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Advisory panel proposes new ways to fund IMF

page 35

Managing Director Rodrigo de Rato has submitted to the IMF's Executive Board a report by a Committee of Eminent Persons, chaired by Andrew Crockett, outlining a package of measures to establish a more stable revenue stream for the 62-year-old institution. The IMF's income has fallen with a decline in new lending, and de Rato had asked the committee to look at a long-term income model for the Fund.

Michael Spilotro/IMF

Europe must face up to hard policy choices

page 41

With sustained economic recovery under way and another successful enlargement of the European Union completed, Europe should finally have something to cheer about. Instead, reform fatigue has gripped many policymakers, and Europe's citizens seem intent on blaming the EU and globalization for their countries' woes. Michael Deppler, head of the IMF's European Department, explains why Europe must face up to its problems and press ahead with much-needed reforms.

Eugene Salazar/IMF

France and Germany need further structural reforms

page 44

France's economic performance over the past few years has surprised many observers, while a brisk economic recovery is under way in Germany. But both European heavyweights need to carry out further tough structural reforms to underpin growth and boost productivity. In Germany, domestic efficiency and labor utilization remain low, while in France fiscal adjustment and action to address labor market rigidities are priorities.

Sean Gallup/Getty Images

Flat tax assessment provokes strong debate

page 48

A new IMF working paper on the flat tax has stirred a heated debate about the benefits and drawbacks of the tax. The authors argue that the flat tax experiment is a failure, finding insufficient evidence that flat taxes boost work incentives or compliance with tax laws. They predict that countries that have adopted a flat tax will probably move away from it. Flat tax supporters say the researchers have made sweeping statements that are not supported by hard evidence.

Thomas Dooley/IMF

IN THIS ISSUE

34 What's on

34 IMF financial data

35 In the news
Eminent persons committee report
Interview: Andrew Crockett
Financial soundness indicators

41 European focus
Interview: Michael Deppler
Germany, France

48 Forum
Flat tax

What's on

FEBRUARY

13–15 Global Forum: Building Science, Technology, and Innovation Capacity for Sustainable Growth and Poverty Reduction, World Bank, Washington, D.C., United States

MARCH

4–6 Institute of International Bankers' 2007 Annual Washington Conference, Washington, D.C., United States

7–8 International Seminar on Strengthening Public Investment and Managing Fiscal Risks from Public-Private Partnerships, IMF, Hungarian Ministry of Finance, International Center for Economic Growth—European Center, Budapest, Hungary

16–20 48th Annual Meeting of the Inter-American Development Bank and the 22nd Annual Meeting of the Inter-American Investment Corporation, Guatemala City, Guatemala

19–23 7th Annual Conference of the Parliamentary Network of the World Bank, Cape Town, South Africa

24–25 G20 Deputies meeting, Pretoria, South Africa

APRIL

2–4 3rd Secondary Education in Africa Regional Conference, Ghana, Ministry of Education, Accra, Ghana

3 1st Global Forum Plenary Meeting on "Policy Reform Options for Effective Development Finance," OECD, Paris, France

14–15 2007 Spring Meetings of the World Bank Group and the IMF, Washington, D.C., United States

16 Special High-Level Meeting of the Economic and Social Council with the Bretton Woods institutions, the World Trade Organization, and the United Nations Conference on Trade and Development, New York, United States

MAY

9–14 IMF High-Level Seminar on Macroeconomic Management and the Japanese Experience in Economic Development, Tokyo, Japan

20–21 European Bank for Reconstruction and Development, Annual Meeting and Business Forum, Kazan, Russia

30–15 June 96th Session of the International Labor Conference, Geneva, Switzerland

JUNE

6–8 G8 Summit, Heiligendamm, Germany

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.*

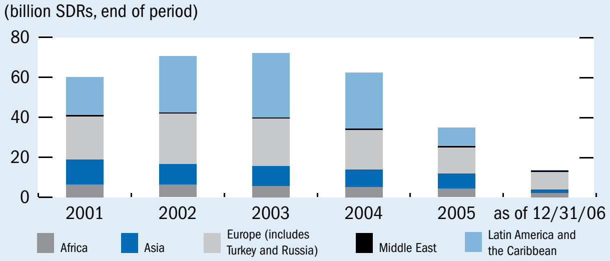
New Perspectives on Financial Globalization
IMF, Washington, D.C., April 26–27, 2007

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

For details, see *www.imf.org.external/np/seminars/eng/2007/finglo/042607.htm.*

IMF *financial data*

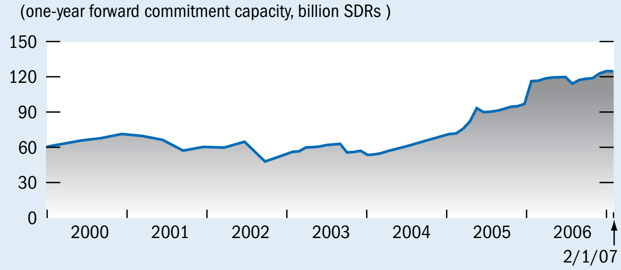
Total IMF credit and loans outstanding, by region
(billion SDRs, end of period)



Largest outstanding loans
(billion SDRs, as of 12/31/06)

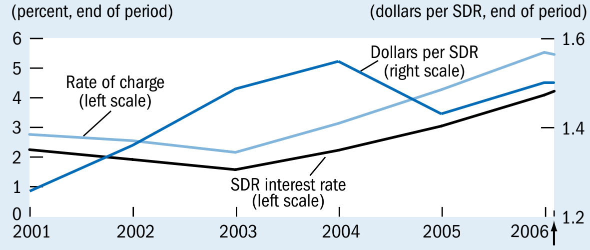
Nonconcessional (GRA)		Concessional (SAF/PRGF)	
Turkey	7.15	Pakistan	0.94
Ukraine	0.55	Congo, Dem. Rep. of	0.55
Dominican Republic	0.31	Bangladesh	0.31
Serbia, Republic of	0.30	Georgia	0.16
Iraq	0.29	Yemen, Republic of	0.15

Available IMF 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: 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.

Eminent persons report

Experts call for new ways to fund IMF

An advisory panel, set up to review how the IMF generates its income, has proposed a package of measures to establish a more stable revenue stream for the institution that is more appropriate to the range of activities now undertaken by the Fund and more responsive to evolving conditions in the global economy.

The Committee of Eminent Persons, chaired by Andrew Crockett, President of JPMorgan Chase International (see Box 1), was formed by Managing Director Rodrigo de Rato last May as part of his medium-term strategy for modernizing the work of the IMF in several major areas, including the IMF's role in a globalized economy, governance of the institution, and its finances.

In a report released on January 31, the committee identified a package of proposals to help put the IMF's finances on a sound long-term footing. "The Committee's report is very positive," de Rato said, "not only because of what it proposes in terms of the income model for the institution, but also because the report recognizes clearly the important international public contribution that the Fund makes. . . . This is an important and good day for us. We have a serious report from a very widely respected group of people."

Proposals include investing a portion of the IMF's quota resources contributed by its 185 member governments in order to generate a regular income flow, and strictly limited sales of gold (of about one-eighth of the Fund's total gold holdings) to establish an income-generating endowment.

Precarious income stream

The IMF, set up in 1944, has long relied largely on income from its lending operations to finance its work. Lending generates income because the IMF charges countries that borrow a higher interest rate than it pays to countries that are the creditors to the Fund. As Crockett pointed out during a press conference, a curious feature of the IMF's current method of financing its operations is that "when the world economy is not doing well and the Fund has to lend in crisis situations, it is well furnished with resources. When the Fund is successful in stabilizing the global economy, then it is short of resources."

