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IMF support for Iraq prepares way for stabilizing economy and debt relief

To help Iraq stabilize its economy and restructure its massive debt, the IMF in late September approved \$436.3 million in Emergency Post-Conflict Assistance. This financing lends support to prudent monetary and fiscal policies and is designed to bolster institutional capacity and potentially lay the basis for a more ambitious economic program later next year. Two senior staff in the IMF's Middle East and Central Asia Department—Lorenzo Perez, Senior Advisor, and Adam Bennett, Division Chief—talk with Sheila Meehan of the IMF Survey about Iraq's economic prospects and the IMF's recently released staff report.



Reconstruction efforts in Baghdad. IMF financing is intended to promote macroeconomic stability.

IMF SURVEY: What does the IMF's new financial aid mean for Iraq?

Perez: It's a start, a first step.

The IMF's Emergency Post-Conflict Assistance is a window that allows us to help countries that have gone through conflict and have very limited capacity to implement economic programs. In Iraq, we have seen a willingness and a capacity by the interim government to implement policy and put together a program of economic policies and proposals for structural reform that can be supported by the IMF.

The support will assist Iraq in promoting macroeconomic stability by financing (Please turn to next page)

Making room for public investment

How to find public money to invest in infrastructure has become a hot topic in Latin America, where large external debt burdens have placed tight constraints on fiscal policy. The IMF finds itself at the center of this debate because of its ability to influence fiscal policy in countries it has lent money—a fact that applies to many countries in this region. Some European countries are also looking for ways to increase public investment. One issue here is how to invest more without infringing on the rules of the Stability and Growth Pact (SGP). Public-private partnerships (PPPs) are seen as a possible answer, but the IMF is concerned that new guidelines from the European Union's (EU's) statistical agency could be used to find a way around the SGP. Camilla Andersen of the IMF Survey spoke with Teresa Ter-Minassian and Richard Hemming, respectively Director and Senior Advisor in the IMF's Fiscal Affairs Department, about the challenge of reconciling the need for public investment with a sound fiscal policy.

Many governments are becoming increasingly worried that a decline in public investment is holding back economic growth in their countries. The problem is felt most acutely in Latin America, where public investment declined throughout the 1990s (see top chart, page 300) and where economic growth has been disappointing in many countries. At a recent United Nations conference on hunger and development, Brazil's President Luiz Inácio Lula da Silva called on the IMF to allow infrastructure investments to be excluded from the fiscal targets countries must meet to qualify for financial assistance. President Vicente Fox of Mexico made a similar proposal last year at a Group of Eight summit in Evian, France.

A number of factors have contributed to the decline in public investment in Latin America, including privatization and other policies aimed at reducing the role of government in the economy. Yet many people see the IMF as the main culprit. According to Ter-Minassian, (Please turn to page 300)

IMF helps Iraq boost capacity to implement policies

(Continued from front page) expenditure through petroleum or other available resources, maintaining a stable exchange rate, and keeping inflation under control. The program also looks to the future, with work beginning on the design of an ambitious set of structural reforms. There is, for example, interesting work on the budget, where efforts will be made to begin to eliminate domestic price subsidies on oil products.

Security continues to be a problem. We will have to assess, as we go along, how much of a problem there is in formulating and implementing policies.

IMF SURVEY: The IMF has lent in tenuous situations before, but Iraq is a large and extraordinarily volatile country right now. How does the IMF assess prospects and priorities, and to what extent can its financial and technical assistance really help?

BENNETT: This is an unusually difficult situation, even by the standard of post-conflict countries. Since August of last year, we have not been able to go to Iraq, but we have been able to hold very fruitful and regular discussions with senior officials and government ministers in locations outside of Iraq, and we have been able to provide technical assistance in a similar fashion. We also have counterparts—from the Australian, U.K., and U.S. governments—in the field who have been able to facilitate the dialogue.

PEREZ: We have been involved in a number of projects that have been key to economic restructuring and that have been carried out very well. One example is the currency exchange launched during the last quarter of 2003 until January 2004. We also helped, along with the Bank of England and the U.S. officials,

Iraq's central bank carry out auctions of foreign exchange and treasury bills. And we've been able to have discussions with the Ministry of Finance officials and agree on a fiscal program for 2005 that we hope will be implemented successfully. Within this chaos and uncertainty there has been solid proof that certain actions can be taken.

IMF SURVEY: The staff report (see box) projects a steady expansion of oil production over the next few years, with an estimated 3.3 million barrels of oil a day produced by 2009. But the report also underscores the need for significantly more investment in infrastructure and much greater efficiency in that sector. Where do you see this boost in investment coming from?

PEREZ: First, let me say that the projections in the staff report are more in the order of a scenario. It is very difficult to make a rigorous projection about what will happen in Iraq by the year 2009. We have put together a macroeconomic framework for the medium term that looks reasonable and makes sense, but by no means are we saying that this is our projection for that year.

As for investment, in the early years we see a reliance on Iraqi resources. We have talked to experts about how much it would take to maintain the capacity of existing oil wells; how much it would take to start new ones; and how many resources are needed to invest in, or just repair, the refineries. This is, to the best of our knowledge, a sensible scenario but one subject to a lot of uncertainty.

IMF SURVEY: The IMF has not taken a stand on the degree of debt reduction that Iraq will need, but how does it factor oil wealth into projections about debt sustainability?

BENNETT: To assess a country's debt-service capacity, one has to take account of its likely income over the medium and long terms. The key measure is how much income is available to service debt. It is not particularly important whether that income derives from exports of oil, another commodity, services, or manufactured goods. At the end of the day, the question is whether the country can service its debt with its projected flow of income.

PEREZ: Iraq has oil resources, and we hope that it finds more oil resources. But people looking at Iraq should keep in mind that the country has become very poor, and its oil production capacity has deteriorated. There is a tremendous need for investment, and while we project a steady increase in the produc-

Within this chaos and uncertainty there has been solid proof that certain actions can be taken.

—Lorenzo Perez

Oil sector holds key to Iraq recovery

Iraq is expected to see GDP growth increase by about 50 percent in 2004, according to the recently released IMF staff report on the economy. This rebound from a near-total halt in economic activity during the war in 2003 reflects a pickup in activity in the critically important oil sector. Also aiding in the rebound are reconstruction, a partial revival in agriculture, and brisk retail activity. Unemployment remains high, however, and widespread security problems continue to severely hamper economic recovery efforts.

Going forward, oil production is expected to remain the key driver in the Iraqi economy. At present, Iraq produces an estimated 2.1 million barrels of oil a day. In its economic assumptions, the report sees the average daily production improving to 2.4 million barrels a day in 2005 and continuing to climb to an estimated 3.3 million barrels a day in 2009.

tion and export of oil products, we also recognize that substantial resources will be needed to make that happen. In the short run, Iraq does have a very limited capacity to service its debt.

IMF SURVEY: What is the IMF's role in the ongoing Paris Club debt negotiations, and where do we go from here?

