INTERNATIONAL MONETARY FUND

IMF Survey

DECEMBER 5, 2005 VOL. 34, NO. 22

www.imf.org/imfsurvey

Maghreb pursues regional economic integration

Greater economic integration among Algeria, Morocco, and Tunisia could create a regional market of more than 75 million consumers. That market's capacity to improve economic efficiency, attract more investment, and ultimately boost growth and reduce unemployment provided the backdrop for a November 21–22 trade facilitation conference in Algiers. IMF Managing Director Rodrigo de Rato joined top policymakers from the three countries to discuss ways to deepen regional cooperation.

Zineddine Belhadded/Agence Media Image

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Why countries reform

Structural reforms often play a critical role in energizing the development process and sustaining the high growth rates needed to transform countries' economic destinies. This year, in a departure from its traditional concerns with classic international monetary economics, the IMF's Jacques Polak Annual Research Conference focused on structural reforms and explored why and how countries change and what the consequences are.

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Fixing the IMF's governance

Proposals on how to better align decision making at the IMF with the needs of the 21st century abounded at an open forum organized by the IMF's Research Department. Some speakers called for less intervention by the Executive Board in the day-to-day running of the institution, while others argued the IMF could not survive without the political oversight and backing provided by the 24 Executive Directors.

IMF photo

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Lessons from China and India

China and India are fast becoming regional and global economic powerhouses. Are there lessons they can learn from each other and pointers that both can give to the rest of the world? In a sequel to a 2003 conference in Delhi, policymakers, business people, and academics gathered in Beijing to share analyses and lessons and to explore steps the two countries can take to create healthy financial sectors and sound fiscal positions, which will be needed to sustain high growth.

China Society for Finance and Banking

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What's on

NOVEMBER

28–December 9 United Nations Climate Change Conference, Montreal, Canada

DECEMBER

4–9 International Conference on HIV/AIDS and Sexually Transmitted Infections in Africa, Abuja, Nigeria

8 Japan External Trade Organization, *Asahi Shinbun*, and the World Bank, "International Symposium on Economic Integration in Asia and India: What Is the Best Way of Regional Cooperation?" Tokyo, Japan

10 Meeting of Group of Seven Finance Ministers and Central Bank Governors, London, United Kingdom

12–14 UNCTAD, Expert Meeting on Capacity Building in the Area of FDI Data Compilation and Policy Formulation in Developing Countries, Geneva, Switzerland

13–18 The 6th World Trade Organization Ministerial Conference, Hong Kong SAR

JANUARY

6–8 American Economic Association Annual Meeting, Boston, United States

25–29 World Economic Forum Annual Meeting, "Mastering Our Future," Davos, Switzerland

FEBRUARY

10–11 Group of Eight Finance Ministers' Meeting, Moscow, Russia

16–18 Global Conference on Social Responsibility, Vilamoura, Portugal

28–March 1 Joint IMF–Africa Institute high-level seminar, "Realizing the Potential for Profitable Investment in Africa," Tunis, Tunisia

APRIL

3–5 Inter-American Development Bank Annual Meeting, Belo Horizonte, Brazil

5–6 World Economic Forum on Latin America, São Paulo, Brazil

22–23 IMF–World Bank Spring Meetings, Washington, D.C., United States

MAY

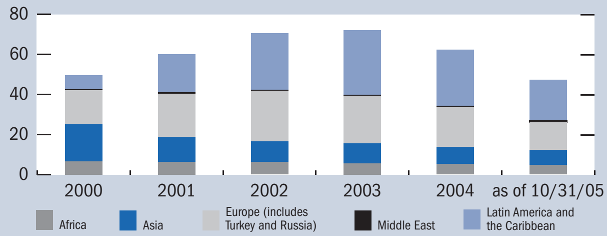
3–6 Asian Development Bank Annual Meeting, Hyderabad, India

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)

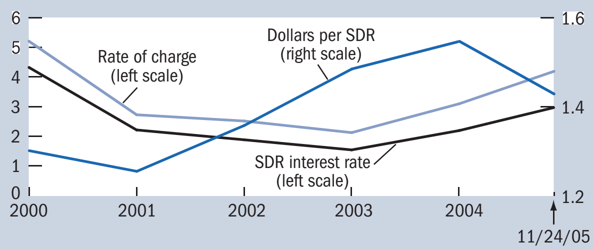


Major currencies, rates per SDR
(end of period)

	November 30, 2005	Year ago
Euro	1.210	1.155
Japanese yen	170.369	158.475
U.K. pound	0.825	0.805
U.S. dollar	1.424	1.536

IMF available resources
(one-year forward commitment capacity, billion SDRs)

Related rates
SDR interest rate, rate of charge on IMF nonconcessional loans outstanding, and dollars per SDR
(percent, end of period) (dollars per SDR, end of period)



Note 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.

Maghreb region aspires to greater economic integration

During a conference on trade facilitation in Algiers, November 21–22, IMF Managing Director Rodrigo de Rato called for greater regional economic integration among the Maghreb countries, which he said could play a crucial role in propelling economic reforms. De Rato, who joined top economic policymakers from Algeria, Morocco, and Tunisia, said greater integration—which could create a market of more than 75 million consumers—would improve economic efficiency, attract more foreign investors, and create opportunities for mutually beneficial trade within the region.

Although the three countries have made important strides toward economic prosperity in recent years, they still need to step up economic reforms that will accelerate growth and thereby reduce unemployment and poverty. Stable macroeconomic conditions and a steady pace of economic reforms have already led to a significant rise in per capita incomes. The region's increasing openness, particularly its growing economic integration with the European Union, and policies that encourage private initiative and investment have also paid off.

The objective of the conference was to advance the dialogue on strengthening regional cooperation among the three countries. Participants focused on the main obstacles to trade and agreed on a work program to promote trade within the region and with the rest of the world.


Zineddine Belhadded/Agence Media Image

IMF Managing Director Rodrigo de Rato (left) with Algeria's Minister of Finance Mourad Medelci and Central Bank Governor Mohammed Laksaci.

Working groups will report on progress made on this front at the next regional conference, which is scheduled to be held in Morocco in November 2006 and will focus on financial sector reform. A conference on private sector development is scheduled for November 2007 in Tunisia. Libya and Mauritania will be invited to take part in the working groups and in the conferences. ■

Estonia's robust economy backed by sound policies

Sound macroeconomic policies and far-reaching structural reforms have helped Estonia sustain economic growth and rapidly converge toward European Union levels in the 14 years since independence. Largely driven by domestic demand, the economy is continuing to grow robustly, the IMF said in its annual economic review. The country is meeting all of the Maastricht criteria, save for inflation, which has increased since mid-2004 and remains well above the Maastricht limit. Aiming at early euro adoption, Estonia entered the Exchange Rate Mechanism II in late June 2004, unilaterally maintaining its euro-peg currency board arrangement.