The IMF's income has fallen with the decline in new lending and recent early repayments by some countries. The institution's income shortfall is projected at about SDR 70 million ($105 million) in the current financial year, ending April 30. It is projected to reach SDR 245 million ($368 million) by financial year 2010 (see Table 1). While the IMF does not face an immediate financing crisis because it has large reserves on which to draw, de Rato fully agrees with the report that continuing to rely on income from lending is not sustainable.

Unanimous support

Crockett said that the proposed package, unanimously supported by the committee, is designed to better align the IMF's income model with the wide variety of functions the institution now performs—including the provision of public goods, such as surveillance and statistics, the resolution and prevention of financial crises, and capacity building through technical assistance and training (see Table 2 and interview on pages 38–39). If adopted, he believes the proposed package of measures would ensure a solid financial foundation for the Fund's important role in the international community.

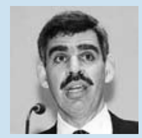
In parallel with the income review, the IMF continues to pursue cost-effectiveness and firm expenditure restraint as core elements of its medium-term strategy. For FY2007, the Fund is committed to zero real growth in its administrative budget; real cuts are proposed in each of the next three years, such that the Fund's real administrative resources are expected to decline by a total of 6 percent by FY2010.

Box 1

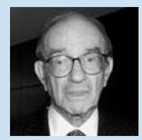
Who's who on the panel

The committee comprised

Andrew Crockett (chair)
President of JPMorgan Chase International.

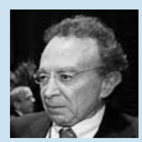


Mohamed A. El-Erian
President and CEO of Harvard Management Company.

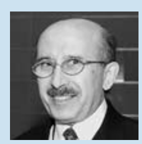


Alan Greenspan
former Chairman of the U.S. Federal Reserve Board of Governors.

Tito Mboweni
Governor of the South African Reserve Bank.

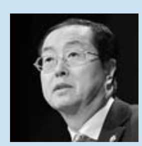


Guillermo Ortiz
Governor of the Bank of Mexico.



Hamad Al-Sayari
Governor of the Saudi Arabian Monetary Agency.

Jean-Claude Trichet
President of the European Central Bank.



Zhou Xiaochuan
Governor of the People's Bank of China.

Key recommendations

The committee's key recommendations involve the following measures:

Expanding investment operations. In 2006, the IMF set up an investment account funded with SDR 5.9 billion ($8.8 billion) to generate income for the institution. The report said the IMF should expand its investment operations in order to use its balance sheet to generate extra income by

• *broadening its investment mandate*, along the lines of the multilateral development banks, which can invest at longer maturities and have less restrictive limits on credit risk. For existing resources in the investment account, additional income is estimated at about SDR 30 million ($45 million) a year.

• *investing part of the quota resources* subscribed by members. If these resources could be invested using the same broadened investment mandate recommended for the investment account, an investment of about one-tenth of total quotas or SDR 20 billion ($30 billion) could yield some SDR 200 million ($300 million) a year.

Box 2

Has the IMF sold gold before?

The IMF has sold some of its gold holdings on several occasions. Following a 1978 amendment to its Articles of Agreement, the IMF may sell gold outright only on the basis of prevailing market prices, or may accept gold in the discharge of a member's obligations at an agreed price, based on market prices at the time of acceptance. These transactions in gold require an 85 percent majority of total voting power. Key gold transactions:

• **Sales for replenishment (1957–70).** The IMF sold gold during this period to replenish its holdings of currencies.

• **South African gold (1970–71).** The IMF sold gold to members in amounts roughly corresponding to those purchased in these years from South Africa.

• **Investment in U.S. government securities (1956–72).** To generate income to offset operational deficits, the IMF sold some of its gold to the United States and invested the proceeds in U.S. government securities. Following a significant buildup of IMF reserves, the IMF reacquired this gold from the U.S. government.

• **Auctions and "restitution" sales (1976–80).** The IMF sold approximately one-third (50 million ounces) of its then-existing gold holdings following an agreement by its members to reduce the role of gold in the international monetary system. Half of this amount was sold in restitution to members at the then-official price of SDR 35 an ounce; the other half was auctioned to the market to finance the Trust Fund, which supported concessional lending by the IMF to low-income countries.

• **Off-market transactions in gold (1999–2000).** In December 1999, the Executive Board authorized off-market transactions in gold of up to 14 million ounces to help finance IMF debt relief for poor countries.

Creating an endowment from limited IMF gold sales. The committee said the sale of IMF gold should be ring-fenced to exclude further sales and subject to strong safeguards to limit their market impact. Of the total stock of 3,217 metric tons of gold, it recommended that the IMF sell only the gold acquired since the Second Amendment of the Articles in 1978 (see Box 2). This gold, which amounts to about 400 metric tons, would generate SDR 4.4 billion ($6.6 billion), assuming a price of $500 per ounce. Investment of profits from such a sale could yield a real return of some SDR 130 million ($195 million) a year according to the report. The committee emphasized that these limited gold sales should be handled in a way that avoids causing disturbances to the functioning of the gold market and, accordingly, should be coordinated with current and future central bank gold agreements so as not to add to the volume of sales from official sources.

Charging for services to member countries. The committee recognized that capacity building represents a fundamental contribution of the IMF to the well-being of many of its member countries and that there may be public policy reasons for not discouraging the use of capacity-building services—especially given that low- and lower-middle-income countries together account for 80 percent of the attributable costs of the Fund's technical assistance. However, the committee supported charging for services in principle, not so much for the revenue that would be generated, but to enhance IMF transparency and accountability in the provision of such services and to ensure that the providers and beneficiaries take a disciplined approach to its costs and benefits. The committee also proposes the resumption

Table 1

How big is the gap?

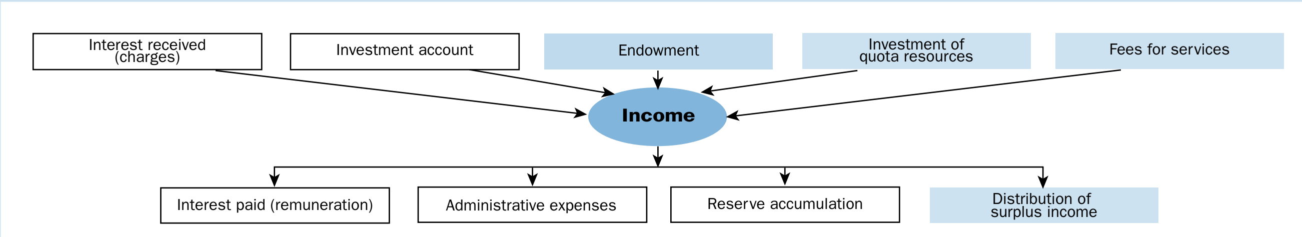
The IMF projects an income shortfall of 245 million Special Drawing Rights (SDRs) by 2010, if nothing is done to increase revenues. The IMF is also curtailing growth in expenditure in real terms, with real administrative resources budgeted to decline by 6 percent by FY2010.

