

## IMF stands ready to help Iraq

The IMF stands ready to play its part in international efforts to rebuild Iraq. Managing Director Horst Köhler told a donors' conference in Madrid on October 24. He assured the conference that the IMF would work actively with the international community in the reconstruction and development of Iraq and for the stability and prosperity of the Middle East as a whole.

The IMF has been engaged in the reconstruction effort from the outset, he noted, and "as the next stage of the reconstruction process gets under way, there is much more that the IMF can and wants to do." The task poses an "immense challenge," Köhler acknowledged, but it also represents a historic opportunity. He saw



Iraq's rebuilding poses an immense challenge and a historic opportunity.

six major and interrelated areas for the IMF's contribution: *(Please turn to the following page)*

### Interview with Peter Heller

## Putting "the future" on the global agenda



Heller: "We're not going to have tax ratios rising to 70 or 80 percent of GDP, so the question is, how do we deal with problems that we can readily foresee, despite obvious uncertainties?"

**A**re we thinking about tomorrow? We should be, says Peter S. Heller, Deputy Director of the IMF's Fiscal Affairs Department, whose new book, *Who Will Pay? Coping with Aging Societies, Climate Change,*

and Other Long-Term Fiscal Challenges, makes an urgent plea for getting serious about the major changes under way. His study offers in-depth analyses of the challenges facing both developing and industrial countries and provides practical policy advice on what can be done now to reduce potential fiscal burdens. Heller spoke recently with Sean M. Culhane of the IMF's External Relations Department about the book and what he hopes it will accomplish.

### IMF SURVEY: Why did you write this book?

**HELLER:** I didn't start with the intention of writing a book. I used a sabbatical year to learn more about some of the big global structural trends that are likely to affect the fiscal situations of IMF member countries in coming decades: climate change, globalization, demographic trends, increased interconnectedness, national security threats, and rapid technological change. I also wanted to understand whether these trends are likely to be synchronous *(Please turn to page 318)*

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## IMF to help Iraq in six major areas

(Continued from front page)

- **Economic policy advice.** A stable macroeconomic framework will require comprehensive reforms, sound institutions, and effective policymaking. There is much that can be learned from the experience of transition and other postconflict countries, Köhler said, stressing the vital role that structural reforms (ensuring transparency; establishing legal, institutional, and regulatory frameworks; and designing appropriate safety nets) can play in laying the foundation for sustained private-sector-led growth.

- **Technical assistance.** In the period ahead, Iraq will need technical assistance in virtually every area of IMF expertise. Köhler promised expanded technical assistance for Iraq to develop modern, unified budget and tax systems; design and conduct monetary policy; and rebuild its statistical database. The IMF will also provide training for Iraqi officials.

- **External debt.** Iraq currently has one of the largest external debt burdens in the world. Without substantial debt relief, Köhler said, the country “has no prospect of restoring its creditworthiness and of regaining access to private capital to finance future growth.” The IMF is working with Paris Club creditors and has approached non-Paris Club creditors to

develop reliable estimates of Iraq’s debt. While the resolution of this issue will ultimately be a matter for Iraq and its creditors, he assured the conference that the IMF stands ready to help in any way it can.

- **Financial assistance.** The IMF also stands ready, Köhler said, “to provide financial assistance in a phased manner and in line with our policies and procedures.” The

IMF could initially make \$850 million available in emergency postconflict assistance, followed by amounts between \$850 million and \$1.7 billion annually under its regular lending arrangements. Over a three-year period, total lending could range from \$2.5 billion to \$4.25 billion. This financial assistance will depend, he said, on a number of factors, including Iraq’s balance of payments need, the strength of its economic programs, and the ability of the Iraqi authorities to implement such programs effectively.

- **Reintegrating Iraq into the region and the world.**

Ultimately, Köhler stressed that the economic futures of Iraq and the Middle East are intertwined. He urged Iraq’s regional partners to be closely involved in the reconstruction efforts and proposed that the IMF would help create both a regional policy framework—aimed at reintegrating Iraq into the regional and world economy—and a regional technical assistance center.

- **International Advisory and Monitoring Board.**

Köhler said that the IMF will shortly appoint a representative to this Board, which has been set up to ensure that the Development Fund for Iraq is used in a transparent way and that the country’s oil and gas resources are exported in a manner consistent with international market best practices.

### Extensive economic dislocation

Lorenzo Perez, the IMF’s Mission Chief for Iraq, provided the donors’ conference with an IMF staff assessment of the current state of Iraq’s economy, near-term prospects for recovery, and macroeconomic strategy. The report cited extensive economic dislocation that owed much to “pervasive state intervention, costly militarization, three wars, and over a decade of international sanctions” and a remarkable deterioration in Iraq’s human development indicators that had, two decades ago, exceeded regional averages.

Although economic activity continues to be hampered by hostilities, looting, and sabotage, progress has been made, Perez said. A budget has been adopted for the second half of 2003, a banknote exchange program (see interview with Åke Lönnberg, page 315) is under way, and a reform agenda is beginning to be formulated. Assuming adequate security, a restoration of basic utilities, and expanded oil production and private investment, the IMF’s Iraq team projected a strong economic recovery in 2004 keyed to potential oil revenue of \$12 billion. Perez also indicated that an ambitious macroeconomic strategy was being developed to establish an open, market-based economy whose strong growth could boost living standards. With the likelihood of substantial uncertainties on the fiscal side, he also underscored the need for considerable reforms in the tax regime and state-owned enterprise areas, among others, as well as generous external debt relief. ■



An Iraqi woman carries a baby alongside marked ground on the outskirts of Baghdad. Homeless Iraqi families are trying to claim the land in the hope of building houses for their families.