The IMF Executive Board commended Estonia's remarkable progress and considered its economic outlook generally favorable. Nevertheless, there are signs of overheating, including rapid growth in domestic credit and a large external current account deficit. The Board welcomed the authorities' intention to remain vigilant in monitoring domestic credit and to take measures should the need arise. Although inflation is not seen as a threat to competitiveness, because it is now declining and core inflation is under control, Estonia will face challenges in meeting the Maastricht inflation criterion in 2006.

Estonia	2001	2002	2003	2004	Proj. 2005
			(percent change)		
Real GDP	6.5	7.2	6.7	7.8	7.9
CPI (average)	5.8	3.6	1.3	3.0	4.0
Domestic credit to nongovernment	22.2	27.8	27.0	31.2	36.3
			(percent of GDP)		
General government balance	0.4	1.4	2.9	1.7	0.4

Data: Estonian authorities and IMF staff estimates.

Although the current account deficit does not appear to reflect eroding competitiveness, it is unsustainable over the long term. Given that fiscal policy is the only effective stabilization tool available, the Board urged fiscal restraint to contain domestic demand and reduce the external imbalance.

The Board also called for continued efforts to maintain product market and wage flexibility to safeguard competitiveness and welcomed Estonia's planned reforms to increase competition in the electricity and telecommunications sectors. ■

France can bolster growth through fiscal restraint, further reforms

The cyclical recovery of the French economy was interrupted in the first half of 2005 as previously strong domestic demand faltered and the external sector continued to exert a drag on growth, the IMF said in its annual economic review. Because growth in 2004 was faster and more consumption-driven than in other large euro area countries, the fall in private consumption in the second quarter of 2005 was unexpected and possibly related to stagnating unemployment, rising oil prices, and political turmoil surrounding the rejection of the European Union constitution. Growth is likely to pick up, however, driven by an improvement in the external environment and a return of domestic demand to a normal pace following the mid-year clarification of the direction of economic policies. Indeed, the third-quarter data, not available at the time of the IMF Executive Board's November discussion, came in strong, prompting the staff to revise its growth projection upward.

The Board commended the authorities for continuing to pursue fiscal consolidation and structural reforms amid the weak economic environment and difficult political circumstances. France's 2006 draft budget targets a reduction in the general government deficit to 2.9 percent of GDP from 3.0 percent of GDP in 2005 and 3.6 percent of GDP in 2004. For 2006, the Board urged the authorities to step up the pace of underlying adjustment and avoid recourse to one-off measures.

France	2002	2003	2004	Proj. 2005	Proj. 2006
	(percent increase)				
Real GDP	1.3	0.9	2.1	1.6[1]	2.1[1]
Domestic demand	1.3	1.8	3.2	2.4	2.0
	(percent of labor force)				
Unemployment	8.9	9.5	9.7	9.8	9.8
	(percent of GDP)				
General government balance	–3.2	–4.2	–3.6	–3.1	–3.3

[1]Revised projections. Earlier projections were 1.5 (2005) and 1.8 (2006).
Data: French authorities and IMF staff estimates.

To prepare for the consequences of an aging population, the authorities need to be ambitious in reducing the share of public spending in GDP and in implementing growth-enhancing structural reforms. The Board encouraged the authorities to focus fiscal consolidation squarely on expenditure restraint and to further strengthen the framework for fiscal governance.

On structural issues, the authorities have undertaken a series of measures in the labor and product markets, and in the financial sector. Executive Directors strongly supported the recent labor market initiatives and urged the authorities to broaden them. They felt that adopting more flexible labor contracts throughout the labor market would help to significantly reduce unemployment and effectively combat the exclusion of some from the labor market. ■

Portugal needs to ratchet up competitiveness, pursue fiscal adjustment

Portugal has yet to emerge from the downturn that followed the bursting of the euro adoption bubble. A gradual recovery started in 2004, driven by domestic demand, but activity weakened during the latter half of the year, the IMF said in its annual economic review. High private indebtedness, weak competitiveness, and the planned significant fiscal consolidation are expected to constrain growth in the near future.

The IMF Executive Board said that in this unfavorable environment marked by large fiscal and external imbalances, slow growth, and a weak competitive position, the government must create the conditions to restart Portugal's per capita income convergence toward the euro area average as soon as possible. Toward that end, it would be crucial to pursue sustainable fiscal adjustment and measures to improve product and labor markets, enhance the business environment, and strengthen human capital development.

Portugal	2002	2003	2004	Proj. 2005	Proj. 2006
	(percent increase)				
Real GDP	0.5	–1.2	1.2	0.5	1.2
Domestic demand	–0.1	–2.6	2.2	1.7	1.3
CPI (average)	3.7	3.3	2.5	2.3	2.5
	(percent of GDP)				
General government balance	–2.8	–2.9	–3.0	–6.0	–4.5

Data: Bank of Portugal, Ministry of Finance, and IMF staff estimates and projections.

The authorities' extensive use of one-off measures kept the budget deficit under the euro area's Stability and Growth Pact ceiling of 3 percent of GDP over the past few years. However, these measures did not address the underlying source of fiscal problems: the steady rise in current expenditure over the past decade. Thus, the authorities decided to largely abandon one-off measures and chart a fiscal strategy that aims to contain medium-term expenditure and bring the deficit below 3 percent of GDP by 2008. The Board said this strategy sets an appropriately ambitious pace of adjustment that is the first step in Portugal's ultimately achieving overall budget balance.

In light of the looming rise in pension and health care spending caused by population aging, the Board encouraged the authorities to find durable measures to improve the quality and efficiency of public expenditure. It also stressed that Portugal needed to pursue structural reforms that would improve labor productivity and enhance competitiveness and, ultimately, speed income convergence. Further, the authorities will need to take additional steps to raise labor market flexibility and improve the responsiveness of wages to productivity and skill differentials. ■

For more information, please refer to Public Information Notice No. 05/152 (Estonia), No. 05/153 (France), and No. 05/147 (Portugal).