	FY2007	FY2008	FY2009	FY2010
	(million SDRs, except where indicated)[1]			
A. Income sources	**590**	**535**	**510**	**451**
Margin on lending (108 basis points)	137	93	82	60
Surcharges	98	64	56	27
Service charge (50 basis points on purchases)[2]	21	10	–	–
Investment and other income	334	368	372	364
B. Administrative and capital expenses	**659**	**659**	**674**	**696**
Administrative budget	608	619	635	655
Capital and depreciation expense	51	40	39	41
C. Income shortfall (A–B)	**–69**	**–124**	**–164**	**–245**
Shortfall (million dollars)	–103	–186	–246	–368
Fund credit outstanding (average in billion SDR)	12.7	8.7	7.6	5.5
SDR interest rate (percent)	3.9	4.4	4.5	4.6

Source: IMF staff.
[1]Assumes U.S. dollar/SDR exchange rate of 1.50.
[2]Includes commitment fees, which are refundable (if purchases are made) so income is generated only if phased purchases are not made.

Proposed new income model

The committee suggested several additional revenue sources to better align the IMF's income model with its activities and to explore ways to distribute possible future surplus income among the membership. Shaded boxes below represent new proposals.



Source: IMF Finance Department.

of reimbursing the IMF for the administrative costs of managing the program of financial assistance to low-income members, which could yield SDR 60 million ($90 million) a year.

Renewed lending. The committee recognized the possibility that renewed lending activity in the future could generate substantial surpluses. While this scenario is not currently foreseen, the committee urged the IMF to explore ways in which such excess resources could be redistributed to members after taking into account necessary reserve accumulations to protect against potential credit losses.

Some proposals that didn't fly

The committee looked at several ideas that it chose not to recommend.

Table 2

Where does the money go?

Breakdown of IMF spending by type of activity for FY2006.

	Total (million dollars)	Percent of total
Public goods	**410.1**	**44.1**
Oversight of the international monetary system	31.4	3.4
Multilateral surveillance	27.2	2.9
Cross-country statistical information and methodologies	30.0	3.2
General research	13.9	1.5
General outreach	26.1	2.8
Bilateral surveillance	221.7	23.8
Regional surveillance	18.5	2.0
Standards and codes and financial sector assessments	41.4	4.5
Credit intermediation	**220.6**	**23.7**
Generally available lending facilities	130.7	14.0
Facilities specific to low-income countries	90.0	9.7
Bilateral services	**213.7**	**23.0**
Technical assistance	175.8	18.9
External training	37.9	4.1
Total excluding governance	**844.5**	**90.8**
Governance[1]	85.8	9.2
Total administrative expenditures (gross basis)	**930.3**	**100.0**

Source: IMF Office of Budget and Planning.
[1]Costs of the Board of Governors, the Office of Executive Directors, the Managing Director and the Deputy Managing Directors, the Independent Evaluation Office, and the Secretary's Department.

Periodic levies: The IMF could collect annual or periodic dues from members. The committee decided against this idea because "subjecting the Fund's administrative expenditure to national budgetary procedures might indirectly threaten the independence of the Fund's policy advice."

Borrowing from the markets: The IMF could use its good credit standing to borrow and reinvest at higher rates. The committee said setting up such a treasury operation is expensive and could be risky.

Become a fund manager for central banks: The IMF could undertake to manage central bank reserves for its member countries, receiving asset management fees. The committee said the IMF did not have expertise in this area.

Voluntary contributions: "Such funding is liable to be lumpy and unpredictable, and should thus not be considered as a stable and sustainable source of revenue," the committee said.

What happens next?

Moving from the proposal stage to implementation is a complex process that could take some time.

Several of the committee's suggestions—those pertaining to investment operations—require changes to the IMF's Articles of Agreement and may require the approval of national parliaments.

The immediate plan is for a period of consultation and consensus building. In particular, the income issue will be discussed at the Spring Meetings of the IMF and the World Bank, to be held in Washington on April 14–15. De Rato will then develop a formal set of proposals for the consideration of the IMF's 24-member Executive Board.

"The process of discussion and consultation with the Executive Board and, more generally, with the IMF's membership on the report's recommendations already began this morning," de Rato said at a January 31 briefing. "I am looking forward to our discussions in the Executive Board and to building a consensus on this important issue." ■

Interview with Andrew Crockett

Proposals could put IMF on firmer financial footing

Andrew Crockett, President of JPMorgan Chase International, recently unveiled a set of proposals for a new income model for the IMF, drawing on the work of an eight-member Committee of Eminent Persons that he chaired. Previously he was General Manager of the Swiss-based Bank for International Settlements (1994–2003), an IMF staff member (1972–89), and an Executive Director of the Bank of England (1989–93). He spoke with Laura Wallace of the IMF Survey *about the proposals, some of which are bound to be controversial.*

IMF Survey: Why do we need to look at the income model now? Is it an issue of the level of income or how the income generating system functions?

Crockett: There's no immediate need, from a financial point of view, for the Fund to have additional income. The reserves built up over the years provide a substantial cushion. But it's becoming apparent that the existing income model is inappropriate in a structural sense for the Fund's needs, and right now, it's not generating enough income to cover expenses—which means reserves are being run down. Thus, we think that the Fund needs to urgently consider how to replace the present income model with a new one.

IMF Survey: If the IMF were created today, would it be based on the current model, which involves such a volatile source of income?

Crockett: Probably not. It was obviously at one time considered appropriate that a financial institution should generate its income out of the intermediation margin between its lending and borrowing rates. But the IMF now has a much wider range of activities than just lending. Since it provides what economists call a public good—and public goods by definition can't be provided out of charges to users—it needs a different income model. And if it simply uses the surplus generated out of lending to finance the public goods, first, that's volatile, and second, that's essentially a tax on those that use one element of the Fund's services—namely its financial intermediation—to benefit the others.

IMF Survey: You've come up with a package of proposals. Do all the elements have to be pursued simultaneously?

Crockett: It makes sense to see them as a package and therefore to implement them as a package. The Fund now has multiple functions, and there are multiple income sources that would be a natural source of finance for those functions. Of course, certain recommendations will require more work; those that require changes to the IMF's Articles of Agreement couldn't be put in place as quickly as the others.


Eugene Salazar/IMF

Crockett: "The present [investment] mandate is actually so restrictive that it prevents the Fund from investing in certain instruments that the World Bank or the multilateral development banks can invest in."

IMF Survey: How does your package fit with the IMF's medium-term strategy?

Crockett: It's separate but related. The medium-term strategy, which hasn't been completed yet, will undoubtedly refine certain elements of the Fund's mission. Once the strategy and the Fund's mission are determined, it will be up to the Managing Director and the Executive Board to determine the resources needed to fulfill that mission. Then the membership at large, through the Board of Governors and the Executive Board, will vote, in a sense, on the appropriate level of expenditures. Our work was to recommend how to generate income to cover those agreed expenditures. Obviously, income and expenditure can't be separated, but we were asked to focus on the income side.

IMF Survey: So expenditure wasn't a part of the calculus?

Crockett: We worked from an estimate that was provided by the Fund staff as to the future path of expenditures and the future path of incomes, if nothing was done. That provided us with a basis to determine the shortfall. We don't know whether that expenditure path will be precisely what is approved by the Board of Governors and the Executive Board, but our recommendations can be adjusted to provide needed income.

IMF Survey: Does that open the door for the IMF to take on additional responsibilities?

Crockett: One of the virtues of what we're proposing is that it provides a degree of discipline—that is, the Fund would be asked to take on additional functions only if they could be justified through clearly identified financing. One of the problems in the past is that the membership, believing the Fund to be a rich organization, has asked it to take on new functions without really thinking about how they would be financed.

IMF Survey: The U.S. Congress has opposed IMF gold sales before. What would be different this time, and how could sales be undertaken without disrupting the market?

