

IMF Backs Plan to Reduce Global Imbalances



AFP

Oil producers could help tackle imbalances by boosting spending.

The IMF plans to follow up on its first multilateral consultation, aimed at reducing imbalances in the global economy while maintaining robust world growth, by monitoring the policy commitments of the five major players involved: China, the euro area, Japan, Saudi Arabia, and the United States.

IMF estimates suggest that, once implemented, these policies could result in a reduction in the U.S. current account deficit of about 1–1¼ percent of GDP, accompanied by reductions in surpluses elsewhere.

In July, the IMF's Executive Board met to take stock of the experience with the first round of multilateral consultations, conducted between June 2006 and March

2007, and to draw lessons for the future. The 24 Directors, who together represent the IMF's 185 member countries, said the consultation had helped deepen agreement on a coherent medium-term approach that would reduce the imbalances while supporting global growth.

In 2000, when the IMF first warned policymakers that imbalances in the global economy could derail global growth, the U.S. current account deficit stood at 4 percent of GDP. Today, that deficit has risen to more than 6 percent of GDP and is matched by large current account surpluses elsewhere, especially in China, Japan, and oil-producing countries.

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IMF Moves to Clarify Aid Role

Under scrutiny from critics and its own official watchdog for its approach to the use of aid in low-income countries, the IMF is taking steps to clarify its role in advising members in the face of high and volatile aid inflows.

At issue is the need to achieve higher levels of economic growth to reduce

grinding poverty in many parts of the world while avoiding destabilizing lurches in the economy triggered by sudden inflows of aid that can highlight economic bottlenecks and cause inflation and exchange rate volatility, which could make the poor even worse off.

The IMF's Executive Board met on July 6 to consider how the 185-member institution can promote the effective and sustainable use of aid, and endorsed a number of recommendations about how to make maximum and best use of such aid.

The discussion was based on two sets of staff papers published on July 19—one on overall program design issues ("Aid Inflows—The Role of the Fund and Operational Issues for Program Design") and the other on fiscal policy issues ("Fiscal Policy Response to Scaled-Up Aid"). The outcome of this discussion

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Eric Miller/Picturedesk

Market in Rwanda, a country already receiving some scaled-up aid.

Update

World Growth Solid Amid Market Fears

IMF Managing Director Rodrigo de Rato said on August 22 that despite recent financial market turbulence, the global economy is still expected to perform well this year, but uncertainty remains about the implications of the ongoing liquidity squeeze for financial markets and for the real economy. The IMF is expected to publish its next forecast for the world economy in mid-October.

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IMF Clarifies Aid Role

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will be integrated with related work in the Fund, such as last year's update of the debt sustainability framework, to present a comprehensive operational framework for guiding the Fund's role in low-income countries.

Unpredictable aid flows

The international community has committed to supporting low-income countries in their efforts to meet the Millennium Development Goals (MDGs) by scaling up aid and improving aid delivery.

Although official development assistance to low-income countries fell slightly in 2006 compared with the previous year, aid from "emerging donors" and other private flows, particularly from health funds, are on the rise (see "Where's the Money?" page 164).

External assistance can offer additional resources for countries to pursue development goals, but can also be unpredictable and can create challenges for macroeconomic management, including if aid volumes were to increase sharply.

The IMF plays an important role by assisting countries in creating and maintaining an enabling macroeconomic environment for the effective use of aid. Helping countries design policy frameworks that support sustained growth and poverty reduction while maintaining macroeconomic stability and debt sustainability is an integral part of the Fund's Medium-Term Strategy (MTS).

In particular, the MTS calls upon the IMF to help low-income countries put in place the policies and economic institutions that will permit them to make use of scaled-up aid in a sustainable manner.

Accommodating the use of aid

Since the launch in 1999 of the Poverty Reduction and Growth Facility (PRGF)—the IMF's primary lending instrument for low-income countries—Fund policies with respect to aid have evolved in a number of important ways.

- IMF-supported programs have become more accurate—that is, less cautious—in predicting aid flows.



Red Cross immunization line at Tchadoua, Niger:

- Programs have increasingly allowed the spending and absorption of aid (see below).
- Increasingly, unanticipated aid flows can be spent, and unexpected aid shortfalls can be offset through higher domestic borrowing or reserve drawdown.
- Concerns related to competitiveness (often referred to as "Dutch disease"—meaning the harmful effects on exports of a sizable worsening of a country's competitiveness as a result of booming inflows of foreign exchange) have not led to limits on the use of aid.

Response to concerns

The recent Board discussion responded in part to concerns raised by the IMF's Independent Evaluation Office (IEO) about the IMF's role in aiding sub-Saharan Africa. Its report, released in February, noted that there was scope for clearer guidance on a number of issues, such as aid projection, accommodation of additional aid flows, and the examination of alternative scenarios in assessing the amount of aid that can be absorbed effectively.

Building on the experience with IMF-supported programs, the Board endorsed a number of program design principles



Issouf Sanogo/AFP

Governments often lack information on private aid flows.

from all sources—public and private. Given that aid disbursements are often volatile and uncertain, there is merit in smoothing expenditures over time so that all programs undertaken are adequately funded.

Effective use of aid flows may require that in certain cases some of the aid be saved temporarily. Limited absorptive capacity—macroeconomic, sectoral, and administrative—may constrain some low-income countries' ability to use aid effectively in the short run. Saving a part of the aid flows to finance higher expenditures in the future, when capacity constraints are less severe, may be an appropriate initial policy stance for those countries to an increase in foreign aid. However, there can be limits to how much aid a country can save. For example, the scope for saving project aid would be limited because its use depends on the project cycle. In addition, donors may be

reluctant to continue providing aid if it is consistently used to build up reserves. Finally, aid recipients face domestic pressures to spend aid to improve economic and social outcomes.

Beyond the emphasis on spending and absorbing, the paper lays out best practices for program design in a number of more specific areas. These include:

- Aid projections should reflect the best estimate of likely assistance based on all available information, not solely on firm commitments by donors. Deliberate over- or underprojection of aid should be explicitly justified.
- IMF staff should stand ready to help countries design alternative aid scenarios that would be consistent with macroeconomic stability. These scenarios are expected to be presented in Poverty Reduction Strategy Papers and/or IMF annual assessments known as Article IV reports.

(continued next page)

aimed at maximizing the effective use of aid while maintaining macroeconomic stability and debt sustainability.

In general, it was established that IMF-supported programs should promote the full use of aid—that is, the spending and absorbing of aid—provided macroeconomic stability is maintained and country-specific circumstances and development needs are taken into account. The spending of aid (by the government) is reflected in a widening of the fiscal deficit, while aid absorption is defined as a widening of the current account deficit, reflecting the transfer of resources from abroad through higher imports.

For countries not in a position to use aid fully (for example, when doing so would jeopardize macroeconomic stability), the IMF will provide advice on how to address constraints. Program documents will also be expected to explain clearly how programs are designed and to justify deviations from a full spend-and-absorb approach.