Stand-By, EFF, and PRGF arrangements as of October 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	145.78	34.28
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	288.94
Macedonia, FYR	August 31, 2005	August 30, 2008	51.68	41.18
Paraguay	December 15, 2003	November 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	704.95
Total			**18,233.82**	**13,175.49**
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	6.88
Burundi	January 23, 2004	January 22, 2007	69.30	28.60
Cameroon	October 24, 2005	October 23, 2008	18.57	18.57
Chad	February 16, 2005	February 15, 2008	25.20	21.00
Congo, Republic of	December 6, 2004	December 5, 2007	54.99	39.27
Democratic Republic of the Congo	June 12, 2002	March 31, 2006	580.00	26.53
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	18.52
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
Malawi	August 5, 2005	August 4, 2008	38.17	32.75
Mali	June 23, 2004	June 22, 2007	9.33	6.67
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	0.57
São Tomé and 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			**2,710.75**	**1,149.33**

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

Annual research conference

Reforms take center stage

Departing from the classic themes of international monetary economics, the IMF's 2005 Jacques Polak Annual Research Conference, held at IMF headquarters on November 3–4, focused on structural reforms and how changes in the "rules of the game" and in institutions can reshape economies. Understanding the impetus for and consequences of reforms, said IMF Deputy Managing Director Agustín Carstens in his opening remarks, is no less central to the IMF's daily work than is understanding the macroeconomics of stabilization.

Eugene Salazar/IMF

Pedro Dal Bó

If reforms are good for society, why is it so difficult to make them happen? According to Ernesto Dal Bó (University of California, Berkeley) and Pedro Dal Bó (Brown University), a possible explanation is that an economist's view of the world does not take into account how social conflict and reforms interact. Assuming that conflict is a relatively labor-intensive activity, then reforms that enhance the productivity of the capital-intensive sector—which would typically make a country better off—may hurt the country because they result in more conflict by reducing the opportunity cost of engaging in conflict activity. This could explain why politicians are reluctant to undertake apparently beneficial reforms. Although it is debatable to what extent this conclusion can be generalized, the Dal Bó study is a reminder that both the potential political consequences of reform and the political constraints on it need to be considered.

Eugene Salazar/IMF

Sanjay Jain

There is wide recognition that the IMF can play a role in spurring reform efforts. Anna Ivanova (IMF) explained that outcome-based conditionality calls on member countries that receive IMF financing in support of their economic adjustment programs to meet particular targets or objectives rather than implement specific actions. This type of conditionality may be more effective in encouraging countries to undertake complex reforms because it does not jeopardize country ownership of those reforms. While the literature on the effectiveness of IMF conditionality has generally found only marginal effects, Bennet Zelner (University of California, Berkeley) presented evidence—in a paper coauthored with Mauro Guillen and Witold Henisz (both with the University of Pennsylvania)—that countries with IMF loans are more likely to undertake market-oriented reforms.

Why reforms can run aground

Just as Rome was not built in a day, deep reforms often require several stages of implementation. Initiating reforms is hard enough, but keeping them going is just as challenging. In fact, as several participants noted, it is not uncommon for successful reforms to run out of steam before they are completed.

Sanjay Jain (University of Virginia) and Sharun Mukand (Tufts University) propose a solution to this puzzle. In their model, some groups benefit and some lose from reforms, but losers can vote to have some of the gains redistributed to them. As reforms progress, however, the ranks of the losers shrink and, at some point, they may lose the political power to force redistribution in their favor. Anticipating this outcome, and unable to know for sure if they will be among the winners in the next stage of reform, losers may choose to block further reforms so that they can enjoy the fruits of the initial reform through redistribution.

IMF First Deputy Managing Director Anne Krueger, in a luncheon address, noted that if economic conditions following initial reforms are too favorable, the impetus for further changes may decline. Conversely, if conditions are too unfavorable, reforms may be blamed. For this reason, a mildly expansionary phase in the economic cycle may be the most propitious scenario for reforms to continue.

Reforms can also run aground if the public fears that elites may appropriate all the gains. In this case, politicians can use the constitution as a commitment mechanism to boost support for economic reform, as illustrated in a paper by Anders Olofsgård and Raj Desai (both of Georgetown University). To support their view, these authors showed opinion poll data indicating greater support for reforms in countries with high political accountability and judicial independence.

Opening up may have some hazards

What happens to reforms when countries liberalize their economies? On the trade front, there may be a downside. Andrei

Levchenko (IMF) and Quy-Toan Do (World Bank) studied the effect of trade opening on institutional quality and found that trade liberalization benefits mostly large firms, while small, inefficient firms are forced to exit. If large firms prefer bad institutions because they prevent new entry and reduce competition, then trade liberalization may worsen the quality of economic institutions by making large firms more politically influential.

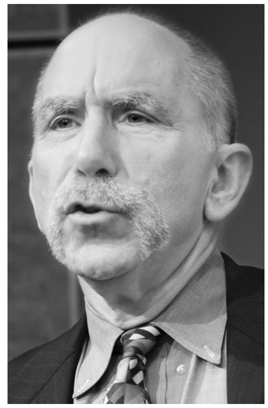
That trade liberalization leads to increased firm exit was confirmed by John Haltiwanger (University of Maryland), who presented an empirical analysis of firm-level data from Colombia in a joint paper with Marcella Eslava (Universidad de los Andes), Adriane Kugler (University of Houston and Universitat Pompeu Fabra), and Maurice Kugler (University of Southampton). Trade liberalization leads to efficiency gains, because the firms going out of business tend to be those with lower productivity. Thus, theory and empirical work support the notion that the initial impact of trade openness is the exit of inefficient firms. The subsequent impact on institutional reform depends on the political power of large firms.

On the financial front, the opening of capital markets across the world has become a catalyst for reform. A paper by Pierre-Olivier Gourinchas (University of California, Berkeley) and Olivier Jeanne (IMF and Princeton University) provides a new model of self-fulfilling capital flight. If investors believe that the government will reform, they will keep their capital in the country, which increases wealth and makes reforms more likely. But if investors believe the government will stall or thwart reforms, they will take their capital abroad, impoverishing the country and making it optimal for the government not to implement any changes. The optimal policy in this case is to liberalize inflows, not outflows.

Abdul Abiad, Nienke Oomes, and Kenichi Ueda (all of the IMF) investigate the effect of financial liberalization on the allocation of capital across firms. In theory, they point out, financial liberalization should reduce the cross-sectional variation in the expected marginal return on capital, because it eliminates preferential credit allocation and credit rationing. To support their theoretical prediction, they use data from listed firms in five emerging market economies to show that financial liberalization reduces dispersion in the efficiency of the allocation of capital.

Public sector reform

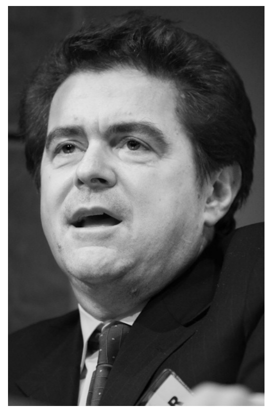
In many countries, corruption and a lack of budgetary transparency are major obstacles to good economic management. What can be done about them? Using World Bank Institute survey data, Francesca Recanatini (World Bank), Alessandro Prati (IMF), and Guido Tabellini (Università Bocconi) find that public agencies maintaining open and transparent procedures tend to be less corrupt. James Alt (Harvard University), David Dreyer Lassen (University of Copenhagen), and Shanna Rose (SUNY Stony Brook) review budgetary processes in the United States to examine what causes variations in budgetary transparency. They find that political competition—manifested in the separation between the executive and legislative branches of government—tends to improve transparency, whereas political polarization worsens it.