Crockett: We haven't designed our proposals to take into account specific political objections. We've focused on what makes sense as an economically rational package. But we're of course aware that the Fund shouldn't do anything to potentially disrupt the gold market or to introduce volatility into the gold price. That's why we've suggested a few safeguards. First, the amount is limited to the portion of the Fund's gold—about 400 tons—that had been sold and repurchased in a transaction about seven years ago. Second, the sales should be fitted in with the existing sales programs of central banks, mainly European ones, so that they won't result in any additional gold sales. Third, the IMF should set up a group that examines the technicalities of the marketing of gold.

IMF Survey: Is this different from what's been proposed in the past for IMF gold sales?

Crockett: I think it is, because what we've suggested means that there would be no additionality of gold sales. It would simply take the place of some gold sales that would have been done by other parts of the public sector, other official sellers.

IMF Survey: Given that some proposals would require amendments to the Articles, how practical is the package?

Crockett: The main proposal that would require an amendment is that usable currencies contributed by members as part of their quotas should be available to the Fund for investment in capital markets—and then the return on that investment would become income for the Fund. Currently, all members have the right to immediately repurchase the resources they've placed with the Fund, which is called a reserve tranche. We believe it's appropriate that the Fund have access to those resources to invest, rather than to always be in the position of having to return them to members.

Is the package practical? We think so because it relates the sources of income to expenditures. And I believe that the proposals endorsed by our group—which includes Mr. Trichet, Mr. Greenspan, Mr. Zhou Xiaochuan, and several other central bank governors with long experience in the international monetary system, several of whom have been ministers of finance as well—ought to appeal to Fund members.

IMF Survey: How would investments be managed under a less restrictive investment mandate? Are you worried about potential conflicts of interest for IMF staff?

Crockett: The present mandate is actually so restrictive that it prevents the Fund from investing in certain instruments that the World Bank or the multilateral development banks can invest in. So we're not proposing anything excessively liberal or risky.

The question of conflict of interest was one that we thought about quite a lot because, although I believe it's more optical than real, the Fund does have access to the thinking of member countries about their macroeconomic policies, and it makes recommendations about these policies. That obviously has an effect on interest rates and exchange rates and on all the factors that would affect the return on the Fund's investment. So we suggest one of two approaches.

The first, which we favor, is that the investments should be handled by an outside body, as is the case at the moment with the Fund's existing reserves. Investments can be placed in the hands of professional managers, whose fees and charges would be small relative to the additional income. The other possibility would be for the Fund to invest the funds itself, with a dedicated staff with "Chinese walls" to prevent communication between the staff doing the investment and the staff that might have access to privileged information. But that approach would require hiring additional staff, and we don't really see it as desirable as using third-party managers. The third-party managers, incidentally, could include public sector organizations like the World Bank, whose Treasury Department is very competent, or the Bank for International Settlements.

IMF Survey: Finally, with such a geographically dispersed group, how were the deliberations conducted?

Crockett: Given that five of the eight members were central bank governors, the most convenient place was at the bimonthly governors' meetings in Basel, although one meeting was held in Melbourne at the time of the G–20 meetings. Alan Greenspan is writing a book and didn't want to take time out, so he came to the IMF's Washington headquarters—once in the middle of the night—and we met by videoconferencing with him. ■

The full text of the "Final Report by the Committee to Study Sustainable Long-Term Financing of the IMF" (Crockett Report) is available on the IMF's website (*www.imf.org*).

IMF takes "major step" on key financial benchmarks

The IMF has published standardized indicators designed to allow analysts to assess the soundness of a country's banking sector and compare it with those of other countries.

In all, 62 countries judged to be of importance to the global economic system participated in the pilot project, which has its roots in the financial crises of the late 1990s. Data for 40 of the countries are on the IMF's website and information for most of the remaining 22 will be posted shortly. The pilot project is called the Coordinated Compilation Exercise for Financial Soundness Indicators.

Rob Edwards, Director of the IMF's Statistics Department, called the dissemination of the financial soundness indicators "a major step" in the IMF's efforts, as part of its medium-term strategy, "to strengthen the surveillance of member countries' financial systems, increase data transparency, and promote cross-country comparable data."

The IMF Executive Board plans to evaluate the exercise this autumn and determine whether to go forward with a permanent effort to disseminate financial soundness indicators. The pilot project asked all 62 participants to produce a dozen soundness indicators for deposit-taking institutions (mainly commercial banks) that measure, for these institutions as a whole, capital adequacy, asset quality, earnings and profitability, liquidity, and sensitivity to market risk (see box). The countries were also encouraged to produce another 28 indicators that not only provided additional information on the banking sector but also covered nonbank financial institutions (such as insurance companies and pension funds), financial sector customers (such as corporations and households), and the real estate and securities markets.

Testing for financial soundness

The 62 countries in the Coordinated Compilation Exercise pilot project were asked to produce 12 core indicators that measure the soundness of deposit-taking institutions.

Measure	Indicator
Capital adequacy	Regulatory capital to risk-weighted assets Regulatory Tier 1 capital to risk-weighted assets Nonperforming loans net of provisions to capital
Asset quality	Nonperforming loans to total gross loans Sectoral distribution of loans to total loans
Earnings and profitability	Return on assets Return on equity Interest margin to gross income Noninterest expenses to gross income
Liquidity	Liquid assets to total assets (liquid asset ratio) Liquid assets to short-term liabilities
Sensitivity to market risk	Net open position in foreign exchange to capital

Source: IMF's *Financial Soundness Indicators Compilation Guide*, 2006.

Eugene Salazar/IMF

IMF Deputy Managing Director Murilo Portugal (left) recently hailed the production of the financial soundness indicators in a meeting with Statistics Department staff members. "Five or six years ago, people thought that this could not be done," he said.

After the financial crises in Latin America, Russia, and especially Asia a decade ago, the paucity of data available to gauge the well-being of financial systems became apparent, according to Armida San Jose, a Division Chief in the Statistics Department, which shepherded the project. In many cases there was no available information or countries did not make the data public, she said. And among countries that did make public the data, they were often not comparable.

Response to crises

The IMF held a brainstorming conference in 1999 that brought together, among others, central bankers and bank regulators, private financial institutions, representatives of international organizations, credit rating agencies, and academics to think through whether a set of financial soundness indicators was needed and, if so, what to produce and how to do it. That conference set off a chain of events that led to the IMF's production of a guide to compiling financial soundness indicators and the decision to conduct the pilot project using that Compilation Guide as its base. San Jose said that the pilot exercise is an innovative approach in the way IMF staff and country officials work together and learn from each other to produce a new form of aggregate statistics.

San Jose also said that for a variety of reasons, not all statistics produced under the pilot exercise are fully in line with the recommendations in the Compilation Guide. But if a statistic is not fully consistent, that is noted in the so-called metadata (information about the data) that are published along with the data. ■

The financial soundness indicators and the countries in the CCE can be found on the IMF website (*www.imf.org/external/np/sta/fsi/eng/cce/index.htm*).

Interview with Michael Deppler

Europe's problems are mostly home-grown

With a sustained economic recovery under way and another successful enlargement of the European Union (EU) under its belt, Europe should finally have something to cheer about. Instead, reform fatigue has gripped many policymakers, and Europe's citizens seem intent on blaming the EU and globalization for their countries' woes. For instance, a new FT-Harris poll showed that an overwhelming majority of citizens in the big euro area countries now believe that the euro has damaged their national economies. In this interview with Camilla Andersen of the IMF Survey, *Michael Deppler, head of the IMF's European Department, explains why the notion that Europe's problems are caused by excessive globalization is badly off the mark.*

IMF Survey: Growth has picked up almost everywhere in Europe. But will it be able to sustain its newly found momentum in the years to come?