PEREZ: Negotiations between the Paris Club creditors and Iraq are scheduled to begin in mid-November in Paris. As is customary, IMF staff will be invited to make a presentation to the creditors and answer questions about both the debt sustainability analysis it prepares for the Paris Club and the program being supported by the IMF's Emergency Post-Conflict Assistance. Given the complexity of these negotiations, it may take more than one Paris Club meeting.

BENNETT: In a broader sense, our main role is with the Iraqis—to work with them to continue to formulate and implement needed policies. We intend to maintain a close dialogue over the next 6 to 9 months to monitor progress, ensure things don't fall through the cracks, and help them build their capacity to implement a more ambitious program. When Iraq is in a position to implement a more ambitious program—perhaps in the second half of 2005—a Stand-By Arrangement could be an appropriate step to take.

IMF SURVEY: The staff report makes considerable mention of the risk to the IMF in lending to Iraq at this point. It also mentions that assurances were sought from Iraq's creditors before the assistance was granted. Is this unprecedented?

BENNETT: Not unprecedented, but this is the first time it has been done in the case of emergency assistance. We are lending in an unusually difficult situation, and we have not yet had a resolution of Iraq's debt burden. Because of this, we felt we needed to garner additional assurances, and the precedent we followed was that of the Systemic Transformation Facility, which was created to enable the IMF to provide early financing to countries of the former Soviet Union in 1993. That situation was also highly uncertain—both in terms of Russia's debt and with regard to the likelihood of policy implementation in a chaotic situation.

For Iraq, we obtained two things from the Paris Club and from a critical mass of other creditors. First, the creditors agreed to defer debt service on existing obligations through the end of 2005—the period of the program supported by emergency financing—so that we could be confident that the program was fully financed. And, second, they affirmed our preferred creditor status during the repayment period of IMF resources, so that we would have first call on available resources when the time comes for repayment.

IMF SURVEY: Emergency Post-Conflict Assistance is designed to have a catalytic effect and boost international support for the recovery effort. Will it be able to do this?

PEREZ: Where the program will have a strong catalytic effect is in the debt relief negotiations. Such a program is a necessary part of the Paris Club negotiations, and tied to the Paris Club are the non-Paris Club creditors, notably, for example, Saudi Arabia, Kuwait, and the United Arab Emirates.

Unsustainable debt is a major barrier to foreign investment, since it leaves potential investors without a clear picture of whether a country can service its debt or maintain an open capital and current account. Our experience has been that foreign donors feel more comfortable if a country has a program with the IMF; this tends to guarantee a macroeconomic framework that is sustainable and reliable.

BENNETT: There have been complaints of a shortage of donor funds, but the real problem is that security must improve to allow project implementation to accelerate. If this happens, resources already on the table can be used more quickly, and when the fruits of these investments become more evident, the flow of donor financing could improve considerably.

PEREZ: I'd also like to add that the press seems to focus on the activities of the United States and the other large donors or on the IMF, World Bank, or the United Nations when discussing Iraq's reconstruction efforts. What I want to remind readers of the *IMF Survey* is that there are quite a number of very committed Iraqis working in Baghdad and other parts of Iraq, many times risking their lives to go to work. We in the IMF see this all the time, and it is something that encourages us about the future of Iraq. ■



When Iraq is in a position to implement a more ambitious program—perhaps in the second half of 2005—a Stand-By Arrangement could be an appropriate step to take.

—Adam Bennett

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The complete text of the staff report, as well as Iraq's Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding, is available on the IMF's website (www.imf.org).

IMF to help countries protect public investment

(Continued from front page) “the IMF is considered responsible for this problem because the decline in investment has occurred in an environment of overall fiscal retrenchment, often associated with IMF programs.” But, she says, “the blame is only partly justified. While the IMF might recommend cutting public expenditure, it does not typically have an opinion on where expenditure cuts should occur—except when it comes to protecting essential social programs.” By and large, she says, how to carry out the adjustment—the emphasis to put on revenue raising versus expenditure cutting—is a country’s own choice.

Public investment has suffered, Ter-Minassian explains, because it is much easier for governments to cut capital spending on infrastructure and other public projects than to trim current spending, which includes civil service wages and social security transfers. Cuts in current spending almost invariably affect

interest groups with political influence, and reducing such spending becomes even more difficult if it is undertaken in a climate of low economic growth and rising unemployment.

Should the IMF change its approach?

So what can the IMF do to help countries boost investment in infrastructure? The governments of Brazil and Mexico have proposed that the IMF target the current fiscal balance—which excludes investment—instead of the overall fiscal balance—which includes all government spending—in its loan programs. IMF staff just completed a study of this proposal, concluding that there are serious risks in such an approach. Ter-Minassian notes that “an exclusive focus on the current balance guarantees neither macroeconomic stability nor debt sustainability—not to mention the quality of the investment.”

The IMF is proposing instead to maintain the primary focus on the overall fiscal balance, but it will at the same time pay more attention to trends in the current balance and, more generally, to the balance between public saving and investment. “Where there has been an excessive compression of public investment, the staff will encourage countries—including those with IMF programs—to protect public investment spending while undertaking fiscal adjustment,” Ter-Minassian says. This should result in a better balance between public savings and public investment. Hemming adds that the IMF staff will encourage countries to develop their capacity to assess, prioritize, and manage public investment, but will leave project selection to countries. “The IMF will certainly not be ‘cherry picking’ projects—this is not a game we wish to get into,” he says.

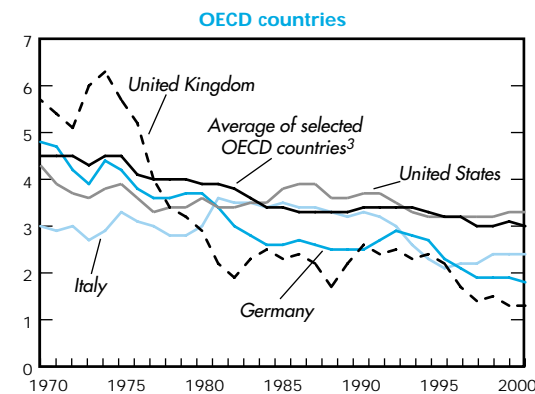
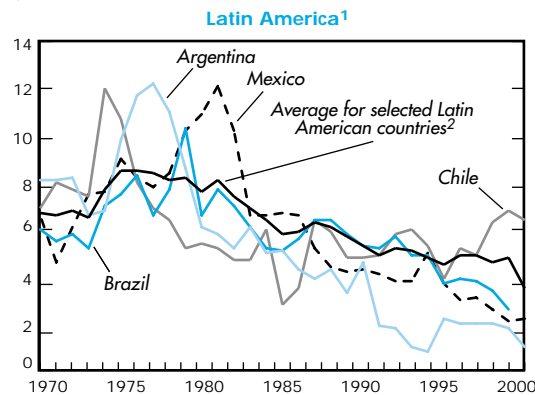
Assessing the scope to increase public investment is one goal of several pilot studies currently under way in Brazil and other countries. According to Ter-Minassian, “the pilot studies will seek to make such an assessment within a responsible fiscal framework consistent with macroeconomic stability and public debt sustainability.” The pilot studies will be completed by the end of 2004 and will inform the IMF’s further work.