Eugene Salazar/IMF

James Alt

Political economy of macroeconomic adjustment

Impending disaster can spur even the most reluctant politician to action. And crises, finds Alberto Alesina (Harvard University), can force reform, in particular fiscal and monetary reform, that will reduce fiscal deficits and inflation. Describing the theoretical war-of-attrition model, Alesina points out that delay becomes a tactical tool when different social groups are fighting over reforms. Delay is costly, but caving in to the demands of the other group is even worse. While delays are costly for society, too, it is rational for each group to wait, because the cost of waiting for different groups is revealed as time passes. The winner is the group with the lowest waiting cost. In this model, passage of time alone increases the probability of reforms, but crises can also trigger a resolution.


Eugene Salazar/IMF

Alberto Alesina

Political systems that allow more vetoes are less likely to generate early reforms, whereas external commitments accelerate the resolution of wars of attrition by increasing the cost of waiting. Based on empirical data, Alesina showed that stronger governments—presidential or clear-majority parliamentary systems—are more likely to undertake macroeconomic stabilization policies in times of crisis.

Although the conference explored many aspects of the political economy of reforms, it did not exhaust the topic. One important question still to be explored, suggested Krueger, is given that crises can spur reforms, what conditions will spur a country's reforms so that crises can be avoided? ■

Enrica Detragiache and Akito Matsumoto
IMF Research Department

IMF governance: overcoming reform inertia

IMF "voice and representation"—a catchphrase for the distribution of power among the IMF's 184 member countries—have been hotly debated for at least the past five years. Various proposals to change the famously complicated quota formula that is the main determinant of each country's voting power have been discussed and then rejected. Countless opinions on how to reconfigure the IMF's 24-member Executive Board have been voiced, but none has been heeded. On November 4, the IMF's Research Department hosted an Economic Forum in conjunction with its annual conference (see pages 354–55) that revisited these issues.

James Boughton, the IMF's official historian, shed some light on the inertia that seems to grip all attempts to redistribute power among member states. Today's quotas still reflect decisions that were made when the IMF was founded in 1944 because countries cannot agree on what basic principles should guide the redistribution of votes, he said. Two considerations compete for attention. First, it is desirable for countries to have roles commensurate with their importance and influence in the world economy. Second, it is desirable for all countries to have adequate representation, so that low-income countries and those with relatively little international trade are not shut out of the decision-making process.

Closing the gaps between the current distribution of voting power and both of these competing principles is probably impossible, Boughton said. Instead, he indicated ways to minimize the negative effects of reform inertia on the IMF's legitimacy. For instance, the importance of quotas can be reduced—and to some extent has been reduced—by breaking the link between member countries' financial contributions to the IMF and their quotas, as well as between the amounts member countries can borrow from the IMF and their quotas. Boughton also noted that the functioning and legitimacy of the Executive Board could be strengthened by reducing the use of formal vote taking (the Board already operates largely by consensus, but vote taking has become more prevalent in recent years). And while the United States is the only country able to block decisions that require an 85 percent majority, other countries could do more to exploit their ability to form coalitions that would give them veto power—but they need to agree and speak with one voice, he said.

One country that has paid a price for the IMF's reform inertia is the Republic of Korea. Now the 11th largest economy in the world, Korea's quota in the IMF ranks it 28th—trailing much smaller economies, such as Belgium and Denmark. According to Jong Nam Oh, the first Executive Director to come from Korea (something that became possible when Australia ceded the post of Executive Director for the chair the two countries share with 12 other member states), this perceived unfairness has contributed to the IMF's reputation as "a bad institution." Oh saw talk of creating an Asian Monetary Fund as a reflection of the IMF's perceived lack of legitimacy in emerging market Asia. "The IMF does not like to hear it, but the idea of an Asian Monetary Fund reveals the discontent of those countries with the huge gap between actual and calculated quotas." The IMF–World Bank Annual Meetings, which will take place in Singapore in September 2006, provide a timely opportunity to address the underrepresentation of Asian and other emerging market economies, Oh said.

Lack of legitimacy harms effectiveness

Carlo Cottarelli, Deputy Director in the IMF's Policy Development and Review Department, argued that addressing the voting rights issue is important for both the Fund's legitimacy and its effectiveness. In recent years, the Board has increasingly insisted that the staff apply the same procedures for carrying out economic analysis to all countries, regardless of their level of economic development, he said. This has had the effect of limiting the discretion of the staff in deciding what to focus on for a given country, thereby making the work of the institution more cumbersome and time consuming. Cottarelli traced this "obsession with formal equality" to the simmering discontent of certain Executive Directors with what they perceive as a lack of proper representation and voice. As an example, he pointed to the IMF's work on debt sustainability. Such analysis is not relevant for all countries. But some Executive Directors, particularly from chairs representing emerging market economies, insist that all countries, in the name of equality of treatment, undergo debt sustainability analysis, tying up resources that could be used more productively elsewhere.

"Addressing the legitimacy issue through the proper instrument—voting rights—would help the effectiveness of the Fund. We could become more flexible, selective, and eventually more effective," Cottarelli said. He also proposed less involvement by the Executive Board in the IMF's daily work and argued that it was necessary to insulate the IMF's staff more effectively from political pressure coming from member countries.

IMF photo

An early Executive Board meeting. The IMF's historian, James Boughton, saw today's quotas reflecting decisions made when the IMF was founded in 1944.

The IMF needs its Executive Board

A vigorous defense of the Executive Board was launched by Tom Scholar, Executive Director for the United Kingdom. "The basic structure established by the founders of the institution has stood the test of time," he said, referring to the Executive Board as a "very farsighted model." Political oversight and backing for the IMF's work was absolutely necessary because of the intensely political nature of staff advice and analysis on matters ranging from tax-and-spend decisions to structural reforms. "The Board, in that context, provides the political legitimacy and the accountability, without which I don't think the institution would have survived," he said.

This, in Scholar's view, applied in particular to the Fund's lending activities, and here he disagreed with the idea of giving the IMF more discretion and independence along the lines of what is enjoyed today by many central banks. Who would write the rules that would govern the IMF's activities, he asked? Central banks pursue a single clear objective—a specific inflation outcome. The IMF's goals are much more difficult to spell out. And even if such rules were to be established, it would be difficult to implement them without political backing. "The first time that the rule pointed to a genuinely tough decision where, for example, the Fund decided not to support a country facing a financial crisis . . . I think we would find that the Fund in that form would not survive the criticism that would follow," Scholar said. Even if the decision was made on sound economic grounds, there would, he noted, be widespread calls for greater oversight and accountability.

