on either side. In contrast, the ECB does not have a range around its target. That has put the institution under unnecessary pressure. If the target had been set at 2 percent with a margin on either side, it would have been well within its target most of the time. Instead, it has missed its own target over and over again.

**IMF SURVEY:** Is the target too ambitious?

**KENEN:** The target may be somewhat low, particularly since we don't know how much below 2 percent the ECB wants the inflation rate to be. Putting aside for a moment the problems faced by those EU member states that would like to join the euro area, the original 12 members of the euro area lucked out in that some of the higher-inflation countries did not weigh heavily in the ECB's aggregates. While Italy is a decidedly different case, the two biggest countries, France and Germany, have experienced a decline in their inflation rates, and this set the tone for the entire euro area. That has made the ECB's job a lot easier than if the faster-growing accession countries had joined monetary union from the beginning.

**IMF SURVEY:** What about the ECB's accountability?

**KENEN:** Virtually all central banks are in some way subject to government oversight. That's certainly true of the Bank of England, whose governor must write a letter to the chancellor if inflation exceeds 3 percent. In the United States, the chairman of the U.S. Federal Reserve spends a good deal of his time testifying before congressional committees. There is no comparable intergovernmental oversight of the ECB, and it is more independent than any other central bank in two ways. First, while the European parliament does hold hearings and has established a committee to oversee monetary policy, it has no power over the ECB. Second, there is only one way of changing the mandate of the ECB, and that is to amend the Treaty of Maastricht—something that requires the unanimous approval of every EU country. So in a way, the ECB is

the most independent central bank in the world, which leads to a strong and effective executive board and a good deal of autonomy.

**IMF SURVEY:** How influential are the 12 national central bank governors?

**KENEN:** Outsiders have no way of knowing to what extent the debate in the ECB's governing council focuses on the euro area or on individual countries. But the whole point about monetary union was that the ECB would look at euro area aggregates, not at national performance. National central bank governors participate in the ECB's council meetings to debate the performance of the whole economy of the euro area, just as the regional bank governors in the United States debate the entire U.S. economy when they meet at the Federal Reserve. The president of the Fed bank in Dallas does not pound the table and say "things are going awry in Texas," at least not to my knowledge! I would credit Wim Duisenberg, the first president of the ECB, and also Otmar Issing, the bank's first chief economist, for establishing a similar principle at the ECB.

**IMF SURVEY:** How does the ECB's credibility as a central bank compare with that of the U.S. Federal Reserve?

**KENEN:** I would think that the Fed enjoys greater credibility, although I would measure the difference in inches rather than

miles. The ECB has done very well in establishing itself. It is highly regarded by most central banks and most monetary economists. The inflation targeters, such as my colleague Lars Svensson, would say it should have a symmetrical target (a target with a margin on each side), and I agree. But overall the performance has been pretty good, and I would certainly not blame the ECB for the sluggish economic performance of the euro area. Much of the debate in Europe right now is about why the sustainable growth rate is so low. And that is a reflection of real, not monetary, factors.

**IMF SURVEY:** Is the ECB to blame for the lack of growth in the euro area?

**KENEN:** No. The forces that slowed down the European economy are caused by the structural features people talk about so much and by the fact that much of the recovery has been export-based. Until recently at least, investment had not picked up and consumer spending was slow, and I don't think that is the influence of monetary policy.

**IMF SURVEY:** Do poor performers, such as Italy and Portugal, threaten the viability of monetary union?

**KENEN:** Let's take the extreme case. What is the probability that Italy will withdraw? This has been discussed by some less responsible politicians in Italy from time to time. The answer to that is twofold. The first problem is that you cannot legally withdraw. ECB membership is an obligation of EU membership, except for those countries that have not qualified or have opt-outs, like Britain and Denmark. The second problem has to do with international law. If a country chooses to introduce a new currency and redenominate its debt, that is its legal right. The trouble is that the euro is not Italy's own currency. It is a European currency. And debt denominated in euros is not something that is uniquely Italian. If Italy were to withdraw, the new Italian currency would depreciate, thereby increasing the debt burden. But there is also the possibility that if I was holding euro-denominated bonds, in Italy and under Italian law, I might still have the right to go to the European court and say I am entitled to be paid in euros. This would increase the debt burden even more. So withdrawal is a very remote possibility and fraught with all kinds of dangers.

What Italy does face is what Germany faced in the early years of monetary union. Germany came in with an overvalued exchange rate and experienced a long period of stagnation partly for that reason. Italy now faces an overvalued currency, and this is going to mean a period of austerity until the Italians can bring their wage costs down. That is one reason why there is a certain dissatisfaction in Italy right now. It is going to be a painful process. Spain is another country with similar problems. ■

### The European Central Bank explained

The European Union has 25 member states, but only 12 countries have so far adopted the euro. These countries—Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain—form the euro area, also known as the eurozone or euroland.

The European Central Bank (ECB) conducts monetary policy on behalf of the euro area countries. But it does not act alone. As part of the eurosystem, it works together with the national central banks of the 12 euro area countries.