In an environment of scaled-up aid, macroeconomic policy formulation should be based on a longer-term view of spending plans and resource availability. These plans should be consistent with available financing

Wage Ceilings: For Exceptional Use Only

The IMF Executive Board clarified policies about the use of wage bill ceilings in IMF-supported programs. Wage bill ceilings are caps on government spending on civil service wages. The proportion of programs with wage bill ceilings under the IMF's Poverty Reduction and Growth Facility (PRGF) has declined from 40 percent during 2003–05 to about 32 percent as of June 2007.

Only 3 out of 28 PRGF arrangements—those for the Central African Republic, Chad, and Malawi—had limits on the wage bill as a quantitative performance criterion; another 6 programs include them as indicative targets (a weaker form of conditionality).

Wage bill ceilings can help restrain wage spending in cases where such expenditures threaten macroeconomic stability and squeeze out other priority spending (such as on medication and schoolbooks). Although designed as a short-term measure, such ceilings have tended to persist in programs and have not always been efficient in achieving their objectives. Although wage bill ceilings have been implemented flexibly, they have been criticized on the grounds that they have prevented countries from increasing employment in critical sectors such as health and education.

As countries strengthen their budget and payroll systems and formulate fiscal policy using medium-term frameworks, the need for wage bill ceilings as a means for controlling wage and employment costs is diminishing. However, developing these systems in low-income countries will take time. In the interim, there may be a need for wage bill ceilings on occasion. Such ceilings will be used in exceptional circumstances and will be based on the following criteria:

- **Clear justification.** The rationale for wage bill ceilings should be guided by macroeconomic considerations. Program documentation should justify their use in a transparent manner, including their consistency with the MDGs.
- **Limited duration.** Wage bill ceilings are a temporary device. Governments should tackle the root causes of wage-related fiscal problems, such as the need for civil service reform and strengthened payroll management.
- **Sufficient flexibility.** Wage bill ceilings should be flexible enough to accommodate spending of scaled-up aid, particularly for sustainable donor-financed employment in priority sectors such as education and health.
- **Periodic reassessments.** The need and rationale for wage bill ceilings should be reassessed at the time of program reviews.

Where's the Money?

At the 2005 Gleneagles summit, the Group of Eight (G8) leaders promised to double aid to sub-Saharan Africa by 2010. Two years later, there is little sign that the promise is translating into increases in overall aid to most sub-Saharan countries. Excluding debt relief, aid to sub-Saharan Africa from the world's major donors—grouped in the OECD's Development Assistance Committee (DAC)—was static in 2006, leaving a challenge to meet the Gleneagles commitment.

Aid to all countries (including middle-income recipients) declined, in constant 2005 dollars, to \$103.9 billion in net aid in 2006, down 5.1 percent from 2005 (see chart). This figure includes \$19.2 billion of debt relief, notably exceptional relief to Iraq and Nigeria. Excluding debt relief grants—which were at a record high in 2005 as a result of the first phases of several large Paris Club debt relief operations—net aid fell by 1.8 percent in 2006, according to preliminary data published by the OECD (the Paris-based Organization for Economic Cooperation and Development).

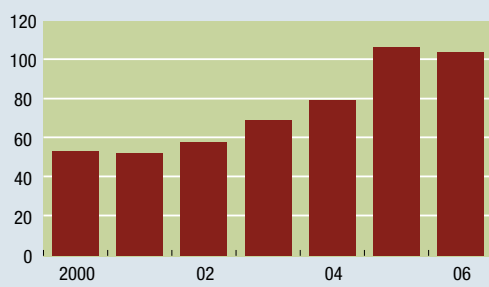
On balance, according to the World Bank's *Global Monitoring Report 2007*, there is "scant evidence of any substantial scaling up of aid on the horizon."

However, the overall picture may not be so bleak. Although, in real terms, the decline in official development assistance in 2006 was the first reduction since 1997, aid levels were still the highest recorded, with the exception of 2005 (see chart).

Further to climb

Official development assistance (ODA) fell slightly in 2006, but is still almost double levels at the start of the decade.

(ODA, billion dollars)



Source: OECD.

In addition, although aid recorded by the DAC fell, other forms of aid are on the rise, including from private sources, health funds, and emerging market donors, such as China. China's official assistance to Africa in 2006 was estimated at \$19 billion, and it has said it will step up aid further. Overall aid from private sources doubled during 2001–05 to \$14.7 billion, according to the World Bank. Global funds to combat HIV/AIDS are estimated to reach \$9 billion in 2007, according to the United Nations Development Program.

Nevertheless, according to several recent studies, further progress toward the Millennium Development Goals (MDGs) would require substantial net increases in official development assistance. Estimates by the World Bank and the United Nations suggest that additional official assistance of

about \$40–60 billion a year would be needed to meet the MDGs.

Based on the 2005 G8 commitment in Gleneagles to double aid to Africa, the OECD estimates that assistance from the DAC countries would rise by \$50 billion in real terms between 2004 and 2010.

- Programs should reconcile the full use of aid with price stability while avoiding the crowding out of private investment. Achieving this requires the effective coordination of fiscal, monetary, and exchange rate policies. It is important that programs be based on a clear understanding of the authorities' exchange rate regime because this determines how absorption might take place.

- Minimum levels of poverty-reducing spending could be used in IMF-supported programs to protect and expand priority outlays.

- Given the limited evidence of negative effects on competitiveness from increased aid inflows, spending should in general not be constrained due to Dutch disease concerns unless a competitiveness problem emerges. Emphasis should be placed on steps to strengthen competitiveness, for example by channeling aid toward productivity-enhancing expenditures such as infrastructure investment.

- The Debt Sustainability Framework should be used to keep debt levels manageable and assess whether the concessionality of aid flows is appropriate.

- The IMF should coordinate with the World Bank and key donors if microeconomic concerns regarding the ability to use aid effectively arise.

- Strengthening domestic revenue mobilization should be an integral part of the macroeconomic policy response to scaled-up aid. Such a strategy should emphasize broadening the revenue base by reducing exemptions and improving revenue administration.

- Close monitoring of spending is important for ensuring debt sustainability. Inefficient spending will add to the debt burden without significantly improving economic and social outcomes. Good governance and quality of fiscal institutions have a strong positive correlation with efficiency of spending.

- Poverty and social impact analysis (PSIA) should be taken into account where appropriate to incorporate the interests of the poor and help mitigate any adverse effects of reform measures. IMF staff would not be expected to conduct PSIA work, but to rely on the work of the

World Bank and other development partners, with close collaboration expected on spending composition and PSIA.

- Ceilings in IMF programs that limit the public sector wage bill should be used only in exceptional circumstances when warranted by macroeconomic considerations (with clear justification in program documents). They should be designed flexibly to accommodate scaled-up spending, particularly in priority sectors such as health and education (see "Wage Ceilings: For Exceptional Use Only" on page 163).

- Strengthening fiscal institutions and public financial management systems is critical to effective utilization of scaled-up aid. Countries should prepare appropriately sequenced and prioritized action plans for strengthening these systems based on diagnostic assessments of existing systems. ■

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Plan to Reduce Global Imbalances

(from page 161)

There are those who argue that these imbalances are sustainable and that the world economy will continue its impressive expansion. But many others, including the IMF, do not think imbalances of this magnitude are sustainable in the long run and believe that action is needed to reduce them before they unravel in an abrupt and disorderly way.