Deppler: There is clearly a recovery under way. After growth of close to 3 percent in 2006—which is well above potential—we expect the economy to slow to about 2½ percent in 2007–08. Even though risks from the global economy remain on the downside, they have diminished, and risks from Europe's own economic dynamics strike me as being on the upside. So the odds of a reasonably well-sustained recovery are definitely in Europe's favor this time.

"Few people realize that the euro area has generated significantly more business sector jobs than the United States over the past 10 years."

—Michael Deppler

IMF Survey: What are the main driving forces behind the recovery?

Deppler: Part of the recovery is of a purely cyclical nature. Europe was badly hit by the dot.com bust in 2000, which sparked a series of balance-sheet adjustments in the corporate sector. These adjustments have taken a long time to get sorted out. But everything came together in 2006: strong growth in global trade led to rapid export growth, rising exports drove up investment, and low interest rates led to a strengthening of construction spending. But the most positive news was a pickup in employment. When jobs are created in Europe, you can be pretty sure you are seeing something of a lasting nature.

But structural reforms have also played a role. I am always struck by how pessimistic Europeans and others are about the effects of reforms in Europe. They expect—and "see"—little evidence of any payoff. But when you look at the data, the effects are very visible. For instance, few people realize that the euro area has generated significantly more business sector jobs than the United States over the past 10 years. This achievement is clearly the result of labor market reforms combined with wage moderation.

European Union—by the numbers

	2006	2007
Nominal GDP (trillion euros)	11.4	11.9
Real GDP growth (percent)	2.8	2.4
Population (million)	493	

Sources: Eurostat; and IMF World Economic Outlook database (projections).
Note: Figures reflect the inclusion of Romania and Bulgaria.

IMF Survey: Recoveries in Germany and France differ markedly. How do you explain the differences between the euro area's two largest economies?

Deppler: Germany was *the* pleasant surprise of 2006, with growth of 2½ percent. Given the performance of the preceding years, it was nice to finally see an upturn come together in 2006. Moreover, while one-off factors played a role, it is clear that Germany is poised for stronger medium–term performance, with adjustments in the private sector and public sector reform working together to boost competitiveness.

But when you make comparisons about France and Germany, you have to realize that these two countries have been on different economic schedules over the past two decades. France had a weak performance through much of the 1970s and 1980s, which prompted a long period of adjustment that has paid off over the past 10 years or so [see page 46].

In contrast, Germany performed strongly up until the early 1990s—a backdrop that probably led policymakers to underestimate the adjustments required to integrate the poorer länder in the east and competitiveness considerations. As a result, Germany's performance has lagged for the better part of a decade. But restructuring in the business sector combined with various reforms are now finally paying off [see page 44], with the economy regaining the competitiveness it lost during the 1990s. The broader lesson, which applies to all countries in the euro area, is the importance for governments to keep a weathereye on competitiveness—broadly conceived through prudent fiscal policies and structural reforms.

IMF Survey: Does the euro's strength pose a threat to economic growth as claimed by some European politicians?

Deppler: In our view, the euro is fairly valued, at least when judged within the range of uncertainty that is attached to medium–term exchange rate assessments. If we look at Europe's export performance and its current account, the situation seems pretty healthy.

IMF Survey: Many countries in Europe appear to be suffering from reform fatigue. In what areas should reform-weary politicians concentrate their efforts?

Deppler: There is an understanding of the need to continue reform in official circles throughout Europe. For its part, the EU Commission is pressing ahead with the Lisbon agenda (Europe's blueprint for improving competitiveness) and is seeking to infuse more competition and integration into the financial and energy sectors.

That said, voters have not been very supportive of reform in recent elections, most recently in Austria and the Netherlands. This is partly due to the fact that reforms often have been implemented in a hesitant and partial manner, and have sometimes even been reversed. This has undermined their benefits and fed skepticism. Together with the return of good times, this is leading many to see the rest of the world as the source of Europe's problems—be it in the form of enlargement or globalization—and prompting calls for more attention to domestic needs. But in my opinion, this is to mistake the source of the problems.

IMF Survey: If globalization and enlargement aren't to blame, what is?

Deppler: If there is one sector where Europe is competing successfully it is in the external sector. This is obvious when you look at the growth of exports of goods and services. Regardless of whether you look at the past half century or just the past few years, the external sector has been the strongest driver of growth in Europe. It is true that there are periodic dislocations, with companies laying people off because of external competition, but those losses are dwarfed by the gains to the economy from the broader contribution of the external sector.

In other words, blaming globalization is mistaken because the problem is clearly internal. Low labor participation rates will need to be raised sharply in order to find an acceptable solution to the aging problem. But data on productivity are even more telling. Per capita income growth in the euro area has fallen short of that in the United States by 1 percent a year over the past decade—cumulatively 10 percent or so. But this is not because of exports. European productivity is at world levels in the manufacturing sector. The gap can be attributed entirely to the service sector—precisely that sector of the economy which is still relatively sheltered from global competition. Europe needs to remain focused on the fact that its problem—weak growth—is home-grown.

IMF Survey: So what needs to be done?

Deppler: Where there is an urgent need of reform is in those parts of the economy that are sheltered from competition through a host of laws and regulations that protect the interests of banks, notaries, plumbers, shopkeepers, energy companies, and many others.

From my perspective, the enlargement of the EU and the Services Directive, controversial as they may have been, are precisely the kinds of steps that Europe needs to take in order to strengthen its performance. Indeed, I think it is to the credit of the various governments in Europe that they have pressed ahead with these agendas, albeit in diluted form. So, while I find the public discourse disquieting, I am reasonably confident that Europe remains on the right track and that it will show the improvements in performance to match.

IMF Survey: Part of the popular malaise is rooted in concerns about the social model. Will Europe be able to maintain its way of life in the face of globalization?

Deppler: Yes, but only if reforms continue. Indeed, Europe's own experience suggests as much. But let's first be clear about what we mean by the European social model. There are at least as many models as countries. Perhaps the common characteristic people have in mind is a concern for preserving a fair distribution of income.

So what do we find when we look at experiences across continental Europe over the past decade or two? The countries most concerned about the distribution of income—the Nordic countries and the Netherlands—are also among the most successful reformers and performers in terms of growth.

What other traits do these countries have in common? First, an openness to the rest of the world. The external sector is very prominent in these economies. Second, an openness to markets. According to the OECD, they all have relatively light product and service market regulations. Third, a reliance on the budget rather than market restrictions as a means to redistribute income. The basic approach is to let markets work and then correct negative social consequences through a well-targeted social safety net. And fourth, a willingness to adjust the welfare state in response to new pressures. Cumulatively, this has been a successful strategy—in contrast to strategies pursued in the core of Europe, where attitudes to markets and competition tend to be more arms length, especially when there are strong stakeholders defending special interests. In our view, this leads to a collective shortfall in growth. If these countries—including France and

Germany—want to successfully sustain their social models, they will need to overcome such resistance.

IMF Survey: With the acceptance of Romania and Bulgaria as new members, the EU has taken another big step toward addressing the legacy of the Cold War. But unresolved issues ranging from immigration to representation at the European level have soured relations between old and new members. What can the EU do to help bridge the east-west divide?