The ECB executive board and the ECB council are the two decision-making bodies of the eurosystem. Both are chaired by the president of the ECB, currently Jean-Claude Trichet of France. The executive board consists of six members who are appointed for a nonrenewable eight-year term of office. The council, which meets twice a month, is composed of the six members of the board and the governors of the euro area's 12 central banks. The council makes decisions about interest rates on the basis of simple majority voting (each member has one vote). The board is entrusted with implementing the policies decided by the council and conducts the daily business of the ECB.

## Danish flexicurity model holds lessons for rest of Europe

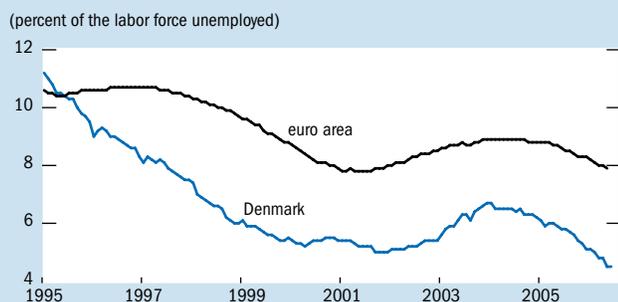
The Danish labor market model has been dubbed “flexicurity” for its ability to deliver simultaneously labor market flexibility and social security. Employers are free to hire and fire, which has encouraged them to employ a record number of people. In return, workers are entitled to generous social security benefits if they lose their jobs. At the same time, active labor market policies ensure that no person remains unemployed for more than six months at a time before being offered a new job or training. This unique mix has reduced unemployment in Denmark to a 30-year low and has helped make its economy one of the strongest in Europe. Could the Danish model work in other European countries? Paul Hilbers and Jianping Zhou of the IMF’s European Department have analyzed the Danish flexicurity model and find that it can help reduce unemployment, but is costly to implement and therefore not automatically applicable elsewhere.

Denmark’s economy has been shining recently. Economic growth averaged slightly above 3 percent in 2005 and the first half of 2006, and unemployment fell to 4.4 percent this summer (see Chart 1). In contrast, most other European countries continue to suffer from chronically high unemployment. Reforms that would help labor markets perform better in the long run and create more jobs encounter strong political opposition from workers and unions, who fear that their rights will be eroded. Because the Danish model has managed to achieve buy-in from all partners in the labor market and has enjoyed obvious success, it has caught the attention of policymakers elsewhere in Europe. At recent summits discussing the Lisbon Agenda (the European Union’s blueprint for improving competitiveness), the European Commission has encouraged member states to pursue reforms based on the flexicurity model.

Chart 1

### Putting people to work

Denmark has outperformed the euro area in reducing unemployment.



Data: Eurostat.

The model (see Chart 2) combines three key elements:

- **Labor market flexibility.** Measured by how restrictive employment protection legislation is, the Danish labor market is more flexible than that in many other European countries. In practice, this means that Danish employers, both in the public and private sectors, can lay off workers rather easily. This is not a novel aspect of the Danish social system—protection against dismissal has historically been low, a feature that has been linked to the country’s openness and its many small and medium-sized enterprises.

- **An extensive social safety net.** Danes enjoy a high level of social protection, including generous unemployment benefits. The average net replacement rate (what people receive from the state when they lose their jobs, calculated as a percentage of their salary) is about 80 percent, among the highest in Europe.

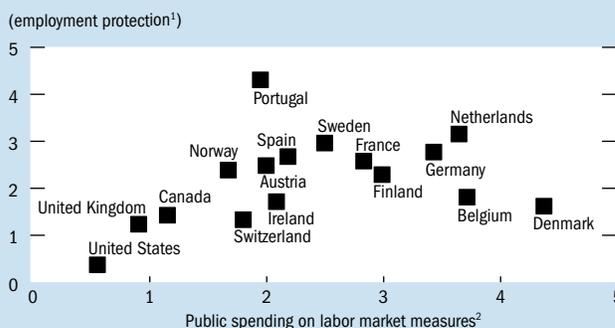
- **Active labor market policies.** A large variety of labor market programs facilitate and encourage reintegration of the unemployed into the labor market. But these programs are expensive. As a result, Denmark is at the top in terms of its per capita spending on labor market programs.

Each element of the Danish model has a different effect on unemployment. On the positive side, the flexibility enjoyed by employers helps reduce structural unemployment by improving labor market dynamics. Active labor market policies also contribute to lowering structural unemployment, although this is partly due to a well-recognized statistical phenomenon: participants in labor market programs are considered to be employed. On the negative side, generous unemploy-

Chart 2

### The flexicurity model

Denmark combines flexibility for employers with a strong social safety net.



<sup>1</sup>Organization for Economic Cooperation and Development (OECD) index on employment protection legislation for regular jobs (2003). Higher numbers indicate more restrictions on hiring and firing.

<sup>2</sup>In percent of GDP; includes both active and passive labor market measures. Data: OECD.

ment benefits increase structural unemployment by reducing incentives to work and by raising reservation wages (the wage at which unemployed people are willing to work). Similarly, the tax wedge on labor income that is necessary to finance labor market programs and welfare benefits raises unemployment through its negative effect on labor demand and labor supply. On the whole, however, the positives outweigh the negatives. The reduction in unemployment in Denmark since the early 1990s that can be attributed to flexibility and labor market programs appears to have more than offset the negative impact of the high labor taxes on employment.