IMFC strategy

Since 2004, the IMF's International Monetary and Financial Committee (IMFC) has called for joint action to address the risks posed by the imbalances. The IMFC Strategy, as these recommendations have become known, has evolved over time, reflecting the changing nature of the problem.

But, in April 2006, imbalances were still growing, and IMF Managing Director Rodrigo de Rato felt that more urgent action was required. He suggested that the problem be addressed in a framework involving only the key players. The objective of the first multilateral consultation, as this process is now known, was to seek to reduce the imbalances while maintaining the robust growth enjoyed by the world economy in recent years.

A new forum

The purpose of a multilateral consultation is to bring together a small group of countries to promote dialogue on, and, eventually, a common solution to, a particular problem of systemic importance. To ensure a free and frank exchange focused on policy implementation, the consultations are informal and confidential and involve only high-level policymakers.

The United States, China, the euro area, Japan, and Saudi Arabia all agreed to participate in the first round of multilateral consultations. Some of these economies are direct parties to the imbalances, through current account deficits or surpluses, and

some represent large shares of global output. The IMF invited them to participate because those five economies could, as a group, play a major role in reducing the imbalances and sustaining world growth at the same time.

The consultations began with discussions between IMF staff and each participant, followed by three meetings involving all five participants. The last of these meetings took place in March 2007. In mid-April—just ahead of the meetings of the IMFC—the five participants and the IMF issued a joint report, in which the participants stressed that reducing global imbalances is a multilateral challenge and a shared responsibility, and that an orderly unwinding of imbalances would benefit all countries in the world. They reaffirmed their commitment to the strategy that had been set out by the IMFC a year earlier and agreed to publish detailed statements of their policy intentions.

A set of policy plans

Taken together, these policy plans will help countries make significant progress in all the key areas of the IMFC Strategy. At their July 20 meeting, the IMF's Executive Directors particularly welcomed the individual policy plans of the five participants—even if those plans did not always match the level of ambition advocated by the IMF in its dealings with those economies. The Directors felt that the publication of these policy intentions provided a valuable road map for the future, enhancing public scrutiny and helping foster confidence that the international community was working together to address the problem.

Monitoring will be key

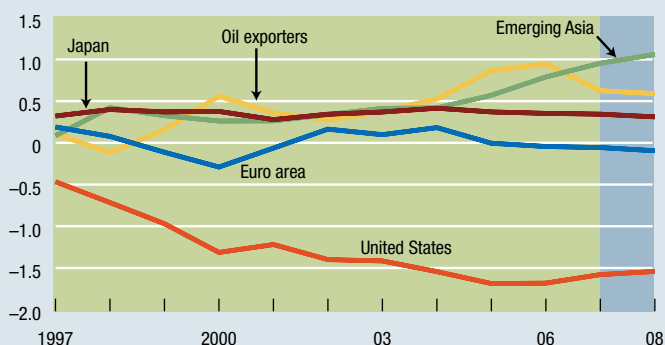
Looking ahead, the IMF's Board emphasized that the multilateral consultation would ultimately be judged by progress toward reducing the imbalances and sustaining global growth, and by implementation of the policy plans. In that regard, some of the Directors felt that specific time frames and benchmarks would have made it easier to keep track of implementation. IMF staff will continue to monitor progress both in Article IV consultations with the five economies and in the *World Economic Outlook* and the *Global Financial Stability Report*, the IMF's two flagship publications. The Directors also stressed that while the five economies will have to play a key role in facilitating an orderly adjustment, other countries must play their part.

More generally, the Directors considered that the new approach constituted a valuable new instrument for enhancing and deepening the IMF's multilateral surveillance. They underscored that involvement of the Board and the IMFC at the appropriate time is crucial to give the process legitimacy and to allow the international community to assess results. ■

A mirror image

The current account deficit of the United States has been matched by surpluses elsewhere, particularly in emerging Asia and in oil-exporting countries.

(current account balances, percent of world GDP)



Source: IMF staff.

David Robinson
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Putting Financial Globalization to Work

Capital flows to emerging market and developing countries are expected to top \$1 trillion in the near future. New IMF research finds that while most countries stand to benefit from foreign direct investment (FDI), they should liberalize other flows only as part of a broader package of reforms.

Financial globalization is here to stay, and all countries, essentially, are affected by it to varying degrees. Advanced countries have seen the most rapid increases in financial flows over the past two decades, but emerging markets and developing countries have also become financially more integrated (see chart).

Even those countries that have sought to “lean against the wind” of financial globalization by maintaining extensive capital controls have seen some increase in the size of their external assets and liabilities.

Should financial globalization, defined as the extent to which countries are linked through cross-border holdings, be viewed primarily as an opportunity for countries to finance investment projects that are good for growth or as a source of possible volatility and crisis? What have we learned from research on these topics over the past few years? A paper prepared by IMF staff in the Research Department, entitled “Reaping the Benefits of Financial Globalization,” takes stock of what we know about the effects of financial globalization.

Data from the past 30 years reveal two main lessons. First, the findings support the view that countries need to carefully weigh the risks and benefits of unfettered capital flows. Whereas advanced economies largely benefit from the free movement of capital, emerging market and developing countries should make sure they meet certain thresholds—which include the quality of their institutions and policymaking and their level of domestic financial development—before they open up their capital account. If they do not meet such thresholds, finan-

Key Points

The issue: Is financial globalization primarily an opportunity to share risk internationally and finance investment projects that are good for growth, or is it a source of possible volatility and crisis?

Policy considerations: While opening up to FDI at an early stage is likely to benefit all countries, a decision to liberalize short-term debt-creating inflows should take into account a country’s financial market development, perceived institutional quality, and macroeconomic policies. But delays in opening up also carry costs.

Policy implications: Capital account liberalization should be pursued as part of a broader reform package encompassing a country’s macroeconomic policy framework, domestic financial system, and prudential regulation.

cial liberalization can lead to macroeconomic volatility.

Second, there are also costs associated with being overly cautious about capital flows. Opening up the economy to outside investment may in itself encourage changes that are good for efficiency and growth, for instance by stimulating development of the domestic financial sector.

Effects of financial globalization

In theory, opening up the economy to investment from abroad should have largely positive effects. Financial globalization encourages international risk sharing, stabilizes spending by households and the government (by allowing international capital to supplement domestic capital when there is a shortfall of revenue), and fosters economic growth.

In practice, however, the benefits have been less clear cut. Although advanced countries have benefited from risk sharing, there is little evidence that the same is true for emerging market and developing countries. As international financial integration has increased, so has

volatility—but only in those countries with relatively weak domestic financial sectors and institutions.

In terms of growth, the evidence is also mixed. Whereas FDI does encourage long-run growth (our paper shows that an increase in FDI of 10 percentage points of GDP increases growth by 0.3 percentage points on average), the impact of debt on growth depends on whether the money is put to good use, which in turn is influenced by the quality of a country’s policies and institutions.