Scholar agreed, however, that there was room for improvement. He felt that the Board's approach to surveillance—as a "confidential advisor"—is about 30 years out of date, and he called for more frank analysis and debate in country staff reports, greater acknowledgement of differences of view within the Fund, and more realism in IMF country programs. Tensions between economic and political considerations in lending decisions should be exposed more transparently, and the Executive Board should be made "more visible and more accountable," he said.

Put the central banks in charge

The most radical proposal of the day came from Columbia University's Charles Calomiris. The IMF needs to rethink its mission instead of tinkering with quota recalculations and moving chairs around in its boardroom, he said. "When you think about governance, you have to first think about what you are doing, and then the governance will follow from what you want to do." But in rethinking its mission, the Fund faces a basic problem. "The IMF has stayed small, but the financial markets have gotten big." And this has made the IMF irrelevant in terms of managing emerging market financial crises. "You are not even close to mattering," Calomiris said.

For the IMF to matter once again, he said, the institution must refashion itself as a lever, able to harness market discipline and work with private capital markets to create advance credit lines that could be used to coordinate liquidity assistance to countries in crisis. What would this entail in terms of IMF governance? If the goal is to focus on liquidity provision, then central bank governors, rather than finance ministers (as is presently the case) should be in charge of running the Fund, Calomiris argued. And the logical next step would then be to move the IMF's headquarters from Washington to Switzerland. ■

Camilla Andersen
IMF External Relations Department

The full transcript of the Economic Forum, "Reforming the IMF: Governance and the Executive Board," is available on the IMF's website (*www.imf.org*).

Lessons from two emerging giants: China and India

China and India are emerging as increasingly important regional and global economic powers. What can each learn from the other, and what can the world learn from both? In Beijing in late October, a conference on China's and India's changing economic structures—a follow-up to a 2003 conference in Delhi (see box)—examined experiences and shared views on what will be needed to sustain high growth, with a focus on how to strengthen financial sectors, ensure fiscal stability, and deepen regional cooperation.

The conference—organized by the IMF, the China Society for Finance and Banking, and the Stanford Center for International Development—drew policymakers, business people, and scholars from India, China, and the region's emerging market countries and featured keynote addresses from the People's Bank of China Governor Zhou Xiaochuan and Reserve Bank of India Deputy Governor Rakesh Mohan. In contrasting several major features of the two economies, Zhou paid particular attention to the contribution of the service sector to growth. He also paid tribute to the advances that India has made in its financial "ecology"—the institutions, laws, and regulations that underpin the system—adding that China had made this a priority, too. Looking ahead, he said, China's reforms will focus on building a harmonious society, including improving living standards in the countryside, promoting energy efficiency, and protecting the environment.

In his remarks, Mohan looked beyond the two countries to highlight several conundrums confronting the global economy, notably the muted impact of higher oil prices on global growth, falling long-term bond yields at a time when the U.S. Federal Reserve has been raising short-term interest rates, and the persistence of low consumer price inflation despite abundant liquidity. These questions have implications, too, for monetary policy, Mohan said, expressing particular concern about whether price-related instruments, such as exchange rates and interest rates, may be losing some of their effectiveness.

Financing the future

In three sessions devoted to financial sector reforms, participants contrasted developments in the banking sector, securities markets, and financial liberalization in China and India. On the banking front, while both countries are moving away from their earlier, heavy reliance on state-owned banking systems, reforms have taken different routes. China has focused on modernizing operations and strengthening commercial orientation, while upgrading the regulatory and supervisory environment.

Why India and China have grown

India and China now account for nearly 20 percent of global output. A conference in Delhi in late 2003, sponsored by the IMF and India's National Council of Applied Economic Research (NCAER), examined what led to rapid growth in both countries. A volume of the proceedings, *India's and China's Recent Experience with Reform and Growth*, coedited by Wanda Tseng (IMF Asia and Pacific Department) and David Cowen (IMF Regional Office for Asia and the Pacific), is now available.

Lord Meghnad Desai (U.K. House of Lords and London School of Economics) opens the book with a perspective on what led to China's lead and India's lagged growth performance over the last quarter of the 20th century. Suman Bery, Kanhaiya Singh (both NCAER), and Arvind Panagariya (Columbia University) take an in-depth look at reforms that have helped raise factor productivity and gradually accelerate growth in India since 1990. James Gordon and Poonam Gupta (both IMF) explore the role of the service sector in India's growth, and Hu Angang, Hu Linlin (both Tsinghua University), and Chang Zhixiao (Peking University) offer valuable lessons from China's experience in addressing urban-rural disparities and maintaining social cohesiveness.

Turning to the financial sector, Saugata Bhattacharya (Hindustan Lever) and Urjit Patel (Infrastructure Finance Development Company) weigh what India needs to do to increase the efficiency of financial intermediation. Chen Yuan (China Development Bank) highlights the challenges China faces in reforming its financial sector and increasing investment efficiency. Abhijit Banerjee, Esther Duflo (both MIT), and Sean Cole (Harvard University) consider the role of resource allocation in India's growth—specifically whether banks underlent and what the policy response might be.

Finally, Nicholas Lardy (Institute for International Economics) looks at China's relatively more aggressive trade liberalization, and Jonathan Anderson (Union Bank of Switzerland) and Narendra Jadhav (Reserve Bank of India) analyze China's and India's different reform paths on capital account liberalization. Eswar Prasad and others (IMF) explore the links between global financial integration and growth—a key interest as these two countries take center stage among emerging economies.

India has dealt explicitly with nonperforming loans—an issue in both countries—by moving these loans onto the government's balance sheet. India's experience with large-scale state and private bank ownership and the role played by different types of banks (such as community financial institutions) prompted lively discussions on the optimal degree of government involvement in the banking sector and the risks that may arise during the process of privatizing this sector.

Of the two countries, India has taken the lead in developing its securities markets. The sophisticated regulatory and market infrastructure for its capital markets is state of the art in many respects. As participants noted with some irony, this success stems in part from a crisis in the early 1990s that prompted a strengthening of oversight and regulatory bodies. China has stepped up the pace of capital market development, seeking to address nontradable government-owned shares, which have adversely affected its stock markets, and to establish an interbank market for short-term bills issued by major corporations.

As China and India become more integrated into the global financial system, the urgency of financial sector reform has increased. In particular, the need to liberalize the financial sector and make it more resilient to both internal and external shocks has become pressing. At the same time, policymakers recognized that, through transfers of technical and managerial expertise, foreign institutions can play a useful role in developing financial markets in both countries.