### Exporting flexicurity

Should other European countries seek to emulate Denmark? The answer is not obvious. First, Denmark has traditionally combined a flexible labor market with a high level of income protection. But the results have not always been good. In the early 1980s, Denmark experienced high and rising unemployment and inflation, chronic current account deficits, and mounting public deficits. Only after unemployment benefits and labor market policies were tightened did unemployment come down.

Furthermore, other countries in Europe have been able to lower their high unemployment rates with rather different

### Bad memories drive economic reform

The Danish economy has undergone major changes over the past two decades. In the early 1980s, the economy suffered from chronically high inflation and unemployment, unsustainable budget deficits, and large current account deficits. A macroeconomic stabilization program was adopted in the mid-1980s, followed by structural reforms in the 1990s.

Memories of bad times and the payoffs of reforms have cemented a strong nationwide consensus on the need for prudent economic policies. As a result, economic performance has been much more favorable since then. Significant growth during the late 1990s was sustained through labor market reforms that reduced structural unemployment. Fiscal consolidation and the buoyant economy turned large fiscal deficits into sizable surpluses, and the public debt-to-GDP ratio fell sharply. As Denmark registered current account surpluses, the foreign debt position improved markedly.

Since 2001, Denmark has given higher priority to fiscal consolidation and increasing the labor supply. Key objectives of the current coalition government include making public finances sustainable in the long term and increasing the labor supply so that Denmark can tackle the pressures arising from an aging population. In this context, the recent welfare agreement, which includes key measures to push back retirement, was an important step forward in addressing these issues.

social models. For example, Sweden, which is comparable to Denmark in terms of the size of its public sector and the generosity of its welfare system, has a more rigid labor market—as measured by the level of protection against dismissal—but has achieved lower unemployment during most of the past three decades. Ireland and the United Kingdom have achieved substantial reductions in their unemployment rates by using the so-called Anglo-Saxon model, which is characterized by relatively low unemployment protection and low replacement rates.

Also, the cost of implementing the Danish model is often overlooked. The tax burden in Denmark is relatively heavy, which is necessary if the country is to finance its high spending on labor market programs and unemployment benefits (the two programs amount to about 5 percent of GDP a year). Because most countries that are tempted to adopt the Danish model typically start from a high unemployment level, a move toward the Danish model would, in the short run, trigger a sharp increase in the cost of unemployment benefits and labor market programs. This would, in turn, widen the tax wedge, which would have a negative impact on employment. Using a calibrated model for France as an example, the analysis finds that implementing the flexicurity model might be costly, and the reduction in structural unemployment during the first few years may be limited. The costs associated with flexicurity may make the model less applicable to countries with high unemployment and weak public finances.

Even so, key aspects of the Danish model may warrant consideration by other countries. The notion of a trade-off between the population's willingness to accept labor market flexibility and the presence of a well-functioning social safety net is worth looking at, as is the need to develop effective labor market policies to avoid high costs and perverse incentives. The Danish government's ongoing analysis of the challenges facing the flexicurity model, as well as its ability to respond to them with policy changes, is also noteworthy. For instance, since the economic crisis in the early 1980s, reforms have been implemented to shorten the maximum period that people can participate in labor programs (see box). The government has also tightened the eligibility criteria for unemployment benefits. Finally, the welfare agreement reached by major political parties in June 2006 included further measures to reduce the period during which unemployment benefits are offered. ■

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Copies of IMF Country Report No. 06/342, *Denmark: Selected Issues*, are available for \$15 each from IMF Publication Services. See page 324 for ordering information. The full text of the report is on [www.imf.org](http://www.imf.org).

## Burundi emerges from civil conflict to a brighter future

**D**ecades of political instability and civil conflict severely undermined Burundi's institutional and productive capacity. But today, according to a recent IMF country study, Burundi is looking to a brighter future as it works toward securing macroeconomic stability and implementing structural reforms to boost economic growth and reduce poverty.

Burundi was taking its first steps toward democracy when a coup d'état erupted in 1993. The protracted civil conflict that ensued devastated the economy (see Chart 1). As security degenerated, large numbers of people were displaced, economic activity dropped sharply, and donors reduced their financial assistance. A blockade imposed by neighboring countries in 1996 led to even more intense economic restrictions.

Between 1993 and 2005, real income per capita in Burundi dropped by almost half—to about \$110 a year—and the poverty rate reached almost 60 percent in 2001. According to the United Nations Development Program, Burundi is now one of the least developed countries in the world. By 2000, financial imbalances had widened, the external debt had become unsustainable, and the state's heavy participation in the economy had severely weakened the productive sector. Total

### Burundi at a glance

Capital: Bujumbura  
 Area: 10,740 square miles  
 Population: 7.6 million (2006)  
 GDP per capita: \$107 (2006)  
 Life expectancy: 42 years (men),  
 44 years (women)  
 Main exports: coffee, tea, sugar,  
 cotton, hides



Data: Burundi authorities and IMF staff estimates.

factor productivity declined steadily between 1993 and 2000, especially in agriculture, which accounts for roughly half of Burundi's GDP.