The study’s analysis identified a number of factors that are likely to be involved in the effect of financial globalization on economic volatility and growth.

Financial sector development. Well-developed financial markets help moderate boom-bust cycles that are triggered by surges and sudden stops in financial flows.

Institutional quality. Strong institutions—including the rule of law, freedom from corruption, and government efficiency more generally—play an important role in directing financial flows toward FDI and portfolio equity. A sound institutional framework thus makes it easier to share risk internationally and supports economic growth.

Sound macroeconomic policies. If macroeconomic policies are weak, financial openness may result in excessive borrowing and debt accumulation, thereby increasing the risk of crisis.

Trade integration. Countries that are open to trade are less likely to experience sudden stops in inflows and current account reversals. Openness to trade can also mitigate the effects of a crisis by facilitating economic recovery.

The study also finds that financial globalization does not seem to make countries more vulnerable to crisis. In fact, crises are, if anything, less frequent in financially open economies than in economies that restrict capital flows. Our estimates show that financially open countries



Construction in Dubai, United Arab Emirates, where real estate is booming after being opened to foreign investment.

with well-developed domestic financial systems, strong institutions, sound policies, and open trade have an even lower risk of experiencing a crisis.

Capital controls no free lunch

Countries should proceed with caution when it comes to opening up their economies to capital flows, but policymakers should also bear in mind that keeping capital controls in place can impose significant costs on the economy. These include

Lower international trade. There is ample evidence showing that capital controls encourage fraud through mis-invoicing. And new research suggests that capital controls increase the cost of engaging in international trade even for firms that do not seek to evade capital controls.

Higher cost of capital. Capital controls make it more difficult and expensive for small firms to raise capital. The cost of borrowing is also higher (about 5 percent on average) for multinationals located in countries with capital controls than in countries without them.

Distortions in the economy. Economic behavior is likely to be distorted by capital controls as individuals and firms seek ways to evade the measures. This may result in an uneven playing field in which well-connected firms—rather than the most efficient ones—survive.

Administrative costs. The government has to spend significant resources on monitoring compliance with capital controls and on updating them to close loopholes and limit evasion.

What, then, do these findings entail for the advice the IMF gives to member countries? In general, capital account liberalization should be pursued as part of a broader reform package encompassing a country's macroeconomic policy framework, domestic financial system, and prudential regulation. In particular, long-term, non-debt-creating flows, such as FDI, should be liberalized before short-term, debt-creating inflows.

Our empirical results broadly support this approach. Opening up to FDI is beneficial for almost all countries, even those with relatively weak fundamentals. But before liberalizing other types of flows, countries need to carefully consider whether they meet the thresholds beyond which the net benefits of financial globalization become positive.

In sum, all countries should aim to embrace financial globalization. But before opening up their capital account, governments should examine the readiness of their financial sector and their level of institutional development. At the same time, they should also weigh the possible risks involved in opening up to capital flows against the efficiency costs associated with capital controls.

Looking ahead

While a cautious approach to liberalization remains warranted when domestic fundamentals are weak, the net benefits that countries can derive from financial integration are likely to become more substantial in the future.

First, markets are moving toward a more equity-based structure, which tends to have a beneficial impact on international risk sharing and economic growth.

Second, many emerging market countries have reformed their economies in recent years, bringing them up to the thresholds where the benefits associated with financial globalization begin to outweigh the risks.

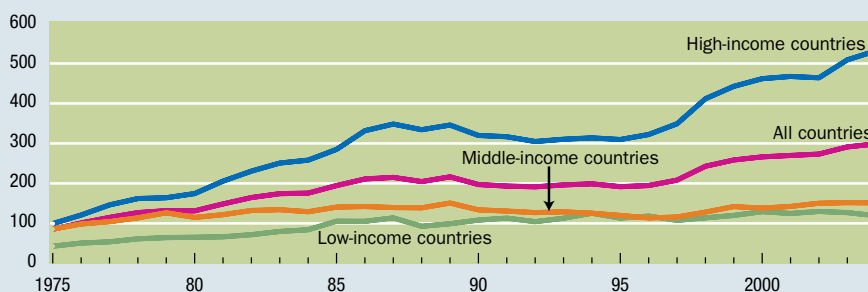
These developments should make it easier for countries to reap the benefits of financial globalization in the years ahead. ■

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Leader of the pack

The worldwide increase in financial globalization has been driven mainly by high-income countries.

(gross external assets and liabilities, percent of GDP)



Source: IMF, *World Economic Outlook*.

Africa: Sustaining the Momentum

Sub-Saharan Africa is experiencing its fourth year of strong growth. Higher oil revenues, strong commodity prices, and increased debt relief are being used to make inroads into poverty. While parts of Africa are plagued by wars and tarnished by corruption, elsewhere improved macroeconomic performance and better policies are helping countries put their economies on a firmer footing.

The challenge is to keep things going. The record shows that it is much easier to start a period of high growth than to maintain the pace: growth surges that last only a few years are quite frequent in Africa, as elsewhere. What is rarer is when these growth periods endure.

Leaders of the 53-member African Union met in Ghana July 1–3 to discuss ways to accelerate regional integration and link the continent more closely to the global economy—steps that are essential for spurring further growth, boosting employment, raising living standards, and reducing poverty and deprivation. An increasing focus will need to be placed on implementing the structural reforms that will help foster vibrant market-based economies.

What is the IMF doing to help African countries take advantage of this opportunity? After all, without faster and more sustained growth, poverty will not see much reduction in the continent. Thus, growth must accelerate if Africa is to edge closer toward achieving the Millennium Development Goals (MDGs).

IMF's role in Africa

The IMF has long helped African countries achieve and maintain macroeconomic stability, improve public financial management systems (which promote good governance), and develop an effective financial sector that helps foster growth spearheaded by the private sector. Although most countries in the region are enjoying strong growth and benign inflation, many are still falling short of meeting any of the MDGs.

Making a permanent dent in poverty and achieving progress toward the MDGs will take not only higher overall donor resources but also the steadfast implementation of growth-critical reforms, the targeted and efficient use of available resources, and improved coordination of macroeconomic policies to increase the absorption of higher aid inflows.

The IMF is trying to help address these challenges. Its Medium-Term Strategy renews the IMF's commitment to helping low-income countries in its core areas of expertise through policy advice, capacity building, and financial assistance, and seeks to improve the IMF's effectiveness.



Kenyan roses: Export success has made Kenya the largest supplier of cut flowers to Europe.

Antony Njuguna/Reuters

Refining the tool kit

The IMF is reviewing the effectiveness of its policy advice and program design and continuing to refine its tool kit for low-income countries. It is discussing how to take on board recommendations in two recent reports—one, “IMF and Aid to Sub-Saharan Africa,” from the IMF's own watchdog, the Independent Evaluation Office, and the second from the External Review Committee on Bank-Fund Collaboration.