Coverage of fiscal statistics

Latin American countries also complain that the IMF is treating them unfairly in another area: fiscal statistics. Whereas the statistics used by the IMF for European countries are limited to the general government, and in other parts of the world often cover only the central government, the entire public sector in Latin America is covered—including all public enterprises, regardless

Public investment has declined in both Latin American and OECD countries

(percent of GDP)



¹Includes public enterprises.

²Unweighted average for Argentina, Brazil, Chile, Colombia, Ecuador, and Mexico.

³Unweighted average for Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Norway, Portugal, Spain, Sweden, United Kingdom, and United States.

Data: International Finance Corporation and Organization for Economic Cooperation and Development (OECD)

of whether they are commercially run or not. Latin American leaders argue that this puts the region at a disadvantage by constraining infrastructure investment and making fiscal deficits seem larger than elsewhere.

“It is important to recognize that we have broader coverage in Latin America,” Hemming says, “because there is a history of public enterprises engaging in fiscal activities on behalf of the government. This contributed significantly to the debt crisis of the 1980s.” But the IMF recognizes that the approach is unfair—countries should be treated equally. It is therefore proposing to exclude all public enterprises that are commercially run from the fiscal statistics it uses for surveillance and programs in Latin America. As a general rule, these statistics will cover the general government plus those public enterprises that are not commercially run and carry out significant quasi-fiscal activities, according to Ter-Minassian. Criteria for deciding whether public enterprises are being run on commercial terms are being tested as part of the pilot studies currently under way.

Other ways to increase investment?

While the problem of declining public investment is felt most acutely in Latin America, there are also problems elsewhere, including in Europe (see bottom chart, page 300). Members of the EU have complained that the SGP, with its strict limits on fiscal deficits, limits their room for maneuver when it comes to public investment. For much of the rest of the world, data problems make it difficult to ascertain the extent of the problem. “But there is no doubt that there are infrastructure gaps in most developing countries and emerging market economies. These countries will be looking with interest at how this issue plays out in Latin America,” Hemming says.

Meanwhile, countries are exploring other avenues. The United Kingdom, which suffered from low public investment for a number of years, has been a pioneer in finding ways to boost capital spending. “The United Kingdom introduced a golden rule that allows the government to borrow to invest in infrastructure and other public goods,” Hemming says. This was made possible by a low level of debt, a focus on achieving value for money in public spending, and a high level of fiscal transparency. As a safeguard, the golden rule is combined with a debt rule.

Public-private partnerships

The United Kingdom has also helped secure greater involvement of the private sector in infrastructure and other public services through PPPs. These are now being used successfully in other countries, including Chile, Ireland, and Italy, and interest in them is growing.

Hemming explains how PPPs work: “The government asks the private sector to build an asset—such as a prison or a road—and then provide services either to the government in the case of a prison or to the public in the case of a road.” If successfully implemented, PPPs can provide a significant boost to overall investment. But, says Hemming, “PPP should be treated with care, because they give governments the opportunity to move traditional public investment off budget, and liabilities off the government balance sheet.” And there are no guarantees PPPs will offer better value for public money than traditional public investment and government services.

A key, therefore, is to get the fiscal accounting and reporting right. In particular, the full fiscal implications of PPP projects—including future fiscal risks—must be properly accounted for. If a project is undertaken by the private sector but the government is absorbing much of the risk—for instance by guaranteeing the income earned by a private partner—then this should be reflected in the fiscal accounts, Hemming says.

The accounting problem is magnified by the fact that there is currently no international accounting standard for PPPs, so countries are either following their own rules or are relying on regional organizations to tell them what to do. Because of the interest in PPPs in many EU countries, Eurostat recently developed new guidelines for classifying PPPs as either private or public investment. But while it welcomes Eurostat’s initiative, the IMF is concerned about the effect of the guidelines. “The problem with Eurostat’s approach is that it ignores many categories of PPP risk,” Hemming says. “It will allow EU countries to disregard the fiscal implications of many PPPs and could provide a means by which euro area countries can get around the fiscal constraints of the SGP.”

Ter-Minassian adds that “even if Eurostat’s criteria for classifying PPPs as private or public investment are followed, there should still be full disclosure of fiscal costs and risks so that at least the taxpayer is aware of the burden that the government is undertaking for the future. This would also allow the European Commission to take PPPs into account when assessing member countries’ fiscal policies.” ■

For more information on this topic, please refer to the papers “Public Investment and Fiscal Policy” (SM/04/93) and “Public-Private Partnerships” (SM/04/94), both of which are available on the IMF’s website (www.imf.org).



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Two new issues for monitoring: hedge funds and energy trading

Since the 1998 crisis surrounding the U.S.-based Long Term Capital Management (LTCM) fund, the hedge fund industry has grown considerably (see chart). Although the industry remains relatively small compared with other asset classes (for example, U.S. mutual funds), its rapid growth has renewed calls for more oversight and possible regulation and raised questions about the role of hedge funds in certain markets, including the energy markets. In Chapter II of the September 2004 Global Financial Stability Report, the IMF argues that a better understanding of the hedge fund industry is essential before taking policy actions, including the possible regulation of what is largely an unregulated sector. The report also takes issue with pinning recent energy price hikes solely or primarily on hedge funds. Conny Lotze of the External Relations Department explores these issues with Todd Groome, Division Chief, and William Lee, Senior Economist, in the International Capital Markets Department.

IMF SURVEY: Is the speculative activity of hedge funds in the oil market causing the price hike?

GROOME: We do not believe that is the case. Hedge funds appear to be no more participating in this market movement than pension funds, investment banks,

and mutual funds. All investors are diversifying their portfolios into alternative investments such as commodities, including oil. We do not believe that speculation in the energy market is the primary reason why prices are up. Most investors in the world believe that we face real supply constraints in the face of

growing demand and that we will likely experience a period of sustained higher prices that will induce more infrastructure investment and eventually alleviate current bottlenecks.

IMF SURVEY: The *Global Financial Stability Report* suggests that you intend to closely monitor energy trading and energy market developments as part of your financial market surveillance work. Why?

GROOME: There is a lot of activity in the financial markets, including among energy assets—both cash and derivative. Enron's crisis did not halt the growth or interest in these markets; in fact, it arguably helped by making it evolve, mature, and become a bit more stable. There have also been interesting structural developments in the energy markets. Some of the big investment banking firms have bought companies that generate power—which signals how serious they are about remaining in the energy trading business. The more they get into these markets, the more they need the physical assets to hedge positions, because you can't always rely on using financial instruments exclusively to hedge in the energy markets.

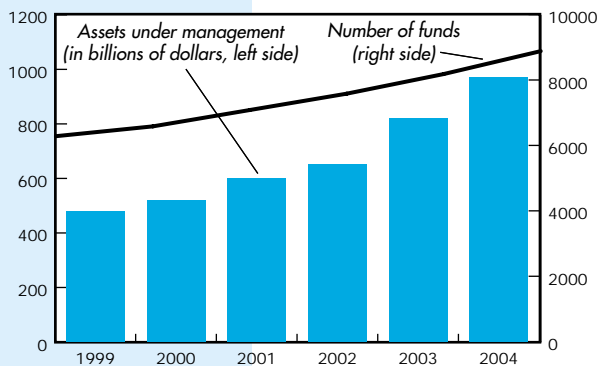
IMF SURVEY: What is behind this growing activity in the energy market?