The poor performance of public enterprises, exacerbated by falling international commodity prices in the late 1990s, led to large financial losses, external and domestic payments arrears, and decapitalization of crucial agricultural production in crops such as coffee, which accounts for 80 percent of exports. These losses worsened Burundi's fiscal situation, even as an accumulation of nonperforming loans weakened the financial system.

### Burundi faces key challenges of boosting growth and raising social spending

A recent economic review by the IMF focused on the key challenges to launching the economy on a higher growth path and raising social spending to achieve the Millennium Development Goals. The program, supported by the IMF's Poverty Reduction and Growth Facility, was on track in 2005, although growth fell short of target, largely because of a poor coffee harvest and drought in the north. Inflation fell markedly in the second half of the year, reflecting the tightening of monetary policy and the appreciation of the nominal exchange rate.

IMF Executive Directors commended the authorities for their progress in implementing the program in 2005 in a difficult post-conflict environment. Good progress had been made in the fiscal,

monetary, and foreign exchange areas, although reforms in the productive sectors, fundamental for a sustained recovery, had been delayed. They encouraged the authorities to proceed with structural reforms that would stimulate private sector activity, improve the business climate, and reactivate the privatization agenda.

Directors welcomed Burundi's strong fiscal and buoyant revenue performances, despite import duty reductions. Public expenditure management needs to be improved, and budget execution, financial control, and public procurement practices reinforced. Governance and transparency need to be further strengthened, including through the progressive withdrawal of state intervention in the economy. Directors emphasized the need to bolster banking supervision and to pass laws to combat money laundering and reinforce central bank independence. They emphasized that Burundi would need continued access to grant financing.

Prospects for 2006 are for a rebound in growth and a further reduction in inflation. The program provides fiscal space to start addressing urgent social needs, consistent with macroeconomic stability, in part through a shift from security to social spending. Implementation of the program could help make 2006 a pivotal year in Burundi's economic turnaround. ■

Burundi	2003	2004	2005	Proj. 2006
		(percent change)		
GDP at constant prices	-1.2	4.8	0.9	6.1
Consumer price index	10.7	8.0	13.4	2.5
		(percent of GDP)		
Total expenditure and net lending	34.9	39.8	36.8	41.8
Current account balance	21.1	-25.5	-34.3	-37.9

Data: Burundi authorities and IMF staff estimates.

### Early steps to economic recovery

Building on the 2000 Arusha peace accord, Burundi began to make progress on several fronts, and a window of opportunity opened to secure macroeconomic stability and implement reforms to reduce poverty and accelerate economic growth. With improved security and renewed support from the international community, including through a disarmament, demobilization, and reintegration project launched in 2004, economic growth began to recover to an average of 2 percent in 2001–05.

The country also began to reduce its large financial imbalances and ease exchange and trade restrictions. The authorities reduced the top import tariff rate from 100 percent in 2003 to 30 percent in 2005, and the spread between the parallel and official exchange rates disappeared (see Chart 2). Reforms improved tax recovery and boosted revenue; together with rising external support, they allowed the government to spend more, particularly on basic social needs and investment.

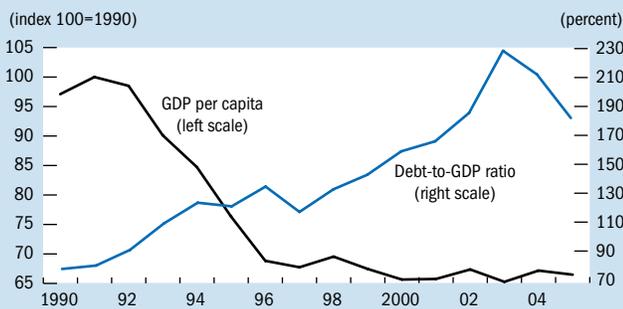
In 2005, the government also began to reduce the role of the state in the coffee sector by liberalizing trade. Its next step is to privatize the state-owned washing and hulling enterprises. The government's overriding objective is not only to increase productivity but also to create conditions for Burundi to become a niche producer of high-value mountain-grown Arabica coffee. If the reform is carried out, the production and quality of coffee could recover and even surpass previous highs. For example, had the 2005 vintage been comparable to the 1990–93 average, producers' per capita income would have been 50 percent higher.

In August 2005, a democratically elected government took office. In September 2006, the last holdout rebel group signed a peace accord with the government.

Chart 1

### Widespread devastation

Civil conflict resulted in a collapse in per capita income, and the external debt situation became unsustainable.



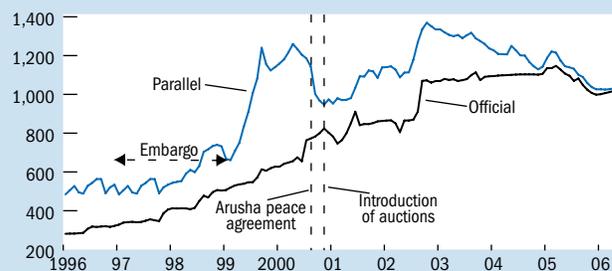
Data: Burundi authorities and IMF staff estimates.

Chart 2

### Turning a corner

Liberalization of the exchange regime and economic reforms have stabilized the exchange rate, and the parallel market has been reabsorbed.