To help countries that want IMF support and endorsement of their economic policies without a borrowing arrangement, the IMF has introduced the Policy Support Instrument (PSI). In June, Mozambique became the fifth African country to opt for a PSI (see box). The Fund also introduced the Exogenous Shocks Facility (ESF), which provides policy support and financial assistance to low-income countries facing external shocks, and is reviewing how to better assist so-called fragile states.

The IMF is also reviewing how to help ensure that countries have the budgetary leeway (“fiscal space”) to expand priority spending on social services and infrastructure, and is looking for ways to increase their capacity to absorb aid and debt relief effectively. Countries must achieve these aims while trying to preserve the hard-fought gains provided by macroeconomic stability and avoiding past debt-related problems.

Expanding fiscal space

Countries can expand fiscal space by mobilizing resources from domestic revenue, external grants, and domestic and external

loans; and by increasing the efficiency of spending, including by reducing untargeted and low-priority expenditures.

Increased resources need to be spent wisely, and such spending, particularly on social services and infrastructure, is being accommodated in all IMF-supported programs in Africa unless it would threaten macroeconomic stability. Fiscal and financing targets in IMF-supported programs will continue to be designed to accommodate higher poverty-reducing spending. Indeed, many programs include floors (or minimum levels) for poverty-reducing spending, for example in Rwanda, Sierra Leone, and Uganda.

Mobilizing domestic and external resources. In countries where revenue is inadequate to meet national policy challenges, the IMF provides advice and technical assistance to increase tax revenue by widening the tax base, improving tax policy design, and strengthening tax and customs administration.

The Fund also plays an important role in the mobilization of external resources. It lowered countries' debt under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative and, most recently, under the Multilateral Debt Relief Initiative.

External loans increase resources for development. However, countries need to avoid falling into the debt trap of the past. The IMF and the World Bank have refined their debt sustainability framework to help countries implement debt management strategies that will avoid a renewed buildup of unsustainable debt.

But more needs to be done. The scaling up of aid promised at the economic summit in Gleneagles has not yet materialized.

Mozambique's new PSI

The IMF's Executive Board approved on June 18 a Policy Support Instrument (PSI) for Mozambique under the IMF's PSI framework, which is intended to support the nation's economic reform efforts. The PSI for Mozambique is aimed at maintaining macroeconomic stability as foreign aid is scaled up, promoting structural reforms, and implementing the broader policy agenda as envisaged in the Mozambican authorities' national poverty reduction strategy.

Approval of Mozambique's PSI signifies IMF endorsement of the policies outlined in the program. The IMF's framework for PSIs is designed for low-income countries that may not need, or want, IMF financial assistance but still seek IMF advice, monitoring, and endorsement of their policies.

PSIs are voluntary and demand driven. PSI-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a Poverty Reduction Strategy Paper. This is intended to ensure that PSI-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. Members' performance under a PSI is normally reviewed semiannually, irrespective of the status of the program.

The IMF will continue to remind donors of the need to live up to their commitments and will give a candid assessment when it thinks that macroeconomic conditions allow for an increase in aid inflows.

Increasing the effectiveness of spending. Well-functioning public expenditure management (PEM) systems are essential if

“The scaling up of aid promised at the economic summit in Gleneagles has not yet materialized. The IMF will continue to remind donors of the need to live up to their commitments.”

countries are to use public resources effectively to achieve and sustain high rates of growth. They also improve governance by making public expenditures more transparent (including to citizens) and help assure donors that their resources are being used for the intended purposes.

The IMF provides advice and technical assistance on expenditure policy and PEM systems, including medium-term fiscal frameworks, treasury management, and budget control. In this context, programs have also relied on the use of wage bill ceilings to prevent macroeconomic imbalances when the wage policy is not coordinated with sectoral priorities and overall resources.

A recent IMF study concluded that wage bill ceilings have not restricted the use of available donor funds, but also found that they are not the best instrument for addressing the underlying problems of budget control. As PEM systems are strengthened, these ceilings increasingly become redundant. The IMF has already strongly reduced reliance on such ceilings and, going forward, is committed to using them only selectively and transparently.

Increasing absorption of aid

A key objective of IMF-supported programs is to ensure that conditions are favorable for the effective absorption of aid. In general, this requires that various macroeconomic policies (monetary, fiscal, and exchange rate) be well coordinated and that key reforms in areas such as trade, the financial sector, governance, and public financial management be implemented.

The IMF's analysis of the scope for using aid takes into account many factors, not just inflation and reserves. Important considerations are aid volatility, the incidence of shocks, debt sustainability, export competitiveness, the domestic debt burden, and microeconomic capacity constraints to higher spending. ■

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See the *IMF Survey Magazine* online for related articles: “Rwanda’s Task: Manage More Aid,” “Central African Republic: Recovering from Conflict,” and “Africa’s Better Policies Are Paying Off”—an interview with Abdoulaye Bio-Tchané, Director of the IMF’s African Department.

Low-Income Countries Need to Upgrade Financial Management

Sound fiscal institutions and public financial management (PFM) systems are essential if low-income countries are to benefit from scaled-up aid. Weaknesses in PFM systems can undermine budgetary planning, execution, and reporting; reduce fiscal transparency; and result in leakage of scarce public resources. Low-income countries, particularly those that will benefit from scaled-up aid, should prepare an action plan for strengthening their PFM systems.

Weaknesses in existing PFM systems

Public financial management comprises the institutional framework, systems, and procedures that govern the preparation, execution, and reporting of the budget. PFM systems in most low-income countries require substantial upgrading, and in many cases have not improved significantly in recent years:

Assessments and action plans prepared jointly by the World Bank and the IMF for 23 heavily indebted poor countries in 2001 and for 26 in 2004 provided the first opportunity for periodic PFM assessments to measure progress over time. Nineteen of the 26 countries were assessed as still requiring substantial upgrading (see Chart 1). Budget execution and the ability of countries to track poverty-reducing expenditures were especially weak.



Katse Dam, Lesotho: Public financial management reform should include more coverage of donor-funded projects in budgets.

Assessments under the multipartner Public Expenditure and Financial Accountability (PEFA) Program, in which the IMF participates, suggest a similar pattern of relatively poor performance in key areas of budget preparation and execution. Countries assessed in seven budget categories showed a median score of around 2.0 against the international good practice standard of 4.0 (see Chart 2).

Recent evaluations of the IMF's technical assistance activities in low-income countries reached a similar conclusion. One evaluation concluded that in many countries, budget plans were based on unrealistic assumptions, were not comprehensive, and lacked a medium-term focus; accounting and payments systems and other areas of budget execution were weak; budgetary institutions were fragmented; and broader institutional problems such as weak legislative oversight and poor accountability of senior budget officials were common. In some countries reviewed, civil conflict had added to these problems.

Countries that are emerging from conflicts or have suffered major disasters face special challenges in strengthening their fiscal institutions. These countries have generally received large injections of aid resources that their PFM systems are often not able to cope with, either because of the logistics of handling a sudden increase in inflows of aid, or because institutions and PFM capacities have been significantly weakened and cannot respond adequately or meet donor expectations. In many postconflict or disaster-affected countries, there is often a sudden influx of foreign experts to work alongside national staff or sometimes even to run the central fiscal institutions until national staff can take over.