Fiscal choices

On the fiscal side, there was wide agreement on the overarching aim of maintaining high growth and employment rates, as well as a degree of social harmony, but there was recognition of the potential tension between other goals—notably funding human capital development and improving physical infrastructure. The former had been shifted in many instances to households, particularly in China, while the latter is seen as of increasing importance owing to ongoing urbanization, particularly in India.

Understandably for two large and populous countries, fiscal federalism was a hot topic. Of particular concern was the lack of local budgetary discipline in both countries. This indiscipline, participants pointed out, is likely to arise when local governments have to rely heavily on transfers from the central government or on various levies and charges or questionable "entrepreneurial activities" to fund their operations, rather than on the ability to raise sufficient revenue locally. Although the overall size of government has been shrinking in both countries, many were mindful of growing populism and the attendant spending pressures.

Scope for increased trade

Much of a session devoted to Sino-Indian economic cooperation focused on trade. The two countries' economic structures were generally viewed as complementary rather than competitive—although some participants warned against taking the "China as factory, India as back office" paradigm too far. Bilateral trade has increased more than tenfold over the past decade and continues to be characterized by India's modest but persistent deficit, a drop in tariff rates (particularly in India), and an increase in trade intensities. These trends seem likely to continue.

As for trade with the rest of Asia, China is much more integrated with northeast Asia and ASEAN than India is. However, the pattern of both countries' trade with ASEAN, which has in part served as a gateway between them, should change as direct trade between China and India expands. Looking ahead, participants saw a relationship that has scope to mature and diversify to include services and foreign direct investment, as well as regional security and health issues.

Regional, global reverberations

What will the rise of China's and India's economies mean for Asia? Participants viewed this as a broadly benign development, with likely gains in living standards, poverty reduction, and intraregional trade. At the international level, the transformation of China and India into major economic forces has the potential to provide alternative sustained sources of demand and help rebalance the global economy. That rebalancing will have implications for the international financial system, too—as international organizations, including the Bretton Woods institutions, will need to adjust to the changing reality of economic power on the ground.

What's ahead for China and India themselves? The conference concluded that the chief challenges going forward will be to achieve an orderly liberalization of capital accounts, maintain economic flexibility, and ensure sound macroeconomic and structural policies. The main risks to this benign scenario are the perceived weakness of domestic banks in both countries and the potential volatility in international financial flows.

In a wrap-up session, participants noted that while China and India are currently on a good macroeconomic path, the next phase of growth will require reforms to remove barriers to increased productivity growth in trade, investment, and financing. There is considerable scope, too, for closer cooperation on regional issues. ■

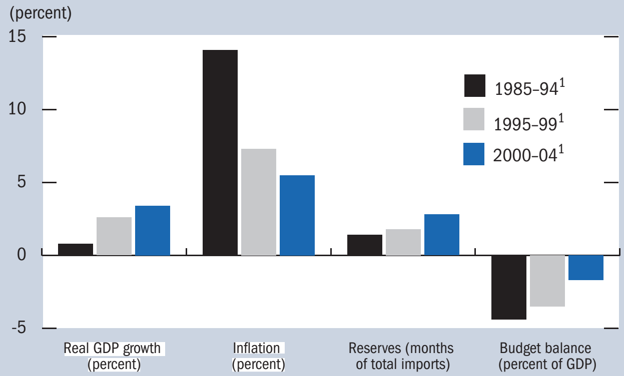
Steven Barnett and Paul Gruenwald
IMF Asia and Pacific Department

South Africa: unlocking the door to faster growth

South Africa has made progress on many fronts since the end of apartheid—including in revitalizing its economy. In a little over a decade, the government has overhauled the institutions of economic management and established a prudent and stable macroeconomic policy framework. Fiscal discipline was quickly established and has been maintained, debt has been reduced, and public finances have been strengthened significantly (see chart). An effective inflation-targeting regime is helping to bring inflation firmly under control, and the buildup of a solid cushion of international reserves has enhanced the economy's ability to withstand external shocks. As a result, South Africa's sovereign credit rating has risen steadily, and interest rates have fallen.

Good gains

South Africa has revitalized its economy since the end of apartheid.



[1]Period average.
Data: South African Reserve Bank.

After years of isolation, the economy has become much more open and increasingly well integrated with overseas markets. South Africa substantially liberalized its trade regime in the 1990s and became a founding member of the World Trade Organization in 1995. Trade flows have expanded rapidly, with the ratio of trade to GDP increasing from roughly one-third in 1992 to about one-half since 2000. The structure of trade has also become more diversified, manufacturing has expanded, and the reliance on primary commodity exports has declined. Exchange controls have been gradually liberalized, and investment both into and from South Africa has increased.

Consequently, the economy is enjoying its longest expansion on record. Economic growth has increased from an annual average of 0.8 percent during the final decade of apartheid to an annual average of 3 percent over the past 10 years. Recent economic performance has been even more impressive, with growth expected to exceed 4 percent this year (see table). These achievements are all the more remarkable given that this progress took place during a period of unprecedented political and social transformation.

Despite these advances, however, huge difficulties remain. The HIV/AIDS epidemic is exacting a heavy social and economic toll. Roughly one out of every six adults is HIV-positive, and life expectancy is falling. Unemployment is still high at nearly 26 percent of the workforce. Poverty also remains widespread, and the acute income and wealth disparities inherited from the apartheid era are still evident.

Laudable progress but more needed

South Africa's economic performance has been impressive, but more must be done to reduce poverty, income disparities, and unemployment.

	2001	2002	2003	2004	Proj. 2005
			(percent change)		
Real GDP	2.7	3.6	2.8	3.7	4.3
Real GDP per capita	1.6	2.4	1.8	2.7	3.3
Consumer price index (annual average)[1]	5.7	9.2	5.8	1.4	3.8
			(percent of workforce)		
Unemployment rate	29.5	30.5	28.2	26.2	25.3
			(percent of GDP)		
National government budget balance	–1.5	–1.2	–2.0	–1.7	–1.9
External current account balance	0.1	29.5	22.4	19.8	19.1

[1]For metropolitan areas.
Data: South African Reserve Bank and IMF *International Financial Statistics* and staff estimates.

Still faster growth needed

While recent growth has been impressive by South Africa's historical standards, it has not been enough to make significant inroads into unemployment, poverty, and underdevelopment. In per capita terms, real incomes have risen by just 1.5 percent a year on average over the past 10 years. One of the main challenges facing South Africa today, therefore, is to generate and sustain even higher rates of economic growth.

How can the country unlock the door to faster growth? It is clear that macroeconomic stability, one of the essential preconditions for sustained growth, has been firmly established. The government is committed to preserving its hard-won gains in this area and is focusing on ways to stimulate economic growth within a stable macroeconomic environment while pursuing initiatives to reduce unemployment and improve social conditions.