(average exchange rate; Burundi francs per U.S. dollar)



Data: Burundi authorities and IMF staff estimates.

### Challenges ahead

Burundi is on the right path but still faces major challenges that will require sustained reform efforts. These efforts are outlined in a Poverty Reduction Strategy Paper that Burundi adopted in September 2006. The country must create a business-friendly environment to attract private investment, which will allow the private sector to drive growth. In the public sector, administrative capacity and the quality of institutions need to be strengthened with the help of the international community.

To address entrenched social problems, the government must shift the composition of budget expenditure so that more spending benefits the poor. Constraints in the agricultural sector, which employs more than 80 percent of the labor force, will also need to be tackled. Burundi has adopted a graduated approach to liberalize the state's extensive holdings, attract private investment, and boost value added.

A strengthening of public financial management is important to ensure that the government's spending is efficient and prioritized. Toward that end, in 2004–05, Burundi installed a computerized system that has improved the control, tracking, and reporting of expenditures. The next steps, with IMF technical assistance, are to expand the system to line ministries, incorporate payroll management, and integrate revenue and project spending. The authorities also plan to elaborate a medium-term expenditure framework to help them implement their poverty reduction strategy. ■

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This article is based on Country Report No. 06/307, *Burundi: Selected Issues and Statistical Appendix*. Copies are available for \$15.00 each from IMF Publication Services. Please see page 324 for ordering details.

## Helping countries cope with aid volatility

In July 2005, world leaders meeting in Scotland announced a \$50 billion increase in official development assistance to poor countries to help them achieve the Millennium Development Goals (MDGs) by 2015. This prospective surge in aid is focusing policymakers' and researchers' attention on the macroeconomic challenges associated with absorbing large aid inflows. How can aid (both official and private flows) be used as efficiently as possible so that it boosts countries' growth and helps them achieve the MDGs?

It is generally agreed that the best way to lift the poor out of poverty is to accelerate economic growth, but there is little agreement on how foreign aid affects growth. One reason may be that, in the past, aid was used in ways that did not systematically lead to an acceleration (or a deceleration) of growth, with both microeconomic and macroeconomic factors contributing to the disconnect between aid and growth. A recent IMF Working Paper examines these macroeconomic factors and explores whether there are any macroeconomic policies that could dampen the potential Dutch disease (when real exchange rate overvaluation hurts export industries and overall productivity) effects associated with large and volatile aid flows.

### Aid-growth disconnect

Although the study focuses on macroeconomic factors, microeconomic factors also impinge on aid effectiveness. But even when microeconomic distortions are minimized, countries trying to absorb large amounts of aid are likely to face substantial macroeconomic challenges. It has been argued that the systematic, adverse effects of foreign aid on the competitiveness of recipient countries' exports may explain why aid does not appear to boost growth. This argument, made by Raghuram Rajan and Arvind Subramanian in "What Undermines Aid's Impact on Growth?" (IMF Working Paper 05/126), is supported by evidence that the share of labor-intensive and tradable industries in the manufacturing sector declines as foreign aid increases. Indeed, productivity gains in tradable sectors, combined with strong performance of manufactured exports, have typically characterized virtually all cases of sustained growth since World War II. Although manufacturing exports remain feeble in many sub-Saharan African countries, the same was true of

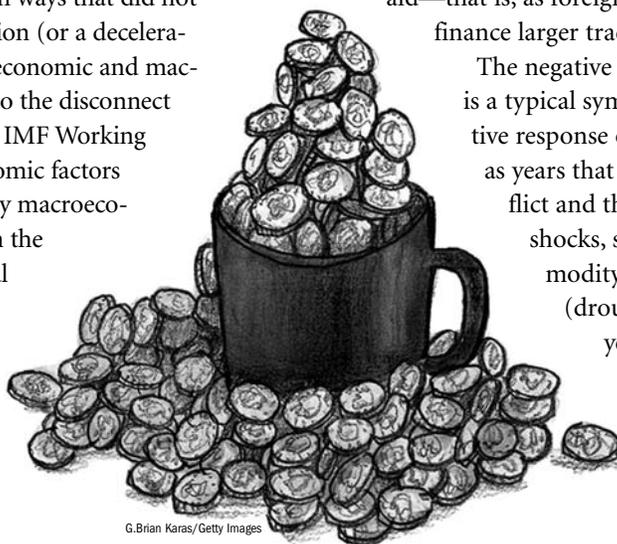
the East Asian "dragons" during the early 1960s, just before their impressive economic takeoff.

How have exports reacted to aid flows and macroeconomic policies in poor countries? The study measures typical responses, develops a theory that delivers predictions consistent with such responses, and examines the welfare implications of alternative macroeconomic policies (see box).

### Signs of Dutch disease?

The findings show that poor countries have indeed been affected by Dutch disease: foreign aid tends to cause both the trade balance and exports to deteriorate. But a lower trade balance is also consistent with a financing role of foreign aid—that is, as foreign aid rises, recipient countries can finance larger trade deficits.