GROOME: We believe that the energy market—especially oil and natural gas—is undergoing a structural change. Why? Supply, supply, and supply. China is certainly a big part of the recent surge on the demand side and, no doubt, much of China's increased demand is structural. But the other component most frequently cited by investors for a sustained price adjustment has been the lack of infrastructure investment. If the level of investment in refineries and delivery systems in the 1980s and 1990s hadn't greatly diminished from the level in the 1970s, meeting China's and others' increased demand would not be such a problem today. So we have a bottleneck in supply—particularly for refined products. But keep in mind that we can expect prices to decline once capacity has been adequately expanded, which takes time.

IMF SURVEY: In general, why are hedge funds so poorly understood?

GROOME: There isn't enough transparency in the hedge fund industry for third parties, particularly the official sector, to fully understand whether and how hedge fund market activities may pose systemic risks. With the large inflow of capital into the sector, we see two reasons why we should seek more transparency. First, there are so many new investors coming into the hedge fund world, seeking to diversify their portfolios, that demand is much greater than the supply of hedge fund capacity. This shifts the balance of market power to the hedge funds, even in relation to large institutional investors such as pension funds. Second, brokers, dealers, and banks that act as counterparties to hedge

Hedge funds are taking off



Note: 2004 numbers are estimates.
Data: 2004 Van Hedge Fund Advisors

funds are aggressively competing for this profitable business, and some counterparties may relax credit terms and allow much greater levels of leverage.

IMF SURVEY: Why not rely on market discipline to encourage greater transparency?

GROOME: A lot of the reports that came out after the LTCM crisis said that market discipline had failed to limit risk taking by hedge funds. We believe in markets, and we think that market discipline is a good and often very effective influence. However, we don't believe that market discipline alone should be relied upon.

LEE: We think markets work. But can market discipline itself do the job? The answer is not necessarily. Market discipline has failed in the past, and we're trying to understand better why.

GROOME: Moreover, without sufficient transparency, market discipline doesn't have the ability to be exercised effectively. In addition, market forces themselves—supply and demand—will ebb and flow, and at the moment don't favor greater transparency or market discipline.

IMF SURVEY: You propose monitoring to detect systemic risks. Who should monitor, and how should it be done?

GROOME: The banks and brokers that are themselves the counterparties to hedge funds have the best access to relevant information. As systemically important and highly regulated and supervised institutions, the system exists for effective monitoring by the regulators of these banks and brokers, including their activities related to hedge funds or any other activity.

The regulatory authorities may ask the banks as part of their normal supervisory review process to break out their hedge fund exposure by strategy, which the largest and most active banks and brokers say they do already for internal risk management purposes. The strategies they should be most concerned about are often easily identified: you look for the smaller margins, the lower or inconsistent levels of liquidity, and the use of higher levels of leverage. Once the supervisors begin monitoring, they will develop a better ability to detect potential or rising risks.

LEE: The best way to monitor and understand the hedge fund industry is through indirect observation. Look through the eyes of the hedge funds' main counterparties—the prime brokers and the banks. But this needs to be coordinated. The supervisors of the main counterparties also need to understand what questions to ask about hedge funds and related market activities. But getting agreement among supervisors isn't a simple task, especially when you have an industry that is

global and operates across borders. Nevertheless, it shouldn't be beyond their capabilities.

IMF SURVEY: Where specifically should regulators look for systemic risks?

LEE: Almost one-half of the industry's assets are in equity-related hedge funds. In very general terms, we aren't particularly worried about them. We are more concerned about the other half of the industry that is engaged in fixed-income, convertible arbitrage, and similar strategies. That is where we think there is less transparency, higher leverage, and many of the ingredients that contributed to LTCM's collapse. That is where we suggest focusing the monitoring effort.

IMF SURVEY: What happens if a trend is detected that could evolve into a potential risk?

GROOME: The supervisors may begin by asking questions of the banks and prime brokers. History has shown that the right question will change, or certainly influence, the behavior of regulated entities. A recent example is the lending to telecoms in the late 1990s. Institutions were deemed to have too much telecom exposure, so the supervisors began to ask questions and request information in this area. Subsequently, the banks changed their behavior and began to monitor their risk to telecoms more precisely and to reduce exposure to that sector.

IMF SURVEY: Could there be another LTCM?

GROOME: Keep in mind that—with all due respect to hedge fund investors—we aren't worried about a hedge fund failing. We're worried about systemically important institutions like banks and brokers getting hurt. If there was going to be an accident related to hedge fund activities, we suspect it would most likely occur in the fixed-income markets. It would arguably be in sectors where margins are tight, leverage is relatively higher, and 90 percent, or a substantial majority, of the market participants are hedge funds. Any asset class where 80–90 percent of participants are hedge funds is a market that is subject to relatively higher risk, because these participants are active, highly leveraged, and likely to react to a market shock in the same way at the same time.

Having said that, we want to emphasize that hedge funds are an established investor group and a constructive influence on efficient market behavior. Hedge funds, like other institutional investors, can contribute to or adversely affect financial stability. As such, we still don't know what we don't know about hedge funds, and we support efforts to improve our understanding of their market activities. ■



Groome: "If there was going to be an accident related to hedge fund activities, we suspect it would most likely occur in the fixed-income markets."



Lee: "Market discipline has failed in the past, and we're trying to understand better why."

High debt levels hurt economic growth by hampering investment and productivity

We know that at low levels, external debt has positive effects on growth but, above a certain threshold, this effect turns negative. In a recent study, Catherine Pattillo, H el ene Poirson, and Luca Ricci build on their research in this area by asking how exactly debt affects growth. Is it mostly through an effect on the accumulation of the factors of production (investment in capital and labor) or on factor productivity growth? They find that high debt levels have a strong negative effect on both.

Economic theory suggests that “reasonable” levels of borrowing are likely to enhance economic growth, both through factor accumulation and productivity growth. Countries at early stages of development have small stocks of capital and are likely to have investment opportunities with higher rates of return than in advanced economies. As long as they use the borrowed funds for productive investment—and do not suffer from macroeconomic instability, policies that distort economic incentives, or sizable adverse shocks—economic growth should increase and allow for timely debt repayments.

What the theories say

But too much debt does create problems. “Debt overhang” theories, for example, argue that if there is some likelihood in the future that debt will be larger than the country’s repayment ability, expected debt-service costs will discourage further domestic and foreign investment. Potential investors will fear that the more is produced, the more will be “taxed” by creditors to service the external debt and, thus, they will be less willing to incur investment costs today for the sake of increased output in the future. The expectation that some portion of the debt will have to be forgiven can also at some point discourage private foreign investors from providing new financing, thus lowering capital accumulation.