Key areas for PFM reform

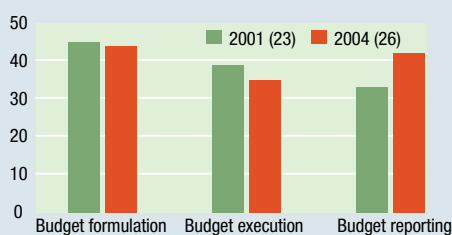
A first critical area is to establish a coherent and well-integrated approach to strategic planning and budgeting. Reforms should include strengthening the relationship between the planning and budgeting cycles, strengthening the role of the cabinet in strategic decision making, integrat-

Chart 1

Could do better

Public financial management (PFM) systems in most low-income countries require substantial upgrading.

(countries meeting benchmarks in percent of total)¹



Sources: IMF and World Bank estimates.

¹PFM performance in heavily indebted poor countries; total countries assessed in each year in brackets.

ing more closely the recurrent and development budgets, and increasing the coverage of donor-funded development projects in the budget. Strengthening these areas is of critical importance to the effective and efficient utilization of aid. However, while these reforms are urgent and require an immediate start, they are also institutionally demanding—by requiring changes in the role of key players in the budget process—and can be politically sensitive, so change is likely to be slow, complex, and subject to resistance.

A second important area is to build capacity in budget execution and reporting to ensure the efficient, effective, and transparent use of public resources. Such reforms should initially focus on upgrading the classification of expenditures and revenues and the accounting, internal control, and fiscal reporting systems. Still, on budget execution, frequently encountered problems such as spending arrears and weak control of expenditure commitments need to be contained. Special attention should be paid to tracking poverty-reducing public spending to ensure that it reaches the intended recipients. Techniques such as the use of Public Expenditure Tracking Surveys (PETS) and audit reports can help identify persistent weaknesses in the expenditure chain. Public procurement and payroll management are other areas that are likely to require strengthening.

A third area of particular importance to scaled-up aid is taking steps to more fully incorporate donor aid in the budget. According to a recent survey by the Organization for Economic Cooperation and Development, on average only 37 percent of external aid is channeled through country PFM systems. This complicates fiscal management.

A fourth area is to take initial steps to give the budget a results orientation. This would allow the governments to get a sense of whether scaled-up spending is having the desired effect on economic and social outcomes. However, advanced forms of results-oriented budgeting are not appropriate for low-capacity countries.

Chart 2

Relatively poor performance

In key areas of budget preparation and execution, low-income countries reach only halfway toward international good practice standards.

(aggregate score; perfect score = 4)¹



Source: PEFA Secretariat, World Bank.

¹Public Expenditure and Financial Accountability Program assessments.

PFM action plans

Low-income countries should prepare an action plan for strengthening PFM systems based on a comprehensive diagnostic assessment. To deal with capacity constraints, it is often sensible to implement these plans in a series of steps. In the case of postconflict countries, the action plan may also need to address weak legal and regulatory frameworks (such as tax and budget laws), an ill-defined fiscal authority (the ministry of finance), and poorly developed PFM systems.

The PFM action plans—which give priority to the most urgent reforms described above—should decompose reforms into key functional components such as the regulatory framework, business systems and operating procedures, information technology systems, and training and capacity-building needs. Monitoring progress in each area is essential so that problems can be addressed before they become obstacles to the overall reform process.

The action plan, which should be country specific, should also identify critical needs, measures that are more complex and require institutional/legal changes, and measures that are less urgent and can be addressed over the medium term. On content, in addition to the areas listed above, the action plan may also include, depending on country circumstances:

- Developing capacity in treasury systems, cash management, and debt manage-

ment to strengthen budget execution and help countries build their own medium-term debt strategy.

- Strengthening the capacity of subnational governments: delivery of services such as education, health, and sanitation is increasingly being delegated to subnational governments, whose PFM systems are typically weaker than those of the national government.

- Linking PFM reforms to broader public sector reforms: the reforms of PFM systems are more effective if they are part of a broader public sector reform of the civil service, governance and transparency, and the legal framework.

- Gradually increasing the role and capacity of the national audit authority to provide an independent check on the integrity and reliability of the government's financial statements and the value-for-money of key expenditure programs.

Coordinating technical assistance

The IMF has an important role to play in helping countries design and implement PFM action plans in many areas that are part of its core mandate—for example, budget classification, accounting, internal control, and fiscal reporting. Such assistance should put emphasis on country ownership of the reforms; learn from lessons of the past to use technical assistance more effectively; where appropriate, make effective use of external finance and partnership arrangements with the World Bank and other assistance providers; and leverage the resources of staff from headquarters and the regional technical assistance centers that the Fund has established in Africa and elsewhere.

It has been estimated that more than 50 assistance providers work in the PFM area and, in any one country, the average number of providers is around seven. Given the IMF's limited resources and specialized expertise in core areas, coordinating with other donors is thus essential to avoid wasteful overlap and mixed messages. ■

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Central America Aims for Stronger Growth



Philip Coblenz/Picture Arts

Oxcart in Costa Rica, one of three countries in the Central American region with per capita GDP higher than 30 years ago.

Times are better in Central America. After years of political turmoil, the region has made important economic advances against a backdrop of both improved political stability and favorable global economic conditions. Real GDP has recovered (see table), inflation has remained under control despite the upsurge in oil prices, and exports have been strong. Still, poverty is persistent and widespread, and the small nations that make up Central America remain vulnerable to economic events outside their control. They need to improve productivity and strengthen government finances and the financial sector. Top government officials in the region met in June and agreed that further economic reforms were needed.

The aim of all the reforms is the reduction of poverty, Central America's biggest challenge. Average growth rates of the past decade have fallen short of records achieved in the 1960s and 1970s, and the region's growth performance is less favorable than that of the more dynamic emerging market economies in the world, especially those in Asia. Only three countries in the region (Costa Rica, the Dominican Republic, and Panama) have succeeded in raising GDP per capita

above their levels in the late 1970s, and in only one, Costa Rica, are poverty levels substantially lower. Addressing issues of economic growth will be paramount if Central America is to lift people out of poverty and significantly raise living standards.

But as it seeks to maintain high growth, Central America must also act in areas where it remains economically vulnerable, an assessment that Central American ministers of finance, central bank governors, and financial superintendents concurred with at the recent Sixth Annual Regional Conference on Central America, Panama, and the Dominican Republic, held in Costa Rica. In a communiqué issued on June 29, following the conference, the officials said participants agreed that the region must take "advantage of good times to tackle the daunting tasks of entrenching stronger growth, reducing still-high levels of poverty, and decreasing vulnerabilities against adverse shocks."

Institutional quality

Improving the growth performance in Central America will depend to a large degree on the countries' abilities to implement productivity-enhancing reforms. During 1960–2005, gains in

output per worker almost exclusively reflected increased investment in capital equipment rather than productivity growth; and variations in growth within subperiods and across countries were closely associated with differences in productivity growth.