But while preserving its macroeconomic stability, South Africa needs enhanced dynamism. Compared with other emerging market economies with broadly comparable GDP per capita, population, and sovereign risk rating, South Africa has performed better in terms of fiscal discipline, government debt, and external debt but has lagged behind in real per capita growth. While South Africa has successfully maintained its share of global export markets in recent years, this is partly a reflection of favorable commodity price increases. South Africa's main commodities—coal, metals, and diamonds—account for about two-thirds of export growth since 2002.

The performance of manufactured exports has been more mixed, and South Africa does not appear to be especially well positioned in the product markets that are growing the most rapidly in global terms. In fact, most of South Africa's manufactured export products are either in markets that represent a declining share of world trade or in growing markets in which South Africa's market share is declining. The automotive sector is an exception. South Africa's world market share of cars—its largest manufacturing export product—more than quadrupled from 1998 to 2003. Moreover, this market was moderately dynamic, rising about 7 percentage points faster than total world trade over this period. South Africa's emergence as a significant exporter of cars, however, reflects incentives available through the Motor Industry Development Program, the costs of which are unclear.

Jon Hrusa/EPA Photos

Automobiles are South Africa's largest manufacturing export. Its share of the world market for car exports more than quadrupled between 1998 and 2003.

The gains from trade reform have yet to be fully realized. The overall level of protection is not dissimilar to that in many other emerging markets, but a number of sectors remain heavily sheltered and the tariff structure is excessively complicated. Simplifying this regime, harmonizing protection across sectors, and reducing average tariff rates would enhance competition, increase productivity, and support growth.

But further trade liberalization and stronger competition require flexible labor markets to effectively generate employment. Labor market flexibility could be enhanced by reducing the scope of collective bargaining, streamlining dismissal procedures, and easing the impact of minimum wages. Progress on other important issues, notably reducing skills shortages, alleviating infrastructure bottlenecks, and reducing the generally high costs of doing business, would also encourage more vigorous economic growth.

South Africa has already emerged as a major driving force in the region. The country is by far the largest market in sub-Saharan Africa—accounting for 40 percent of the region's GDP—and is an increasingly important source of investment in the region. South Africa's continued success is therefore vital for the entire region. ■

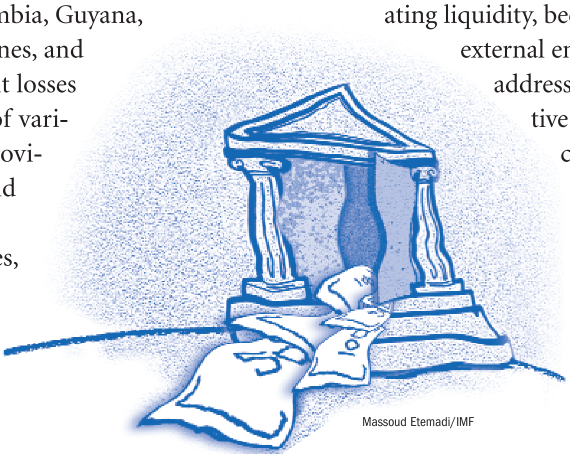
Robert Burgess and Thomas Harjes
IMF Policy Development and Review and African Departments

Copies of *South Africa: Selected Issues*, IMF Country Report No. 05/345, are available for $15.00 each from IMF Publication Services. Please see page 364 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

How central bank losses can be handled

In normal circumstances, a central bank should be able to operate at a profit, based on seigniorage—the net revenue it earns as the issuer of the national currency. For various reasons, however, a number of central banks across the world have recorded losses over the past two decades. Why should this raise concerns, and what can be done about it? A recent IMF Working Paper lays out principles and practices for handling central bank losses.

Central bank losses can arise in several ways. They can stem from day-to-day operations—when operating expenses exceed operating income—or when revaluation losses on assets and liabilities (including currency revaluations) occur. Central banks have also incurred losses in connection with activities that go beyond their conventional functions of stabilizing the country's currency and domestic price level. The central banks of Bolivia, Chile, The Gambia, Guyana, Jamaica, Madagascar, Peru, the Philippines, and Turkey, for example, incurred significant losses during the 1980s and 1990s as a result of various quasi-fiscal activities, such as the provision of subsidies or price guarantees, and costs associated with financial sector restructuring. In a number of these cases, the accumulated losses were equivalent to a significant proportion of GDP before they were addressed.



Massoud Etemadi/IMF

Even good policies may see losses

In recent years, the pursuit of sound policies by many central banks—in both developing and advanced economies—has contributed to historically low inflation and interest rates, including on liquid assets denominated in reserve currencies. The associated low yields on international reserves, together, in some cases, with currency revaluation losses, have negatively affected the profits and capital positions of a number of central banks. In 2004, for example, the European Central Bank (ECB) incurred net losses of some €1.6 billion largely from an appreciation in the external value of the euro. This saw write-downs (of some €2.1 billion) of the euro value of the ECB's holdings of foreign reserve assets because of revaluations. Financial buffers established by the ECB and its member central banks absorbed these losses, and the net worth of the ECB remained positive. Elsewhere, the Reserve Bank of Australia recorded revaluation losses of $A 1.4 billion in its 2005 financial year. These losses reduced net profits to some $A 74 million. They were fully absorbed in a reserve of unrealized profits, which acts as a financial buffer for foreign currency losses, and net worth remained positive.

In many countries, the costs of implementing monetary policy, in combination with low yields on international reserves, have also affected central bank profits negatively. Typically, this has occurred when the financial cost of liquidity absorption has exceeded income earned on the international reserves acquired. The negative financial impact can be worse when central banks do not have access to an adequate supply of government securities and must, instead, use central bank bills to absorb liquidity.

Why disclosure is important

A central bank incurring net operating losses is, in effect, creating liquidity, because it is transferring more cash to external entities than it is receiving. Failure to address these losses, or any ensuing negative net worth (when the value of a central bank's assets falls below its liabilities), is likely to interfere with monetary management and jeopardize the central bank's independence and credibility.

Revaluation losses do not have the same liquidity effect as operating losses but signal the possibility of future outflows as losses are realized. These losses need to be recognized promptly so that appropriate financial buffers can be established. Ignoring such losses in the hope that they may be reversed is not good practice.

To ensure transparency, net losses and their impact on central bank net worth must be properly disclosed in the income statement and balance sheet, respectively. In those cases where losses reduce net worth below legally mandated levels or result in negative net worth, remedial action will be required to ensure that the central bank has adequate financial resources to cover the costs of its policy responsibilities.

The need to adequately cover central bank losses and negative net worth is now recognized in the laws of many countries through provisions for government support. Usually, this support takes the form of a budgetary appropriation by the central government in either cash or government securities to recapitalize the central bank.

Going out of business?