The channel for the debt overhang’s effect on growth may be through productivity growth as well as the volume of investment. The anticipation of future debt relief may, for example, reduce governments’ incentives to pursue difficult policy reforms that would strengthen their repayment capacity, and this disincentive will have a negative impact on productivity growth.

Similarly, the literature stressing the uncertainties created by high debt stocks seems to imply also that debt constrains growth through either the capital accumulation or the productivity channel. In highly

uncertain and unstable environments, even if the fundamentals are improving, investors may hesitate to invest in costly, irreversible projects though they may have higher rates of return in the long run and have beneficial consequences for productivity growth. Instead, investment decisions are made on the basis of short-run rates of return. As a result, productivity growth will tend to be slower in a highly uncertain environment.

Finally, debt relief advocates argue that high debt severely constrains low-income countries’ abilities to provide social services, such as education. For their part, individuals view the decision to acquire human capital as an investment decision, which might be negatively affected if individuals expect most of the anticipated return on their investment (in the form of higher future wages) to be taxed away. High debt levels could thus lower growth by slowing human capital accumulation. This effect may be very difficult to detect, however, as it would affect human capital stocks only with long time lags.

What the data show

Theory, thus, suggests that debt could have negative effects on growth, either through capital accumulation or productivity growth. But what do the data show? Using a data set for 61 developing countries spanning sub-Saharan Africa, Asia, Latin America, and the Middle East over 1969–98, Pattillo, Poirson, and Ricci find that, consistent with their previous study, the impact of debt on growth is very different at low and high levels of debt. At high levels, debt has a large negative impact: on average, doubling debt from any initial debt level at or above the threshold where the impact of further debt accumulation starts to turn negative will reduce per capita growth by about 1 percentage point. At low levels, the effect is generally positive but often not significant.

In terms of the channels through which debt affects growth, the data show that the impact of high debt operates both through a strong negative effect on physical capital accumulation and on total factor productivity. The size of the effects is similar to that of the effect on output growth: on average, for countries with high debt levels (around 65 percent of exports), doubling debt will reduce output growth by about 1 percentage point and reduce growth in both per capita physical capital and total factor productivity by almost as much. In terms of the contributions to growth, approximately one-third of the effect of

debt at high levels of indebtedness occurs via physical capital accumulation and two-thirds via total factor productivity growth. In contrast, the impact of high debt on human capital accumulation is not significant. At low debt levels, the effect of debt tends to be positive for total productivity growth and negative for capital (on average) but generally not significant.

These results are consistent with the speculation that high debt reduces the incentive to invest and to undertake good policies, since the return on such actions can be expected to accrue partly to lenders rather than to citizens and politicians of a highly indebted country. In contrast, the impact of debt on human capital accumulation could not be detected, say the authors, perhaps because it operates with very long time lags.

What about reverse causality?

Does high debt actually lower growth (and its components), or does low growth increase indebtedness? Both directions of causality have been argued in the literature. William Easterly of New York University, for example, contends that low growth does increase indebtedness. He maintains that the worldwide slow-down in growth after 1975 contributed to the debt crises of the middle-income countries in the 1980s and the heavily indebted poor countries (HIPCs) in the 1980s and 1990s. In this view, lower growth reduces tax revenues and primary surpluses and, without adjustment, debt ratios explode. The authors explore this reverse causality. Their evidence suggests that both the effect of indebtedness on growth and the effect of growth on indebtedness are significant.

Policy implications

Based on the study's finding, for the average country in the sample, reducing debt levels would contribute

to growth by boosting both capital accumulation and productivity growth. But reducing debt may not have the desired effect on capital or productivity growth (and therefore output growth) if other macroeconomic and structural distortions or political constraints bind.

It is important to note, say the authors, that although the findings are relevant for current policy debates on the potential impact of the HIPC Initiative and forward-looking assessments of debt sustainability in low-income countries—suggesting that some of these countries may be caught in a low-growth debt trap—the economic and political situations of these countries make them an atypical subsample. Lowering debt alone may not be sufficient to jump-start growth in these countries in the absence of structural reforms that address the key bottlenecks to growth (such as lack of human capital, institutional weaknesses, and inadequate financial intermediation). In addition, HIPCs experience worse macroeconomic and institutional conditions than the average country in the sample. And, in that aid flows to them exceeded their debt service, several HIPCs received a positive net transfer of resources throughout the 1980s and 1990s (as have many other low-income countries). Further research would be necessary to determine the extent to which the findings of this study hold specifically for HIPCs. ■

Copies of IMF Working Paper No. 04/15, "What Are the Channels Through Which External Debt Affects Growth?" by Catherine Pattillo, Hélène Poirson, and Luca Ricci, are available for \$15.00 each from IMF Publication Services. See page 308 for ordering information. The full text of the paper is also available on the IMF's website (www.imf.org).

High debt reduces the incentive to invest and to undertake good policies, since the return on such actions can be expected to accrue partly to lenders rather than to citizens and politicians of a highly indebted country.

Michael Kuhn to head IMF's Finance Department

IMF Managing Director Rodrigo de Rato announced October 13 that he had appointed Michael Kuhn as the new Director of the Finance Department. Kuhn is replacing Eduard Brau, who led the department for the past five years.

"As Deputy Director of the Finance Department since 1999, Michael Kuhn has helped lead the work on modernizing the IMF's financial policies, streamlining the Finance Department's operations, and strengthening its work on financial risk management and



Michael Kuhn (left) and Eduard Brau at Brau's retirement party.

safeguarding the IMF's resources," de Rato said. Kuhn will take over a department that has made great strides in recent years in improving the transparency of the IMF's financial accounts—improvements that the Managing Director attributed to Brau's outstanding leadership.

Kuhn, 54, is a national of Germany. He joined the IMF staff in 1983 and has held senior positions in a number of different departments. Kuhn holds degrees in economics from Golden Gate and Princeton universities.

Per Jacobsson lecture

Summers urges addressing U.S. current account deficit in global context

Lawrence H. Summers, president of Harvard University and former U.S. Treasury Secretary, delivered the annual Per Jacobsson Foundation lecture on October 3 at the Organization of American States, with reflections on the U.S. current account deficit and the global economy.

Summers called for increased national saving in the United States and for further adjustment of the exchange rate against the dollar—particularly through greater flexibility of the exchange rates of key Asian currencies—to reduce the sizable and growing U.S. current account deficit. Addressing a large gathering of policymakers, economists, academics, development experts, journalists, and members of the general public, he said increased national saving and further exchange rate adjustment will work as a remedy when taken together, but not individually.

Placing the U.S. current account deficit within the context of the “very substantial increase in the pattern of global imbalances in general,” Summers emphasized both the scale of the problem and the need to address it in the near, not distant, future. The U.S. current account deficit, he noted, was currently running well in excess of \$600 billion at an annual rate, or in the range of 5.5 percent of GDP, and was “without precedent in the American experience.” It represents about 1.25 percent of global GNP, he added—which means that it is larger, relative to the global economy, than any previously recorded national deficit.