How then to raise productivity in Central America? The extensive literature on sources of growth in developing countries points, for example, to the benefits of strengthening institutions. Indeed, an illustrative simulation suggests that raising overall institutional quality—such as government effectiveness; control of corruption, political instability, and violence; regulatory burden; voice and accountability; and the rule of law—to Chile's level could raise growth by half a percentage point a year in Central American countries with relatively strong institutions (Costa Rica) and by 3 percentage points or more a year in countries with relatively weak institutions (Guatemala, Honduras, and Nicaragua).

A concerted effort to improve institutions and the business environment in Central America is also paramount to ensuring that the Central American Free Trade Agreement with the United States and a potential association agreement

with the European Union will lead to the expected productivity improvements and tangible benefits for all.

Macroeconomic policies have strengthened, but high debt levels and future contingent claims, especially pension benefits, still leave public finances vulnerable. Authorities must take further steps to reduce debt, which, except in Guatemala, remains high, averaging 47 percent of GDP at the end of 2006. In parallel, they need to raise tax revenue further in order to meet pressing social and investment needs in a fiscally responsible manner.

Putting Central America's pension systems on a sound long-term footing is a key component of this strategy. Although Central America has more favorable demographics than countries with low or even declining birth rates, its population will age substantially and the ratio of the working-age population to the elderly will, for example, fall from about 8 today to less than 3 in 2050, rendering the systems unsustainable. Although there is no one-size-fits-all solution, sustainability requires some combination of increased contribution rates, higher retirement ages, and lower benefits in most countries.

“Safer” debt

Another key element in reducing vulnerability is moving toward “safer” debt structures, since sustainability is a function not only of the level of debt but also of its structure. Currency denomination, maturity composition, capital structure, and solvency play an important role in the likelihood of a crisis, and often public sector balance sheets exhibit significant mismatches along those dimensions. An analysis of Central America's sovereign debt structures reveals that, on average, the region has a lower share of short-term debt than the rest of Latin America but a higher share of foreign currency debt. In line with broader developments in emerging markets more recently, Central America has been able to reduce its foreign currency exposure and lengthen its maturity structure modestly. Such efforts are a step in the right direction and should be continued.

Inflation reduction, monetary policy

Central American countries have succeeded in reducing inflation, but bringing it all the way down to the level of trading partners generally remains a challenge. In pursuit of this objective, countries in the region have made substantial progress in strengthening the institutional underpinnings for formulating and executing monetary policy. New central bank legislation has given

Steady Growth

Over the last three years real GDP in Central America has steadily improved, and slower but solid growth is forecast through 2008.

	2004	2005	2006	Proj. 2007	Proj. 2008
Central America	4.1	5.2	6.4	5.8	5.0
Costa Rica	4.3	5.9	7.9	6.0	5.0
Dominican Republic	2.0	9.3	10.7	8.0	4.5
El Salvador	1.8	2.8	4.2	4.5	4.5
Guatemala	3.2	3.5	4.9	4.8	4.3
Honduras	5.0	4.1	5.5	4.8	3.4
Nicaragua	5.1	4.0	3.7	4.2	4.7
Panama	7.5	6.9	8.1	8.5	8.8

Source: IMF, World Economic Outlook database.

the monetary authorities enhanced autonomy and, as a result, the mandate of central banks is more clearly focused on preserving price stability. Direct political intervention in central bank decisions and monetary financing of fiscal deficits have been curtailed.

Nevertheless, monetary policy frameworks have some remaining shortcomings. Efforts to maintain price stability while preserving the external value of the domestic currency raise concerns about objectives, cause policy conflicts (for example, in the case of strong capital inflows), and undermine the credibility of central banks. There is still a potentially strong link between the political business cycle and monetary policy decisions because the executive branch continues to have substantial leeway to remove central bank governors and other members of the board of central bank directors. Furthermore, central banks generally continue to lack financial autonomy because there are often no legal provisions to protect the integrity of central bank capital, which in turn substantially under-

mines the effectiveness and credibility of monetary policy. It will be important to make progress on these issues in the coming years.

Development of financial systems

The financial sector in the region is dominated by banks and, with the exception of Panama—which has a bank asset-to-GDP ratio of 250 percent—there is substantial room for further development. Capital markets are underdeveloped across countries, and equity and corporate bond listings are generally in the single digits. Institutional investors such as pension funds, mutual funds, and insurance companies intermediate only a small share of national savings.

While there is no simple solution to developing private equity and corporate bond markets, there is substantial scope to develop public debt markets, especially through institutional and operational improvements. In most countries, it will also be important to develop and implement a medium-term debt management strategy and improve the technical capacity of debt management units. In that respect, Costa Rica, El Salvador, and Panama have made some improvements over the past couple of years. Deeper and more liquid public debt markets, in turn, would also allow the authorities in countries with their own currency to conduct monetary policy more effectively.

A propitious time for reform

As IMF Deputy Managing Director Murilo Portugal emphasized in his recent speech in San José, Costa Rica, now is the time for Central America to reform, taking advantage of the benign global environment. After all, “it is in the sunny days that we should fix the roof of the house.” ■

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This article is based on IMF Occasional Paper No. 257, *Economic Growth and Integration in Central America*, edited by Dominique Desruelle and Alfred Schipke.

IMF Approves Landmark Framework for Economic Surveillance

In a move to strengthen the IMF's ability to head off risks to the global economy, the institution's 24-member Executive Board adopted on June 15 a landmark decision providing updated guidelines for monitoring the economic health of its 185 member countries (a process known as bilateral surveillance).

Managing Director Rodrigo de Rato, speaking in Montreal on June 18, said that the decision represented "the first-ever comprehensive policy statement on surveillance." He called it "good news for the IMF reform program and good news for the cause of multilateralism."

The adoption of the Decision on Bilateral Surveillance eliminates a significant gap in the IMF's policy framework by providing an up-to-date and more comprehensive framework for the regular health checks of national economies, which complement the IMF's oversight of the international monetary system (a process known as multilateral surveillance).

The landmark step was announced as the IMF moves swiftly on many fronts to better meet the demands of a more integrated world economy. It is also seeking to give dynamic economies (many of which are emerging markets) a bigger say in the running of the institution, reform its sources of income, sharpen the focus of its work on low-income countries, and reexamine its tools to support emerging markets.

Exchange rate policies

By crystallizing a shared vision of what surveillance is all about, the decision should ensure that the policy dialogue between the IMF and its member countries is more focused and effective. Changes are most notable in three areas.

- First, the decision affirms that bilateral surveillance should be focused on the IMF's core mandate, namely promoting countries' external stability. It should



IMF Executive Board in session: Surveillance is a collaborative process based on dialogue, persuasion.

thus help prevent surveillance from being spread too thin.

- Second, it gives clear guidance to the IMF's members on how they should run their exchange rate policies and on what is and is not acceptable to the international community. For the first time, the meaning of exchange rate manipulation is spelled out (see box).

- Third, by making clear what is expected of surveillance, the decision should promote candor as well as even-handed treatment of different countries.