The negative response of exports to foreign aid is a typical symptom of Dutch disease. This negative response occurs in "normal" years—defined as years that do not immediately follow a conflict and that are not affected by large negative shocks, such as sharp reductions in commodity export prices or natural disasters (drought, hurricanes, or earthquakes). In years marked by negative shocks—which account for 44 percent of the observations in the sample—foreign aid does not reduce exports and might even boost them. In sum, the evidence bears out the Dutch disease theory, but only for normal years, which suggests that aid may also buffer exports from negative shocks.



G. Brian Karas/Getty Images

### Macroeconomic policies can help

To gauge the effects of macroeconomic policies, the study measured changes in the central bank's net domestic assets, a variable that reflects both monetary and fiscal policies. In low-income countries, tighter macroeconomic policies improve the trade balance and are associated with stronger exports. Conversely, expansionary policies tend to harm exports (provided there are enough international reserves to finance a larger trade gap). Macroeconomic policies that are countercyclical to aid flows also appear to mitigate the volatility of the trade balance. Specifically, the trade balance in countries in which the central bank's net domestic assets fall in response to a surge in aid flows and rise when foreign aid declines is less volatile—after controlling for openness to

## Temporary monetary policies can have permanent real effects

One intriguing finding of this study is that monetary tightening has a positive effect on exports. In a standard Keynesian model, with capital mobility, flexible exchange rates, and sticky prices, the effect should be the opposite. Indeed, a monetary tightening, by raising interest rates, fuels private capital inflows, causing nominal appreciation and temporary real appreciation as prices remain sticky in the short-run. In this setting, as Paul Krugman shows in “The Narrow Moving Band, the Dutch Disease, and the Competitive Consequences of Mrs. Thatcher: Notes on Trade in the Presence of Dynamic Scale Economies” (*Journal of Development Economics*, 1987), temporary monetary policy tightening negatively affects export competitiveness by temporarily appreciating the real exchange rate.

We develop a model whose predictions are consistent with our empirical results by reversing the key assumptions of Krugman’s model. Specifically, we assume that the capital account is closed, the exchange rate is fixed, and prices are flexible. These assumptions are realistic: most low-income countries are small economies open to trade but with relatively closed capital accounts (both *de jure* and *de facto*). Moreover, the vast majority of them maintained exchange rate regimes that were either fixed or managed floats over the past decades. Finally, low-income countries

usually have large informal nontraded sectors in which prices are quite flexible.

We consider a two-sector, small open economy receiving an exogenously given flow of foreign aid, which is either consumed or invested in productivity-enhancing public goods. Examples of public goods that can enhance overall productivity in the medium term include infrastructures (such as roads, access to electricity, and sanitation), education, and health care. Moreover, as in standard models of Dutch disease, we assume that the economy grows as a result of learning by doing in the tradable (export) sector and overall productivity gains. We add to this model monetary and fiscal sectors, assuming that government bonds are the only interest-bearing financial instrument in the economy.

We show that, under these conditions, changes in the central bank’s net domestic assets affect real variables through changes in the price of nontraded goods relative to that of traded goods. A macroeconomic tightening tends to depreciate the real exchange rate by reducing aggregate demand and thus boosts exports. Our model implies that temporary monetary policy actions have permanent real effects because they modify the productive structure of the economy. Macroeconomic policies do matter.

trade, terms of trade shocks, and the fact that aid flows might respond to changes in the trade balance.

What macroeconomic policy response maximizes welfare for a given net present value of foreign aid? By reducing the net domestic assets of the central bank through a combination of fiscal and monetary actions, a country’s authorities can undo some of the money supply expansion associated with foreign aid inflows, thereby preventing real appreciation, preserving the competitiveness of the tradables sector, and raising international reserves and national savings.

A temporary tightening of net domestic assets is not always the optimal response to a surge in aid inflows. It amounts to postponing aid spending and, therefore, improves welfare only if the economy is better off saving part of its aid for later use. This happens when the current consumption benefits of aid are relatively low, and the net effect of current aid on productivity growth is small, or even negative, because of Dutch disease.

By contrast, when current consumption and productivity benefits of aid are large, tightening macroeconomic policies as aid grows would be unnecessary and, in fact, inappropriate. Years with negative shocks—for which there is no evidence that foreign aid depresses exports—epitomize this case. Macroeconomic policies could even be expansionary when donors back-load aid disbursements and the immediate

consumption and productivity benefits of aid are large. In this case, however, the limited availability of international reserves—especially when reserves are also kept for insurance purposes—could prevent recipient countries from using expansionary policies to bring forward the benefits of foreign aid.

Overall, the results suggest that macroeconomic policies can mitigate the undesired consequences of aid volatility and the risks of Dutch disease. The study argues that when aid flows are excessively front-loaded, tighter monetary and fiscal policies can improve welfare by increasing national savings and heading off Dutch disease effects. But when aid flows are too back-loaded, fiscal and monetary policies should be expansionary, although insufficient international reserves might constrain the effects of these policies.

Finally, although these findings suggest that macroeconomic policies could help shape the impact, over time, of foreign aid, they do not provide any indication that this aid might be too generous or not generous enough. ■

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Based on IMF Working Paper No. 06/145, “Aid Volatility and Dutch Disease: Is There a Role for Macroeconomic Policies?” by Alessandro Prati and Thierry Tresselt. Copies are \$15.00; see page 324 for ordering details.