Summers attributed the widening current account deficit—which is the difference between national saving and national investment—to “reduced saving and increased consumption rather than to increased investment.” U.S. net national savings, which have declined sharply in the past five years, were between 1 and 2 percent in 2003. Meanwhile, he said, a number of Asian emerging market economies had substantially increased their reserves and were effectively financing the U.S. current account deficit through central bank intervention. Their objectives were to maintain “competitiveness and a strong traded goods sector, and an exchange rate that does not fluctuate significantly against the dollar.”

A rapidly growing U.S. current account deficit, financed with reliance on the official sector, poses two risks, Summers said. First, it generates incipient protectionist pressures, such as the recent concern in the

United States over outsourcing. Second, dependency on “international vendor finance,” especially from countries whose governments intervene to maintain fixed exchange rates to create an “illusory sense of stability,” can lead to vulnerability over the medium term. Though at present this arrangement has its benefits—finance at a low cost for the United States when its saving is low, and strong exports and a competitive traded goods sector for the financing countries—its risks cannot be ignored.

In Summers’ view, addressing the problem of the U.S. current account deficit requires global, not just domestic, consideration. He argued that because the related issues of fixed or quasi-fixed exchange rates and international vendor finance lie outside the Group of Seven (G-7) countries, these matters need to be discussed in global forums. The G-7 countries are unlikely to be “the appropriate grouping for the totality of that reflection,” he said.

In response to a question about the seeming mismatch in the time required to take the two recommended actions—increase national saving, which is time-consuming, and adjusting quasi-fixed exchange rates, which could, in principle, be done immediately—Summers noted that a significant part of the effects of an increase in future saving can happen through the expectation of it occurring. Thus, in the United States in 1993–94, following the passage of a program to reduce the fiscal deficit, there was “a rather discontinuous change in the sense of sustainability” before the measures were implemented.



The U.S. current account deficit is without precedent in the American experience.

—Lawrence H. Summers

Andrew Crockett to chair Per Jacobsson Foundation

The Per Jacobsson Foundation has selected Andrew Crockett as its new chair. He will succeed Jacques de Larosière, who has chaired the foundation since November 1999.

Crockett has been President of JPMorgan Chase International since 2003. After working at the Bank of England, he joined the IMF staff in 1972 and rose to the position of Deputy Director of the Research Department. In 1989, he left the IMF to become an Executive Director of the Bank of England. Between 1993 and 2003, Crockett was General Manager of the Bank for International Settlements. He was also the first Chair of the Financial Stability Forum (1999–2003). He has been a director of the Per Jacobsson Foundation since October 1993.

In this way, particularly given the capacity for multi-year budgeting, the expectation of increased future saving “casts a shadow backwards.” On the nature of the exchange rate adjustments, he clarified that because a spectrum of arrangements—from repegging to a managed float—was possible, the timing of the adjustments would depend on a variety of country-specific and global issues.

Toward the end of his address, Summers also reflected on the importance of events such as the

IMF–World Bank Meetings and the Per Jacobsson lectures. These meetings, he said, allow hundreds of people to talk and argue with hundreds of others about critical issues and what can be done. Such discussions ultimately become part of the process that drives policy. ■

The full text of Lawrence H. Summers' speech, “The U.S. Current Account Deficit and the Global Economy,” is available on the Per Jacobsson website (www.perjacobsson.org).

Stand-By, EFF, and PRGF arrangements as of September 30

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	December 31, 2004	128.64	26.80
Brazil	September 6, 2002	March 31, 2005	27,375.12	10,175.48
Bulgaria	August 6, 2004	September 15, 2006	100.00	100.00
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Croatia	August 4, 2004	April 3, 2006	97.00	97.00
Dominican Republic	August 29, 2003	August 28, 2005	437.80	306.46
Gabon	May 28, 2004	June 30, 2005	69.44	41.66
Paraguay	December 15, 2003	March 31, 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	February 4, 2002	February 3, 2005	12,821.20	907.20
Ukraine	March 29, 2004	March 28, 2005	411.60	411.60
Uruguay	April 1, 2002	March 31, 2005	1,988.50	279.60
Total			54,545.58	19,291.09
EFF				
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	250.00
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Total			794.40	373.73
PRGF				
Albania	June 21, 2002	June 20, 2005	28.00	8.00
Armenia	May 23, 2001	December 31, 2004	69.00	9.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	38.61
Bangladesh	June 20, 2003	June 19, 2006	400.33	251.83
Burkina Faso	June 11, 2003	June 10, 2006	24.08	17.20
Burundi	January 23, 2004	January 22, 2007	69.30	42.90
Cameroon	December 21, 2000	December 20, 2004	111.42	31.83
Cape Verde	April 10, 2002	April 9, 2005	8.64	2.49
Congo, Democratic Republic of	June 12, 2002	June 11, 2005	580.00	53.23
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Dominica	December 29, 2003	December 28, 2006	7.69	4.71
Ethiopia	March 22, 2001	October 31, 2004	100.28	0.00
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	June 4, 2004	June 3, 2007	98.00	84.00
Ghana	May 9, 2003	May 8, 2006	184.50	105.45
Guyana	September 20, 2002	March 19, 2006	54.55	37.06
Honduras	February 27, 2004	February 26, 2007	71.20	61.03
Kenya	November 21, 2003	November 20, 2006	175.00	150.00
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	9.56
Lao People's Democratic Republic	April 25, 2001	April 24, 2005	31.70	13.58
Lesotho	March 9, 2001	October 31, 2004	24.50	0.00
Madagascar	March 1, 2001	March 1, 2005	91.65	22.70
Malawi	December 21, 2000	December 20, 2004	45.11	32.23
Mali	June 23, 2004	June 22, 2007	9.33	8.00
Mauritania	July 18, 2003	July 17, 2006	6.44	5.52
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Mozambique	July 6, 2004	July 5, 2007	11.36	9.74
Nepal	November 19, 2003	November 18, 2006	49.91	42.78
Nicaragua	December 13, 2002	December 12, 2005	97.50	41.78
Pakistan	December 6, 2001	December 5, 2004	1,033.70	172.28
Rwanda	August 12, 2002	August 11, 2005	4.00	1.71
Senegal	April 28, 2003	April 27, 2006	24.27	17.33
Sierra Leone	September 26, 2001	March 25, 2005	130.84	28.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	29.40
Tanzania	August 16, 2003	August 15, 2006	19.60	11.20
Uganda	September 13, 2002	September 12, 2005	13.50	6.00
Zambia	June 16, 2004	June 15, 2007	220.10	137.56
Total			4,624.73	1,985.08

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

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- 04/209: Ghana: Enhanced Initiative for HIPC—Completion Point Document
- 04/210: Ghana: Second Review Under the PRGF and Request for Waiver of Nonobservance of Performance Criteria

HIPC=Heavily Indebted Poor Countries
 PIN=Public Information Notice
 PRGF=Poverty Reduction and Growth Facility
 PRSP=Poverty Reduction Strategy Paper
 ROSC=Report on the Observance of Standards and Codes

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The stark reality facing the WTO and the poorest countries

While small and poor countries have acquired a significant say in decision making in the World Trade Organization (WTO), their ability to participate in the “reciprocity game” at the heart of the WTO remains limited. These countries also pose a challenge for the WTO because their interest in the broader trade liberalization agenda is more limited as a result of their existing preferential access to rich country markets. How should the multilateral trading system accommodate the interests of small, poor countries? Aaditya Mattoo of the World Bank and Arvind Subramanian of the IMF spoke with Jacqueline Irving of the IMF Survey about their recent Working Paper on this topic, which draws attention to the “stark reality” that desirable ways of addressing poor countries’ concerns—by providing them with additional financial assistance and nonpreferential market access—are not proving feasible.