The notion of insolvency (or negative net worth) for a central bank differs from that pertaining to commercial enterprises, although similar accounting rules usually apply. Unlike insolvent commercial enterprises, a central bank with negative net worth will not experience the sanction of official liquidation. Its legal status as a specialized monetary agency, in effect, enables it to continue to increase liabilities after this would have ceased to be an option for a commercial enterprise.

While central banks do not "go out of business," resolution strategies for addressing negative net worth may see significant changes in a central bank's policy and functional responsibilities. In some cases, as in the Philippines in 1993, central banks have been reestablished with a new legal identity and powers. In many cases, such changes have formed part of a broader program to restore the health of the financial system or ensure macroeconomic stability.

Circumstances may arise in which the government is unable to recapitalize the central bank. In these cases, the bank should be prepared to disclose its net worth to the public and to take actions to restore and maintain net worth over time. Such disclosure provides assurance that management is taking action and also alerts the financial sector, and the public in general, that the central bank will need to adopt a stringent and prudent approach to any further creation of credit or extension of central bank financial support.

Preserving central bank financial health

Experience has shown that, left unresolved, central bank losses are more likely to worsen over time than to correct themselves. As a corollary, the fiscal costs are also more likely to increase than decrease. Measures used to address threats to a central bank's financial position have included

- avoiding overburdening the central bank with tasks that go beyond responsibilities for monetary and financial stability;
- having the government assume responsibility for any quasi-fiscal costs of the central bank;
- identifying the causes of losses to remove or limit their potential to lead to future losses;
- establishing sound budgetary and financial controls over central bank operating expenditures;
- properly resolving accumulated losses as one means of restoring operating earnings;
- adopting risk-management policies that take into account the potential impact of global macroeconomic developments, and other contingencies;
- establishing adequate financial buffers; and
- developing a communications policy to explain to the public the nature and potential impact of central banking risks and measures used to protect the bank.

Central bank legislation can help in ensuring that adverse financial results do not distract the central bank from its prime objectives. Typically the legislature must include

- the use of financial buffers to cover operational losses and other risks. The level of these buffers may be set as a multiple of capital or, preferably, as a percentage of the central bank's monetary liabilities. Distributable profits are directed first to establishing or maintaining required levels. If profits are insufficient, then negotiable securities that bear interest at market-determined rates may be required; and
- measures to address negative net worth—when losses have exhausted all capital and reserves—or net worth ratios that are below mandated levels. When such points are reached, the government would need to issue to the central bank negotiable securities that bear interest at market-determined rates. This process restores balance-sheet solvency, provides an additional source of earnings to cover policy and operating expenses, and thereby reduces the scope for further operating losses.

Sound accounting practices are essential

There is some debate about which specific accounting standards should apply to central banks. Ultimately, the proper identification and measurement of any losses, and of their impact on net worth, and the selection of resolution strategies, must be based on information produced in accordance with a sound and credible set of accounting standards.

The use of widely recognized standards ensures accurate recognition and valuation of the financial assets and liabilities that are the "stock in trade" for monetary and exchange rate policy implementation. These same standards also allow external auditors to attest to the truth and fairness of the information contained in a central bank's financial statements. The choice becomes paramount for a central bank seeking to explain the financial outcomes—good or bad—of policy choices that are driven by the pursuit of economic policy goals rather than by financial gain. ■

John Dalton and Claudia Dziobek
IMF Monetary and Financial Systems and Statistics Departments

Copies of IMF Working Paper No. 05/72, "Central Bank Losses and Experiences in Selected Countries," are available for $15.00 each from IMF Publication Services. Please see page 364 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

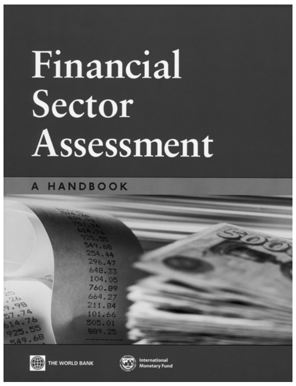
Policy

A new guide to assessing financial sectors

Working from the same page

To help governments and international institutions work from the same page in assessing financial sector vulnerabilities, the IMF and the World Bank have recently published a new manual, *Financial Sector Assessment: A Handbook*. The 480-page book details the general analytical framework, as well as specific techniques and methodologies, used in assessing the needs of financial systems in individual countries for their overall stability and development.

The Asian crisis of 1997–98 drove home the message that a strong and well-regulated financial sector is crucial in a globalized economy. Partly in response, the IMF and the World Bank launched their Financial Sector Assessment Program (FSAP) in 1999. The FSAP aims to alert national authorities to vulnerabilities in their financial sectors—whether originating inside or outside the country—and to assist them in designing measures that reduce these vulnerabilities. Since 1999, the IMF and the World Bank have jointly conducted financial sector assessments for more than 100 countries to pinpoint weaknesses and identify how national systems can be improved.



Governments are also acutely aware that financial sector instability can have serious repercussions for the entire economy, and they have become increasingly interested in undertaking these assessments themselves. Building on the FSAP and other country work, and to aid governments that may want to set up their own monitoring processes for the financial sector, the IMF and the World Bank compiled the assessment handbook to meet the demand for information about sound practices in evaluating financial systems.

"Although the handbook draws substantially on World Bank and IMF experience with the FSAP and from policy and operational work in both institutions, it is designed for use in financial sector assessments, whether conducted by country authorities themselves or by World Bank and IMF teams," says Martin Cihak, an IMF economist who helped produce the handbook. "It is our hope that the handbook will serve as an authoritative source on the objectives, analytical framework, and methodologies of financial sector assessments, as well as a comprehensive reference book on the relevant techniques."

The handbook, which is also available on CD-ROM, is being distributed to the central banks and supervisory agencies of all IMF and World Bank members, as well as other interested international institutions. It is also being made available to a wider audience on the IMF and the World Bank external websites and will be used as a reference text for a range of IMF and World Bank seminars on financial sector issues.

The emphasis of the FSAP is on preventing and mitigating crises rather than on resolving them. At the same time, it ascertains the financial sector's development needs. Sectoral developments, risks, and vulnerabilities are analyzed using a range of financial soundness indicators and macrofinancial stress tests that are identified in the handbook. Other structural underpinnings of financial stability—systemic liquidity arrangements; the institutional and legal framework for crisis management and loan recovery; and transparency, accountability, and governance structures—are also examined as needed to ensure a comprehensive assessment of both stability and developmental needs. As part of the process, the FSAP assesses countries' observance of various internationally accepted financial sector standards, set within the broader institutional and macroprudential context. ■

Jeremy Clift
IMF External Relations Department

Financial Sector Assessment: A Handbook is available online at *www.imf.org/external/pubs/ft/fsa/eng/index.htm.* Printed copies are available for $45.00 each from World Bank Publications.

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