Why new decision was needed

Until now, the main policy statement on IMF surveillance was the 1977 Decision on Surveillance over Exchange Rate Policies, which was crafted in the wake of the collapse of the Bretton Woods system of par values. At the time, uncertainty prevailed about the rules of the game—whether they related to the role of the IMF or to macroeconomic management without fixed exchange rates—and private capital flows played a more limited role in the global economy.

The expectation was that the decision would be revised with experience. In the

event, while the practice of surveillance evolved, the decision itself remained virtually unchanged. As a result, a huge disconnect developed between the best practice of surveillance and the decision that purportedly supported it.

In addition, the principles included in the 1977 decision to provide guidance to member countries on the conduct of their exchange rate policies failed to address the developments that have most challenged the stability of the international monetary system over the past 30 years. Reflecting the key concerns of the period when they were drawn up, the principles focused on preventing exchange rate manipulation for balance of payments purposes, such as gaining an unfair competitive advantage, and on avoiding short-term exchange rate volatility.

By contrast, the most prevalent exchange rate-related problems since 1977 have been the maintenance of undervalued or overvalued exchange rate pegs for domestic reasons and, more recently, capital account vulnerabilities, often arising from domestic balance sheet imbalances.

Changes for IMF

Like the 1977 decision, the 2007 decision is designed to implement bilateral surveillance under Article IV of the IMF's Articles of Agreement, under which members of the IMF commit to a code of conduct on exchange rate policies and domestic economic and financial policies. The IMF has a duty to monitor adherence to this code of conduct as a whole, but the 1977 decision covered only surveillance over exchange rate policies.

The new decision, by contrast, is much broader. It clarifies that the scope of bilateral surveillance covers all policies that can affect a country's external stability—defined as a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements, and encompasses both the current and capital accounts.

The decision also clarifies how to implement surveillance in currency unions, given their specific institutional arrangements, with both union-level and individual members' policies subject to the same scrutiny as the policies of all IMF members.

The new decision also outlines the rules of the game for surveillance:

- Surveillance is a collaborative process, based on dialogue and persuasion.
- The effectiveness of this dialogue requires candor: the IMF must be prepared to deliver clear and sometimes difficult policy messages to members and to candidly inform the international

community (as represented by the IMF's membership).

- Surveillance must be evenhanded while also paying due regard to relevant country circumstances. In particular, surveillance should take into account the effects of recommended policy changes on the member government's objectives besides external stability.

that result in external instability," which focuses on the outcome of the policies at issue rather than their intent. And it elaborates on what is meant by exchange rate manipulation.

The decision also updates the indicators that may trigger a thorough review by the IMF and allow the institution to initiate discussions with a member about its obser-

“The IMF must be prepared to deliver clear and sometimes difficult policy messages to members and to candidly inform the international community.”

- Bilateral surveillance should be embedded in a multilateral perspective—that is, it should take into account spillovers from the global environment to a country and from a country's policies to the stability of the international monetary system.

- Surveillance should take a medium-term view.

Changes for member countries

As for members, the new decision gives clearer guidance on how they should run their exchange rate policies. The decision retains the three existing principles, which relate to exchange rate manipulation and intervention in the foreign exchange markets.

But it adds a fourth principle: “A member should avoid exchange rate policies

vance of the principles. Most important, the indicators have been revised to reflect the greater importance of international capital flows.

They now include both policy developments (such as protracted large-scale intervention in one direction in the exchange market) and outcomes (such as fundamental exchange rate misalignment; large and prolonged current account deficits or surpluses; and large external sector vulnerabilities, including liquidity risks, arising from private capital flows). ■

What is Currency Manipulation?

The IMF's Articles of Agreement state that member countries shall “avoid manipulating exchange rates . . . to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.”

But they provide little guidance on what constitutes such exchange rate manipulation. The 2007 Decision on Bilateral Surveillance fills that gap by clarifying the type of behavior that is at issue.

The decision provides that a member would be “acting inconsistently with Article IV, Section 1 (iii),” if the IMF determined it was both engaging in policies that are targeted at—and actually affect—the level of exchange rate, which could mean either causing the exchange rate to move or preventing it from moving; and doing so “for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate” in order “to increase net exports.”

Ask the Fund

The IMF has created a new mailbox on its website dedicated to debt-related issues in low-income countries, including debt sustainability and concessionality. The intent is to provide a platform to respond to policy and country-specific questions.

Creditors had urged the IMF to set up a “one-stop contact” where they could get answers to questions on such debt-related issues. Now creditors can ask the IMF questions directly through the following web pages—for debt sustainability: www.imf.org/dsa; for concessionality: www.imf.org/concessionality

De Rato to Leave in October

Rodrigo de Rato informed the IMF's Executive Board in June that he will not serve the full length of his term as Managing Director. He said he intends to leave the Fund in October after the 2007 Annual Meetings of the Boards of Governors of the IMF and World Bank Group. De Rato took over as head of the IMF in June 2004.

Nominations for the next Managing Director closed on August 31. The Executive Board plans to select de Rato's successor in September.

Japan's Expansion in Sixth Year

Japanese growth is expected to peak at about 2½ percent this year, before falling back to about 2 percent in 2008, according to the IMF's annual assessment of the Japanese economy. Japan's expansion, now in its sixth year—the longest in Japan's postwar history—has gone hand in hand with increased integration with the global economy.

Good Prospects for Europe

Growth in the euro area, now running at about 2.5 percent, is outpacing that of the United States. Policymakers should seize this opportunity to give the euro area's growth potential another boost, the IMF says in its annual assessment.

Spread of housing problems is main risk to U.S. recovery

The spread of credit problems from housing to other important markets is the major risk to U.S. economic growth, which otherwise should rebound to its potential of 3 percent a year by the middle of 2008, the IMF says in its Article IV report on the United States.



\$62 Million for Côte d'Ivoire

The IMF's Executive Board approved in August \$62.2 million in Emergency Post-Conflict Assistance for Côte d'Ivoire. The assistance supports the authorities' program for 2007 and is intended to help Côte d'Ivoire lay the foundation for sustained recovery, regain political stability, and reunite the country.

IMFC Head Steps Aside

Gordon Brown, Chairman of the International Monetary and Financial Committee (IMFC), has tendered his resignation as head of the IMF's policy advisory committee after becoming U.K. prime minister, the IMF announced on July 11.



Turkey: Taking Growth to Next Level

Since a financial crisis rocked Turkey in 2001, the country has enjoyed a strong economic recovery.

Economic growth has averaged 7½ percent, and inflation has fallen from 70 percent to just below 10 percent. But a large current account deficit and slowing disinflation pose new challenges.

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From the mailbag

Good Times Hide Latin America's Frailties

Every Latin American indicator that looks good today will look lousy if the external environment deteriorates, Ernesto Talvi, Executive Director of the Center for the Study of Economic and Social Affairs, writes from Montevideo, Uruguay.

Symptoms of a "Failed Relationship"

Edwin M. Truman, a Senior Fellow at the Peterson Institute for International Economics in Washington, D.C., argues that both the IMF and the World Bank have a mutual interest in putting past rivalry behind them and implementing the Malan Report on Fund-Bank cooperation.

For full text, see "What Readers Say" at the online *IMF Survey*

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