IMF SURVEY: How does the influence that small and poor countries wield in the global trading system negotiations differ from that of larger developing countries?

MATTOO: The WTO is a mercantilist institution in the sense that countries trade off one another’s protection—you give me better access to your market, and I’ll give you better access to my market. The currency for these negotiations is market size. However, the small and poor countries don’t have much to offer either individually or collectively to the rest of the world in terms of market access. So their influence derives not from this traditional coinage of the WTO but from the fact that the WTO is a very democratic institution. Each country has one vote and to make any major decision, traditionally you need consensus. But legally you need at least a large majority—typically two-thirds of the membership. And the small and poor countries now constitute a majority of the WTO membership. Perhaps even more important, they wield a moral influence derived from generally having benefited little from the global trading system, particularly the Uruguay Round negotiations.

IMF SURVEY: How does small country size affect the main benefits that WTO membership offers?

SUBRAMANIAN: Since the coinage of the WTO is market size, because you have less to offer, you can ask less of your trading partners, and this somewhat diminishes the extent to which you can seek greater access in the markets of your trading partners. By the same token, because one of the important benefits of

the WTO is for a country to be able to open its own markets, the fact that a country has a small market means that the trading partner is less interested in the country opening up its market, resulting in fewer pressures from within the WTO on opening—including making such market openings irreversible. This makes a small country doubly disadvantaged.


IMF SURVEY: At the same time, you have also noted the growing influence of these small and poor countries in the world trading system. What do you think the consequences would be if the demands arising from this growing influence are not addressed?

SUBRAMANIAN: Since, unfortunately, our paper has sometimes been misunderstood, we need to make it completely clear that we think that this influence is desirable. This empowerment of the small and poor countries is going to lead to more egalitarian outcomes. The real challenge is how the interests of these countries are going to be accommodated. If their interests are not accommodated, the ability of the system to deliver even broader multilateral liberalization might be stymied. These interests need to be accommodated in the most desirable way—that is, in a way that allows the system to continue to deliver broader liberalization but also to address the development needs of these countries. If that were not to happen, I think it will be a significant stumbling block to further multilateral liberalization.

IMF SURVEY: You argue that the overall impact of the liberalization of nontariff agricultural support policies on the smaller, poor countries is negligible. Doesn’t this finding contradict the conclusions of recent studies by the World Bank and others showing that large reductions in poverty would result from the dismantling of subsidies on developed countries’ agricultural exports?

SUBRAMANIAN: Most such studies by the World Bank and others calculate the impact of undertaking broad-based liberalization, as well as the impact of eliminating industrial country subsidies. So they calculate the sum total of these effects—the so-called market access effects, which is the outcome when trading partners liberalize their markets and the benefits that accrue when a particular country liberalizes its own markets.

Three or four points about these studies are noteworthy. First, on the market access side, many of



It is important not to overpromise what the WTO and the Doha Round can deliver for the small and poor countries.

—Arvind Subramanian

When small countries and big countries negotiate together on trade, the package of benefits should also include finance issues.

—Arvind Subramanian

these studies do not take into account the fact that when industrial country trading partners reduce tariffs, in many instances this actually adversely affects the exports of small and poor countries because they already have preferential access to the industrial country markets. In fact, Most-Favored-Nation (MFN) liberalization undercuts their competitive advantage and reduces their exports.

Second, a careful examination of these studies reveals that most of the benefits to a country—roughly, two-thirds to three-quarters of the total—arise from what the country does in terms of its own market opening rather than what a partner country does. If that is the case, you've got to ask, for example, will these small and poor countries actually reduce their own tariffs in the course of the Doha Round by the amount suggested in these studies? For the reasons that we advanced earlier, it is probably somewhat unrealistic or optimistic to assume that all of this major liberalization is going to occur and that these countries are going to reap the projected benefits. For these reasons we argue for more caution interpreting the results of these studies.

MATTOO: These studies and our work also reveal that you need to take a more careful look at what the impact of multilateral liberalization is going to be on poor countries. It is true that, in many cases, small and

poor countries already have preferential access, but it is also often true that preferential access is subject to conditions like restrictive rules of origin. This means that a substantial proportion of these countries' exports come in at MFN or nonpreferential rates. There is a need for more empirical work to examine the relative impact of an erosion of preferential access, and the impact of improved access where products are, in effect, being sold at nonpreferential rates.

IMF SURVEY: You argue that accommodating the specific interests of small and poor countries is not only desirable in itself but would further progress in the Doha Round. Can you explain how?

MATTOO: Because the WTO is an organization that, for the most part, works by consensus or at least a substantial majority, its member countries need to agree on the launching and conclusion of any new round. So accommodating the interests of small and poor countries would further overall progress by demonstrating to this group of countries that they have a shared interest in multilateral liberalization and that the aggregate package would leave all countries better off as a consequence of the Doha Round.

IMF SURVEY: The "stark reality" in your paper's title is that desirable ways of accommodating these

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- 04/211: IMF and Turkey to Resume Discussions on a New Stand-By Arrangement on October 11, October 8
- 04/212: High-Level Meetings of Global Unions–World Confederation of Labor with the IMF and the World Bank, October 8
- 04/213: Trinidad and Tobago Formally Begins Participation in the IMF's General Data Dissemination System, October 12
- 04/214: IMF Managing Director Rodrigo de Rato Names Michael Kuhn as Director of the Finance Department, October 13 (see page 304)
- 04/215: High-Level Conference on Financial Sector Issues in Emerging Markets in Asia: Role of the IMF, October 13
- 04/216: IMF Approves in Principle Fifth Review Under Madagascar's PRGF Arrangement and Approves \$16.6 Million Disbursement, October 18
- 04/217: IMF Managing Director Rodrigo de Rato to Visit Saudi Arabia, Lebanon, and Egypt, October 20

Public Information Notices

- 04/110: IMF Executive Board Reviews the Role of the Fund in Low-Income Member Countries, September 30
- 04/111: IMF Executive Board Discusses the Status of Implementation of the Enhanced HIPC Initiative, September 30

- 04/112: IMF Concludes 2004 Article IV Consultation with the Russian Federation, September 30
- 04/113: IMF Executive Board Reviews Poverty Reduction Strategy Papers—Progress in Implementation, September 30
- 04/114: IMF Executive Board Discusses Policy Signaling Instrument, October 1
- 04/115: IMF Concludes 2004 Article IV Consultation with Guinea, October 3
- 04/116: IMF Concludes 2004 Post-Program Discussion with the Philippines, October 3
- 04/117: IMF Discusses Status Report on Crisis Prevention and Precautionary Arrangements, October 6
- 04/118: IMF Concludes 2004 Article IV Consultation with the Democratic Republic of Timor-Leste, October 12
- 04/119: IMF Discusses Operational Debt Sustainability Framework for Low-Income Countries, October 15

Statement at Donor Meeting

"The IMF Is Supporting Iraq," Takatoshi Kato, IMF Deputy Managing Director, International Donors' Meeting for the Reconstruction of Iraq, October 13

Transcript

African Finance Ministers Press Conference, October 3

HIPC = Heavily Indebted Poor Countries
PRGF = Poverty Reduction and Growth Facility

countries' interests—giving them more nonpreferential access to developed countries' markets and more financial and technical assistance—are not feasible. Could you say a little bit about why this is?