## Grading central banks on their financial stability reports

Over the past decade, many central banks, especially in high- and medium-income countries, have sharpened their focus on financial sector soundness. They have highlighted this reorientation through the publication of financial stability reports, but to date, remarkably little has been done to systematically analyze these reports.

A new IMF Working Paper attempts to fill this void. In a survey of 160 documents from 47 countries, the study analyzes the structure and content of these financial stability reports, attempting to identify common trends, issues, and gaps. To assess quality, the study examines five elements of the reports: objectives; overall assessment; range of issues covered; data, assumptions, and tools used; and other features, such as structure. For each of the five elements, three basic characteristics—clarity, consistency, and coverage—are graded on a scale from 1 (noncompliant) to 4 (fully compliant).

### Room for improvement

The study finds that these reports provide useful insights into how central banks analyze financial stability, but there is room for improvement (see chart). To bolster the usefulness of these reports, the paper recommends clarifying the reports' aims, providing an operational definition of financial stability, ensuring the "core analysis" is presented consistently in time, making underlying data readily available, discussing risks and exposures in the financial system more candidly, making greater use of disaggregated data, focusing more on forward-looking indicators (rather than backward-looking descriptions), and presenting a richer set of stress tests that, among other things, includes scenarios, liquidity risks, and contagion and is comparable across time.

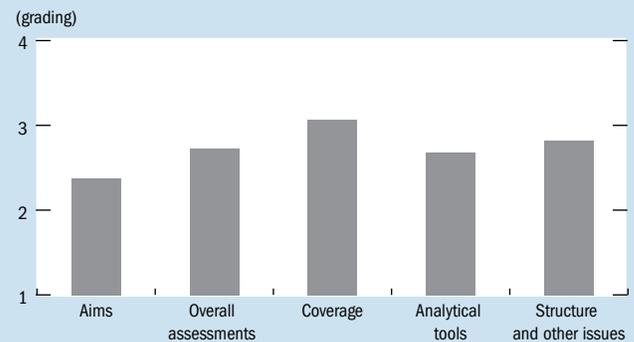
A number of factors explain the differences in the quality of the financial stability reports. Using a panel data regression, the study finds that grades improve with time, which most likely reflects the central bank's increasing experience with analyzing financial stability and presenting the results to the public. Grades are also positively correlated with economic and financial development. Interestingly, central banks that are not directly involved in day-to-day supervision have higher grades—most likely because the arm's-length distance allows these reports to be more candid.

### Implications for the IMF

The wider publication of financial stability reports also has implications for the IMF's financial sector work. With the increasing availability of these reports, more information is

### Clearer aims needed

Financial stability reports can benefit from improvements on several fronts, notably more clearly delineated goals.



Note: Grading runs from 1 (noncompliant) to 4 (fully compliant).  
Data: Author's calculations based on information from individual central banks.

on hand for the IMF and others to analyze. And where these reports play a role in the authorities' financial sector stability framework, they may need to be part of financial sector assessments (for example, in the IMF–World Bank Financial Sector Assessment Program).

For its part, the IMF's financial sector work can complement the analyses carried out by central banks, including issues involving several agencies, such as a systemic liquidity or crisis management framework; assessing compliance with international standards and codes; cross-country analysis of financial soundness indicators; and system-focused stress testing. The IMF can play a role in transferring knowledge from countries that carry out financial soundness analyses and publish reports to countries that do not yet do so.

Finally, as the scope and the quality of financial stability work by country authorities increase, the IMF's financial sector analysis will be judged against a higher standard. This may require more staff training, increased research and other analytical work, and a greater focus on the IMF's strengths and comparative advantages. ■

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This article is based on IMF Working Paper No. 06/163, "How Do Central Banks Write on Financial Stability?" by Martin Čihák. Copies are available for \$15.00 each from IMF Publication Services. Please see page 324 for ordering details. The full text is also available on [www.imf.org](http://www.imf.org).

## China and India: drawing lessons from what works

The dynamic economies of China and India, two of the fastest-growing emerging market countries and among the three largest economies in Asia, are having far-reaching effects on the global economy through, for example, their impact on world trade, their demand for energy and other commodities, and their huge accumulation of foreign currency reserves. What does the future hold? How can each continue to grow and develop in a sustainable way? And what lessons can the two countries draw from each other's experiences? A new book from the IMF, *China and India: Learning from Each Other*, attempts to address these questions.

### From a practical perspective

The book's authors—policymakers and practitioners—infuse analytical material with a strong dose of pragmatism and policy relevance. Reserve Bank of India Deputy Governor Rakesh Mohan discusses how the forces of globalization can complicate the challenges facing monetary policymakers in emerging economies such as China and India, and Governor Zhou Xiaochuan of the People's Bank of China contrasts the growth of the services sector, including financial services, in China and India and weighs the importance (and difficulties) of developing this sector in China.

The book takes a particularly close look at some of the reforms that will be needed to secure sustainable development.