Deppler: For the past 15 years, western Europe has been the beacon for eastern Europe. The enlargement of the EU toward the east has had tremendous benefits not only for eastern Europe but also for the west. Nowadays many people think that eastern Europe is benefiting much more than the west. And it is true that the benefits flowing to eastern Europe, for instance in the form of transfers from the EU, is tangible evidence to that effect.

But western Europe also benefits from the relationship. I have always been struck by the extent to which regional synergies are important to national economic performances. Think about Asia today. It is a hothouse of economic growth and the whole continent is doing well. For people in western Europe to think that they do not benefit from the fact that their eastern neighbors are also doing well is just wrong. People must learn to look beyond the factory closures and focus on the fact that, in the past, something else has always replaced those factories and that, given the right policies, this will continue to be case in the future. Being open to the world is the best strategy for adjusting.

IMF Survey: Will eastern Europe help western Europe become more competitive?

Deppler: Absolutely. For instance, studies show that German firms have become more competitive by outsourcing part of their production to eastern Europe, reimporting it, and then reexporting to the rest of the world. Countries that resist these trends—and they are difficult to resist effectively—will lose out. But people will only be open to change if they achieve a better understanding of what the benefits are. If you look at the way current accounts have moved between east and west, clearly the west is selling more to the east than the east is selling to the west. With its single market and open borders, integration in the EU has been a lasting source of growth for Europe. The Europeans need to continue in this direction.

IMF Survey: The IMF is redefining its mission to focus more exclusively on providing analysis and advice to its member countries. But what can the Fund offer in terms of value-added to a region already receiving sophisticated input from the EU Commission, the OECD, and European think tanks?

Deppler: "With its single market and open borders, integration in the EU has been a lasting source of growth for Europe. The Europeans need to continue in this direction."

Deppler: There is general agreement that Europe could do much more to improve its performance. As you say, there are quite a few institutions that give them advice. In my view, we mostly sing from the same hymn book—we reinforce each other. Given the scope to strengthen performance, I think that is both helpful and beneficial.

That said, the IMF is different from some of the institutions that you mentioned. Unlike the EU Commission, for instance, we are not a decision–making body. Our advice, while certainly not ignorant of political realities, is given more purely from an economic perspective.

This approach has its drawbacks, of course. We do not have the insider's perspective and full awareness of the constraints, and the only way to ensure that our advice is heard is through the power of persuasion. At the same time, that is also a source of strength. Because we are outsiders, it is easier for us to provide perspectives that otherwise tend to get lost in partisan debates.

The advice we offer is grounded in our experience with a variety of regions around the world. While there is a very definite European way of looking at issues, Europe can learn from the experience of other regions. All in all, my belief is that the Fund brings a unique perspective to the table. And with our new focus on financial sector issues, we are building ourselves a niche, but that remains to be fully developed. ■

Germany: Recovering at last

A brisk economic recovery is under way in Germany, ending a period of subdued and uneven growth that persisted for a decade despite a strong performance from exports. In previous business cycles, export growth typically led to general economic recovery within six to nine months. But export industries had to adjust after facing competitiveness problems in the early 1990s, and the same adjustments that helped exporters—wage moderation and a substantial reduction in the workforce—held down domestic demand. That meant the economy was unable to absorb all those workers who lost jobs in export industries as well as in the construction sector, which had a long decline.

Recently, an upswing in investment, coupled with the strong export sector, has sparked a cyclical recovery, resulting in the first increase in full-time employment in five years. However, consumption demand has remained moderate, because of both continued wage moderation and fiscal reforms that have reduced government spending in anticipation of higher costs from an aging population.

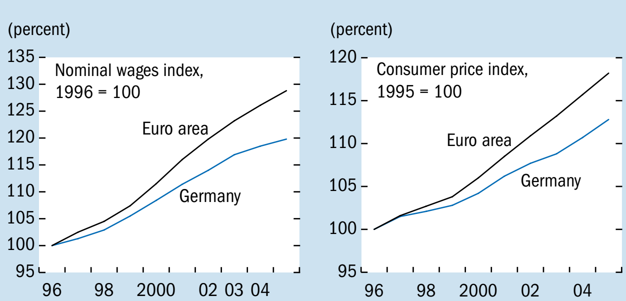
Germany still remains a highly regulated economy and needs to undertake further reforms to address low trend growth, high structural unemployment, and the fiscal risks posed by an aging population and still-high social spending.

The export sector adjusted

A series of shocks undermined competitiveness in the early 1990s. Unit labor costs rose as a result of the wage boom that followed the 1990 unification of East and West Germany. Moreover, because West German labor market institutions, such as restrictions on hiring and firing, were almost universally extended to the former East Germany, firms there could not reduce employment fast enough to close the productivity gap. The pressures of globalization and European Union expansion on industries further aggravated the loss of competitiveness and set the stage for profound adjustment.

Adjusting to global competition

Because of restraints on fiscal policy and a fixed exchange rate, Germany relied on slowing inflation and lower wage growth relative to euro area partners to become competitive.



Source: Eurostat.

Picking up

Germany's GDP and employment are growing again, but at a subdued pace.

	2005	2006	2007 Est.	2008 Proj.	2009
	(percentage change from previous period unless otherwise noted)				
Real GDP	0.9	2.5	1.6	1.7	1.8
Unemployment rate	9.1	8.1	7.7	7.6	7.5
Employment growth	−0.2	0.7	0.5	0.3	0.3
Consumer price index	1.9	1.7	2.2	1.6	1.6
Current account balance[1]	4.1	4.1	4.3	4.3	4.2

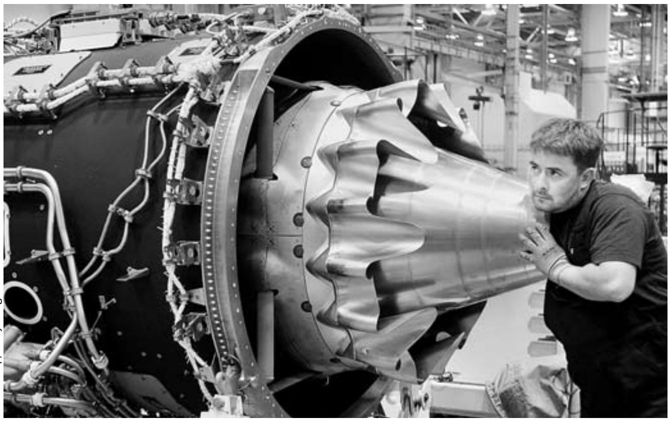
Sources: German authorities; IMF staff projections, end-January 2007.
[1]In percent of GDP.

Because of restraints on fiscal policy and a fixed exchange rate (following the inception of the euro), that adjustment relied almost exclusively on slowing inflation and wage growth relative to euro area partners. Indeed, over the past 10 years, Germany's nominal wages grew 9 percent less than the average wage in the euro area (see chart).

The export sector took the lead in restructuring. Confronted with strong external competition, it shifted production abroad. Export-oriented industries cut back investment in Germany and extensively reduced domestic employment. The manufacturing sector, for example, has lost nearly 40 percent of its workforce since the early 1990s. Given the opportunity to tap into less expensive and increasingly productive labor abroad, corporations sought domestic labor concessions to maintain production and employment at home. As a result, nominal wage growth has moderated to 2 percent annually this decade, barely exceeding inflation. The resulting decline in unit labor costs bolstered profit margins, boosted corporate sector profits, and helped restore external competitiveness.