SUBRAMANIAN: The difficulty these countries have in acquiring further nonpreferential access to developed country markets derives from the fact that a small, poor country has less to offer. This reciprocal exchange of concessions occurs within the WTO because when a country—let's say "country A"—liberalizes, it faces political costs from its import-competing industries. So country A therefore needs an offsetting interest or a benefit from negotiations that would accrue to other local interest groups and so countervail the power of those who lose. So if a partner country has very little to offer, then country A cannot mobilize those interested in removing trade barriers on imports from the partner country to say: It is true that the import-competing group will lose, but we will gain and therefore the political-economy problems will be better addressed. But having said that, one shouldn't overstate that case. If you look at what's happening in the Doha Round now, even though these countries are small, they have managed, for example, to put cutting cotton subsidies on the agenda because of the voice that they've acquired in different ways.

The other desirable way of accommodating the interests of small and poor countries is, of course, by providing financial and technical assistance. While this is desirable, we argue in our paper that there are a number of reasons why this is not feasible. First, we know that additional aid gets promised for a number of different issues, but the question is whether offers of aid are truly an addition to what would have been given otherwise. If not, it is just aid substitution.

Second, can these offers be made credible? It is one thing for countries to promise more aid, but we've seen in the recent past in a number of areas—for example, in the case of aid disbursed for combating HIV/AIDS, mobilizing the additional pledged aid is not easy.

Third, in some ways, what we are proposing is somewhat radical in terms of structure, because we are saying that when small countries and big countries negotiate with each other on trade, the package of benefits should also include finance issues. This means that there needs to be much greater integration of trade and financial decisions both at the global level and at the level of individual countries. In the past, it has been quite difficult to achieve this coordination. It remains to be seen whether this can be achieved in the future.

IMF SURVEY: You further argue that the feasible ways of accommodating these countries' interests—

including by granting them more preferential market access and relieving them of obligations to enhance their welfare—are less desirable. What makes this option "less desirable?"

MATTOO: There is no specific evidence that preferential market access has actually enhanced the growth prospects of countries. Preferential access provides an incentive for a country to specialize in areas that are not always those in which it has a global comparative advantage. When preferential access disappears, there can be substantial switching costs. At the same time, there is evidence to suggest that preferential access relieves a country of the obligation to liberalize its own policies. Consequently, countries that have been dependent on preferential access have often had the highest domestic levels of protection. So, on these grounds, it is not obvious that preferential access is desirable.

From the point of view of the WTO moving ahead, I think granting further preferential market access would, in fact, have undesirable effects, because every time preferential access is granted, the stake of the recipient in further multilateral liberalization diminishes.

IMF SURVEY: What can be done to alter this stark reality and move toward a situation where the more desirable options become more feasible?

SUBRAMANIAN: That's a good and difficult question, because if there were an easy answer, we probably wouldn't call it the stark reality. Some progress, however, is being made toward accommodating small and poor countries' interests through nonpreferential market access benefits—because of the voice that these countries have acquired in the Doha Round and their willingness to engage actively in negotiation. But there are limits to how much can be improved because of the structure and disadvantages of size that these countries face.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
October 11	2.01	2.01	3.10
October 18	2.03	2.03	3.13

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2004).

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

Data: IMF Finance Department

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—Aaditya Mattoo



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To accommodate the concerns of these countries through financial and technical assistance, the international community—both the trade and the financial wings—needs to come together and explore imaginative ways of how more financial and technical assistance could be put on the table in a way that's credible and additional. The bargaining space has to be expanded to include finance.

MATTOO: Returning to the issue of the structural difficulty of negotiating nonpreferential access when your own market is small: a more enlightened possibility that we are beginning to see is that the rest of the world is recognizing that to be able to move on with multilateral liberalization, the richer countries must provide nonpreferential access to the poorest countries even in areas where the former have specific interests. This way, the poor countries don't need to pay with their own access. Other developing countries, the European Union, and the United States may be willing to buy each other off to advance negotiations. So the market size of small, poor countries—where there is an awareness of the need to strike a bargain that benefits everybody—may be less of a constraint.

Turning to financial and technical assistance, it is not easy to see how such assistance can be made credible, additional, and genuinely productive. Experience with aid has not always been very positive. Arvind mentioned the need for coherence and for international organizations like the World Bank and the IMF to work more closely with the WTO. However, that multilateral coherence must, in a sense, be mirrored by coherence at the national level between the ministries of finance and the ministries of commerce, in both industrial and developing countries.

Today, negotiations proceed dichotomously and there is a need for greater internalization of the overall development objectives. The U.K. government, for example, demonstrated how fruitful it can be in terms of greater policy coherence to have stronger links between the people who look after trade and the people who look after development. More such efforts at the national level could then feed into the multilateral context.

Also, all of the international organizations have gotten together to collaborate, first of all, in a diagnostic exercise to identify exactly what is needed to make small and poor countries participate more fully in trade negotiations in a way that furthers their development. However, it is still too early to judge how much additional assistance that integrated framework has generated and how fruitful that assistance has been in remedying the bottlenecks.



Benin is among the countries that have demanded a fairer international trade regime for cotton growers.

SUBRAMANIAN: The thrust of this paper is somewhat of a plea for moderating the goals and expectations that one can have for the WTO order or the Doha Round, because of all the difficulties that we've identified, including the difficulty of giving the WTO a truly pro-development agenda. I think it is important not to overpromise what the WTO and the Doha Round can deliver for the small and poor countries.

MATTOO: Arvind is right. Expectations in a purely limited trade context must be toned down. At the same time, however, we have identified a positive agenda. One of the key contributions of this paper is that it makes clear that it is important to take a more nuanced view of developing countries. There are strong differences between them, which means that their interests are not perfectly aligned. If it were possible to think of the negotiations more broadly as encompassing not just trade concessions but also a credible assurance of multilateral assistance, then we do think that from this larger context of multilateral trade negotiations, the poorest countries could conceivably benefit. However, we admit that this will be difficult in practice. ■

Copies of IMF Working Paper No. 04/81, "The WTO and the Poorest Countries: The Stark Reality," by Aaditya Mattoo and Arvind Subramanian, are available for \$15.00 each from IMF Publication Services. See page 308 for ordering information. The full text of the paper is also available on the IMF's website (www.imf.org).