**Banking sector reforms.** According to Nachiket Mor, R. Chandrasekhar, and Diviya Wah, many dimensions of India's banking sector have improved, but further reforms are needed to strengthen the financial services infrastructure, reduce the cost of intermediation, and broaden access to financial services, especially in rural areas. Nicholas Hope and Fred Hu enumerate the priorities for Chinese banking reforms and assess the role that foreign strategic investors could play in the reform process. Luo Ping compares the efficacy of the regulatory structures and reform processes in both countries and suggests that the Indian experience may provide some useful lessons for Chinese policymakers.

**Development of securities markets.** In two separate studies, G.N. Bajpai and Narendra Jadhav catalogue the development of equity, corporate debt, and government securities markets in India and discuss how policy reforms have contributed to these outcomes. In an examination of China's securities industry, Xinghai Fang, Ti Liu, and Donghui Shi argue that opening up the industry to both internal and external competition could play a crucial role in enhancing efficiency.

**Domestic financial development and international financial integration.** As Suman Bery and Kanhaiya Singh see



India has developed a well-supervised infrastructure for trading securities.

it, international financial integration has some risks, but its potential to stimulate greater financial sector development and improve macroeconomic policy discipline in India outweighs the risks. And, although capital account liberalization could play an important role in China's development, Eswar Prasad, Thomas Rumbaugh, and Qing Wang contend that undertaking further liberalization *before* allowing for greater exchange rate flexibility could pose some risks.

**Macroeconomic policies and sustainable growth.** Steven Dunaway and Annalisa Fedelino find that Chinese fiscal policy, with low levels of fiscal deficits and debt relative to GDP, has been prudent in recent years. The policy has been appropriately guided by a medium-term focus on fiscal consolidation to make room for financing contingent liabilities (including in the state-owned banking system) and rising spending pressures as the population ages. Arvinder Singh also examines the factors behind, and the implications of, labor mobility in China and India.

### Scope for economic cooperation

Finally, Arvind Virmani contends that there is significant scope for trade between India and China; he explores the main barriers to realizing this potential. Nalin Surie compares and contrasts the development models that China and India have followed, picking out some important lessons from each country's experience. The two countries, he says, face similar socio-economic challenges, and effective cooperation between these two giants could have broader benefits for the Asia-Pacific region and the global economy. ■

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Copies of *China and India: Learning from Each Other*, edited by Jahangir Aziz, Steven Dunaway, and Eswar Prasad, are available for \$35.00 each from IMF Publication Services. Please see page 324 for ordering details.

## Measuring success

The quality of business environments is drawing increasing attention from both investors and governments. A recent Cato Institute forum spotlighted two well-known reports that are helping spur reforms by ranking crucial elements in private sector environments. Simeon Djankov of the World Bank and James Gwartney of Florida State University presented the latest findings of, respectively, the joint International Finance Corporation–World Bank *Doing Business 2007* and the Fraser Institute sponsored *Economic Freedom of the World 2006*. Both draw attention to the progress being made in many African countries.

### Promoting economic freedom

In many ways, Gwartney argued, economic freedom “is as important as democracy.” *Economic Freedom of the World* seeks to measure the degree to which a country’s policies and institutions contribute to growth and prosperity. The report’s index analyzes 38 data points in five areas: size of government; legal structure and security of property rights; access to sound money; freedom to trade internationally; and regulation of credit, labor, and business. In the latest report, Hong Kong SAR retained the highest ranking for economic freedom, followed by Singapore, New Zealand, Switzerland, and the United States. The greatest progress—that is, the largest upward movement in the ranking—was made by Ghana, Israel, Uganda, Jamaica, and Hungary.

### Spurring competition

*Doing Business*, launched in 2004, ranks 175 economies on the ease of doing business. Its 2007 report focuses on regulatory reform, examining 213 reforms in over 100 economies and highlighting best practices for governments.

The philosophy behind quantitative measurements and rankings is, as one of the report’s authors observed, “what gets measured gets done.” Comparative data can both spur competition and give governments and policymakers the ability to learn from other countries and prioritize reforms. The rankings are having an effect, said Djankov. Some countries are now targeting reform efforts at laws or regulations that would



Djankov: *Doing Business* has accomplished its twin objectives of “encouraging the reformers and embarrassing those that are not reforming.”

yield an improved ranking. In this sense, he noted, *Doing Business* has accomplished its twin objectives of “encouraging the reformers and embarrassing those that are not reforming.” The 2007 report finds Singapore in its top spot, with New Zealand moving from first to second.

The desire to advance in the rankings may be one factor motivating legislative and policy reform in a number of African countries. Djankov highlighted the finding in the most recent report that Africa ranks third among the world’s regions in the pace of reform. Two-thirds of African countries made at least one reform, he said, and Tanzania and Ghana rank among the top 10 reformers worldwide.

Tanzania and Ghana, for example, have cut fees on property transfers, while speeding up customs clearance time through streamlined procedures and the introduction of new technology. Côte d’Ivoire has eliminated the requirement of obtaining ministerial approval to transfer property and has shortened the period needed to transfer property. Burkino Faso has reduced the time needed to start up a business, and Rwanda has repealed a colonial-era law that permitted only one notary public for the entire country.

Private sector development continues to face challenges in Africa, but such reforms, he said, are surely a step in the right direction for continued and sound development. ■

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