The domestic economy did not

But domestic activities that faced less international competition—notably in the service sector—have been slower to reform. The less dynamic domestic economy was unable to employ workers who lost their jobs in the export and construction sectors, fueling unemployment and a gradual slowing of wage increases. It is only recently that unit labor costs in the overall economy have shown signs of stabilizing, an indication of how much slower adjustment has been in the service sector. Indeed, service sector profitability continues to trail the manufacturing sector: real operating profits in the service sector remained virtually



Sean Gallup/Getty Images

A worker at a Berlin aircraft engine factory, where much of the production is for export.

unchanged between 1996 and 2005, while in the manufacturing sector they rose by 77 percent.

There has been little leeway for fiscal policy to stimulate domestic demand this decade. Amid legacy costs of East-West unification (annual subsidies of approximately 4 percent of GDP), insufficient adjustment during earlier upswings, tax cuts in 2001, 2004, and 2005 equivalent to about 2 percent of GDP, weakening trend growth, and aging-related expenditure pressures, the fiscal deficit breached the criterion set down by the Maastricht Treaty for the fourth consecutive year in 2005. Most important, however, the persistent weakness in employment and domestic demand in turn caused a pronounced erosion in the major tax bases—labor income and consumption.

The authorities responded to these challenges with significant expenditure cuts. The previous government's "Agenda 2010" reforms cut social expenditure, including pensions. These were continued in 2006 by the current coalition government. The expenditure cuts largely offset the stimulus from lower taxation, and the structural deficit stabilized during 2003–04 before registering an improvement in 2005–06.

Without deeper structural change, Germany's long-term growth potential is likely to remain subdued. Although external competitiveness has been restored, domestic efficiency and labor utilization remain low. The current cyclical recovery provides a favorable setting to tackle Germany's structural and fiscal problems. Reforms should be bold and well coordinated to allow Germany to catch up with the increase in living standards other leading economies have achieved over the past decade.

Structural unemployment must be tackled

To broaden the recovery, employment growth needs to accelerate to generate higher household income and consumption. The recent uptick in full-time jobs is encouraging. However, to reduce structural unemployment, there must be changes in generous welfare policies that elevate reservation wages (those at which workers are willing to take a job), especially among low-skilled workers.

Efforts to tackle the core problem of long-term unemployment have been expensive and not fully successful. Improving the functioning of the unemployment insurance system should be a top priority. As recommended by the Council of Economic Experts and several research institutes, unemployment allowances should be cut until there is a demonstrated effort to find work. More generally, Germany's active labor market programs and regulations tend to be complex, expensive, and ineffective. It would be better to eliminate those that are ineffective, and simplify those that are retained to increase transparency—and usefulness—for job seekers.

Product and service market deregulation needs to aim at strengthening competition and raising productivity. Because productivity ultimately determines the standard of living, greater reliance on efficiency gains would put less burden on the need for wage moderation. Ample scope remains to improve competition in network industries (mainly gas, electricity, and telephone).

A more efficient financial sector would also help to strengthen economic performance. Banks and insurance companies are healthier than in recent years, but the improvement in their earnings is largely cyclical and they still underperform most EU peers. There is ample leeway to attract more private capital to public sector banks to harness market signals and facilitate restructuring. Capital markets are deepening and playing a greater role in guiding corporate decisions. The authorities intend to formulate a more effective legal framework for private equity, recognizing that such financing can facilitate the entry of new firms, spur innovation, and enhance corporate governance.

Good progress was made in reducing the fiscal deficit in 2006, and policies are in place for further adjustment in 2007. Although expenditure measures should continue to be the cornerstone for lasting fiscal adjustment, the VAT increase that took effect this year, combined with a reduction in payroll taxes, is a welcome structural measure. Strong revenue growth in the current upswing should be used to reduce debt and prepare for the future.

Beyond 2007, the deficit could begin to rise again as the population continues to age. To prepare, authorities should aim for structural fiscal balance by 2010. To achieve this, further cuts can be made in subsidies and tax expenditures, spending on active labor market programs, and unemployment costs. Measures should also continue to recalibrate future entitlement costs. ■

Jürgen Odenius
IMF European Department

This article is based on Country Report No. 06/436, *Germany: Selected Issues, Chapter I: Exports and Domestic Demand in Germany: Has the Nexus Been Altered by Globalization*; and IMF Country Report No. 06/438, *Germany: 2006 Article IV Consultation—Staff Report*.

France needs to boost competition, tackle debt and labor issues

The French economy's performance over the past few years has surprised many observers, who felt that inflexible labor and product markets and the perceived tendency of government officials to engage in "economic patriotism" would have hobbled progress. But they did not. Behind the appearances and the rhetoric, the French economy has been changing more than is commonly perceived.

The French economy has been performing well (see table). GDP per capita growth has been higher than other countries in the euro area and growth overall has exceeded the euro area average. But the difference seems to be evaporating and, globally, France's position has deteriorated substantially.

Although France has accomplished much, it must tackle many more problems to eliminate the drag on growth.

Recent growth performance

Domestic demand has driven France's economic expansion. Wage increases, employment gains, and low interest rates have supported consumption growth and bolstered the housing market. Fixed capital formation has revived with sales expectations, although profit margins have declined because wages did not moderate enough to offset the higher prices of inputs. Generous dividend payouts and higher tax obligations have further reduced company savings, but low interest rates have encouraged external financing of investment. Despite healthy global demand and the cyclical recovery in Europe, net exports have subtracted significantly from growth since 2002, and wage costs have been rising faster in France than in some of its neighbors.

Current demographic trends and ongoing structural reforms suggest that potential growth (that is, in the absence of shocks) could be higher than previously estimated. Recent fertility rates and immigration numbers suggest that the labor force will grow into the next decade. The authorities estimate that the reforms in goods and services markets implemented between 1998 and 2006 could add 0.1–0.2 percent to potential growth over the medium term, and they see some evidence that the secular decline in total factor productivity growth has ended. Together with the effects of the recent uptick in investment, this suggests that annual potential growth could temporarily rise to 2¼–2½ percent before, in the absence of further reforms, settling at somewhat less than 2 percent a year in the long run.


Marlene Awaad/IP3/MAXPPP

A worker checks a production line at a factory in Rambouillet, France—a country that is grappling with inflexible labor laws.

Room for improvement

France's economy has generally performed well for the past several years, but unemployment remains too high.

	2001	2002	2003	2004	2005	2006
	(annual percent change, unless otherwise indicated)					
Real GDP	1.8	1.1	1.1	2.0	1.2	2.0
Consumer prices (average)	1.8	1.9	2.2	2.3	1.9	1.9
Unemployment rate	8.4	8.9	9.5	9.6	9.9	9.1
General government balance (percent of GDP)	–1.7	–3.2	–4.2	–3.7	–2.9	–2.6
Structural balance[1, 2]	–2.2	–3.1	–3.5	–3.0	–2.2	–1.4
Current account balance (percent of GDP)	1.6	1.0	0.4	–0.3	–1.6	–2.3

Sources: French authorities and IMF staff estimates.
[1]General government balance.
[2]Data for 2005 exclude the Électricité de France (EDF) pension fund transfer (0.5 percent of GDP); percent of potential GDP.

Reforms have helped…

France has already implemented important reforms. The central government's budget framework has been put on a performance-based footing, making the public sector potentially much more efficient. Between 2004 and 2006, the structural fiscal deficit was halved. The new labor market contract adopted in 2005 represented a breakthrough in labor market reform. And product market and administrative deregulation have made France much more attractive to business.

Should one thus expect smooth sailing henceforth? Not exactly. Despite these reforms, growth is becoming less robust and demographics will not remain favorable. Exporters have been unable to benefit fully from the ongoing global expansion and are increasingly wary of the euro's appreciation. Insiders' resistance to reforms persists. And, all too often, France attributes its difficulties to outside forces.

But the underlying problems are homegrown. The fiscal deficit, at more than 2½ percent of GDP, and the public debt, at 64 percent of GDP, are too high, especially with aging expected to add 4.5 percentage points of GDP to public spending by 2050 (see Chart 1). Similarly, unemployment, while declining, was still 8.6 percent of the labor force at end-December, and participation is low (see Chart 2). To deal with aging, a strategy that is viable and intergenerationally fair requires a rapid balancing of budgets, further reforms to enable the economy to grow at close to 3 percent a year for a while, and an increase of about 8 percentage points in the share of people in jobs.

. . . but more are necessary

A top priority is ***fiscal adjustment*** through expenditure restraint, and France's medium-term objectives are ambitious: balance the budget by 2010, reduce central government expenditure by 1 percent a year in real terms, and lower spending growth in other areas. But the 2007 budget essentially marks a pause in adjustment, with no specific policies to deliver the medium-term objectives, whose achievement thus depends entirely on whether the next government takes ownership of them. And, given that taxes will be lowered from their stiflingly high levels, expenditures may have to be reduced much more than the government envisages.

Another top priority is to address ***labor market rigidities***. France will have to reform permanent labor contracts and widen the differential between the minimum and median wages. The contract adopted in 2005 will help create jobs, but it applies only to small enterprises, thus aggravating a key duality in which highly protected permanent jobs coexist with precarious fixed-term and temporary jobs. To resolve this duality, the government needs to reduce the legal uncertainty surrounding permanent labor contracts. In a globalized world, such uncertainty is the enemy of the employee, who correctly fears that once out of a job, he or she will not be rehired easily. It is also well documented that minimum wage increases that exceed inflation destroy jobs and demoralize a rising share of employees who face the prospect of earning minimum wages for the rest of their working lives. Moreover, higher unemployment means more budgetary outlays and higher taxes, which depress activity. To break this vicious circle, minimum wages cannot be allowed to rise by more than inflation. Adverse social consequences can be avoided through a higher earned-income tax credit, a lower tax burden on labor, and reforms in the services sector that enhance purchasing power.

In product markets, France should ***enhance competition*** to put pressure on prices and enlarge the range of consumer products. Deregulating the energy sector, lowering barriers to cross-border activity—including through faster implementation of the European Union services directive—reducing the administrative burden on enterprises, and accelerating the state's withdrawal from commercial activities would all enhance competition and improve the functioning of goods and services markets.

Likewise, ***financial sector reforms*** could help boost the economy's growth potential by making financial markets more efficient. Phasing out administrative savings schemes, most of which have long lost their rationale, should increase competition for resources, foster financial innovation, and help the creation of risk capital markets. Mortgage markets need further reforms to permit households a more flexible use of prudently valued real estate gains and enable them to better align their needs with lifetime income. Complete integration of Europe's financial markets will be a boon for growth. To expedite this process, France and other EU countries should swiftly harmonize financial products, regulation, and legislation and should integrate financial market infrastructure. ■

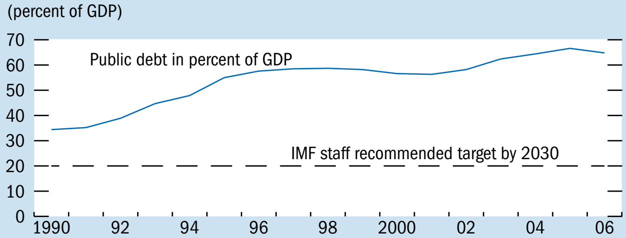
Werner Schule and Luc Everaert
IMF European Department

Chart 1

Debt drag

High public debt is one reason why France is still struggling to boost growth.

(percent of GDP)



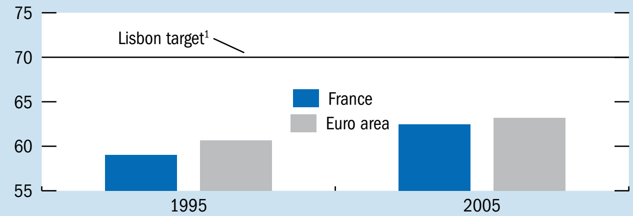
Source: French authorities.

Chart 2

Still below target

More people in France are working, but unemployment is still higher than the euro area average.

(employment rates, ages 15–64)



Source: French authorities.

[1]Part of the Lisbon Agenda—a policy package designed to make the EU more competitive.

Forum

Figuring out the flat tax fracas

Discussing the flat tax always generates heated debate—even about its definition. Proponents claim its simplicity and efficiency can be a key to economic success, while critics argue that it has little effect on economic activity and can be unfair.

A new study by the IMF's Michael Keen, Yitae Kim, and Ricardo Varsano examines the impact of the flat tax in countries where it has been in effect for more than a decade. The authors find little economic evidence that flat taxes boost work incentives, but suggest they have a somewhat beneficial effect on compliance with tax laws. And they question, given political economy considerations, the sustainability of the flat tax in the years ahead.


Thomas Dooley/IMF

Keen: "There is a basic ambiguity when people talk about the flat tax."

The study, which has sparked considerable debate, provided the basis for a January 25 IMF seminar. Keen and Varsano were joined by Kevin Hassett (American Enterprise Institute) and Leonard Burman (Urban Institute) for a panel discussion.

New kid on the block

Progressive taxes, where rates rise with income, have long been the norm. They are seen as fairer and better at stabilizing income over the business cycle than flat taxes. But, since 1994 this conventional view has been challenged, with Estonia, Georgia, Lithuania, Latvia, Romania, Russia, the Slovak Republic, and Ukraine adopting taxes with a single strictly positive marginal tax rate on labor income.

Keen pointed out that these flat tax regimes differ considerably from the concept of the flat tax assumed in academic and policy debates in the United States—the so-called Hall-Rabushka tax, which is a combination of a cash-flow tax on business income and a tax on workers' income, both levied at the same, single rate. Moreover, the details of the flat tax regimes differ vastly across countries and, although some countries adopted a single positive marginal rate near the highest from their previous tax regime, others adopted a marginal tax rate near the lowest.

The evidence does not give much comfort to either side in the debate, Keen said. Neither theory nor evidence bear out the critics' fear that the flat tax is inequitable or weakens automatic stabilizers. The "long-run sustainability of the flat tax remains unclear," Keen noted. Simple political economy models make it hard to explain why flat tax reforms redistribute from the middle of the income distribution to the two ends, he said, and why their adoption does not help countries deal with such vexing issues as how to treat internationally mobile capital income or how to tax the self-employed.

More evidence, please

Hailing the paper as "exceptionally valuable," Burman said he "did not realize that the flat taxes *The Wall Street Journal* was paying such homage to were not the Hall-Rabushka flat tax" and that, in fact, "many advocates of a flat tax in the U.S. would find the flat taxes as described in the paper to be grossly deficient in terms of their effects on economic growth." Hassett described the paper as "a huge and productive undertaking" and a valuable review of the flat tax regimes that countries had actually put in place. But he criticized the paper for not making enough of an effort "to understand the effects of reforms." Because the data used in the paper were limited to revenues for a short time, he added, it was difficult to accept the authors' "sweeping statements" about what the evidence shows. Burman agreed that determining "whether a flat taxes raises or lowers social welfare" is an important question that would require the analysis of a broader data set. The debate, no doubt, will continue to be heated. ■

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The "Flat Tax(es)": Principles and Evidence, IMF Working Paper No. 06/218.

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