The full texts of Horst Köhler’s and Lorenzo Perez’s statements to the International Donors’ Conference for the Reconstruction of Iraq are available on the IMF’s website ([www.imf.org](http://www.imf.org)).

Interview with Åke Lönnberg

## IMF draws on postconflict experience to help Iraq with currency and banking reforms

**T**he IMF has been heavily involved in preparations for the currency reform now under way in Iraq. IMF staff has also been advising on macroeconomic policy issues. What lessons can the IMF draw from its involvement in other trouble spots around the world? Jeremy Clift of the IMF's External Relations Department spoke to Åke Lönnberg (Senior Economist, IMF Monetary and Financial Systems Department (MFD)), who has worked in Kosovo, Timor-Leste (East Timor), the Islamic State of Afghanistan, and, recently, Iraq, about his experience.

**IMF SURVEY:** What is the main focus of the IMF's work in postconflict countries?

**LÖNNBERG:** After a conflict or a breakdown of law and order, it is critical that institutional and administrative capacity be restored or enhanced at an early stage. A framework—underpinned by a simple but realistic policy stance—must be quickly put in place to reestablish macroeconomic stability and lay the ground for a quick resumption of growth. In addition, an early, realistic assessment must be made of external aid flows. Training people is also essential. Once the first bases have been covered—getting the currency roughly right, establishing a functioning payment system, and setting up the key legal foundations—there is a backlog of important things that will still need to be done.

For my department, the major assignment in postconflict economies consists in helping establish or transform central banking functions and the payment and banking systems. We've done this in Cambodia (1991–95), Albania (1991–94), Rwanda (1994–99), Bosnia and Herzegovina (since 1996), Kosovo and Timor-Leste (since 1999), and Afghanistan (since 2001), among other places. So Iraq is only the most recent case of the IMF supporting local capacity building by restoring or transforming central banking functions and the payment and banking systems.

**IMF SURVEY:** How do you do this?

**LÖNNBERG:** We have developed an operational framework for reforming postconflict economies, drawing on practical applications gained in dealing with critical events and milestones reached in our previous work.

Our department's methodology emphasizes the sequencing of actions within a graduated approach. Key early decisions are the choices of a legal tender

and an appropriate exchange rate regime. Setting up and operating a rudimentary payment system on an emergency basis will also be crucial if the established payment system has ceased to function. Preparation of key financial legislation—for example, for central banks, the banking sector, and the country's currency—is also a high priority. Such legislation should be in line with international best practices but always adapted to local legal traditions. Over time, core central banking functions should be restored and clearly distinguished from commercial banking activities. The financial system is strengthened through the (re-)licensing, regulation, and supervision of banks and the reestablishment of an efficient and sound payment system.

**IMF SURVEY:** How flexible are you?

**LÖNNBERG:** In many of the postconflict cases, the banking system was subject to a lot of abuse—directed lending or loans for political purposes—while the average citizen had little access to it. The restoration of a functioning banking system is important, but it is a difficult process, and new and unconventional solutions must sometimes be sought.

For example, in Afghanistan, the IMF early in 2002 encouraged the central bank to use hawala, the indigenous informal funds transfer system. This was perhaps unexpected advice, but hawala is an extremely efficient payment system and, traditionally, has been the most vibrant part of the domestic financial infrastructure. Without the hawala system, the complex banknote exchange reform that took place in Afghanistan in the last quarter of 2002 would have failed. Also, without the hawala system, the central bank's foreign exchange auctions, which have kept inflation under reasonable control, would not have taken place.



Lönnberg, an expert on currency reform, displays samples of Iraqi currency.

It should be noted that the hawala system is virtually unregulated. That is new for the IMF in the sense that we normally would recommend that the authorities use only institutions that are properly licensed, regulated, and supervised. But in this case, tight regulation



Lönnberg (right) shows samples of U.S. dollars and coins to central bank and postal staff in Timor-Leste after the dollar was declared legal tender.

of hawala would just kill the system or drive it underground, which has occurred in other countries and is not very constructive. Instead, attention is being devoted to fighting money laundering and the financing of terrorism.

Another novel field for the IMF has been the active use of

microfinance institutions. In recent years, MFD has supported setting up such institutions in Kosovo and Timor-Leste, and in Afghanistan a microfinance bank was licensed in September 2003. So, we are expanding into areas that five years ago were simply not on the IMF's horizon.

**IMF SURVEY: Getting the banking and payment systems up and running is the key to restarting the economy?**

**LÖNNBERG:** Yes. For example, during serious unrest in Timor-Leste in August–September 1999, all the commercial banks except one were destroyed, and the central bank branch in Dili (the capital) was saved only because of the presence of security forces. As a result, in the immediate postconflict situation, no normal banking and payment operations could take place. Together with the Timorese and the United Nations Transitional Administration in Timor-Leste, work had to start from scratch.

Following the declaration of the U.S. dollar as legal tender in January 2000, cash U.S. currency had to be purchased abroad and brought into Dili. In some cases, the transportation containers were used as storage because of the lack of functioning safes and vaults. The only surviving commercial bank building was taken over and converted into the state-owned Central Payments Office (CPO).

To pay salaries, government employees lined up outside the CPO and initially received their money in plastic sandwich bags handed out by MFD staff and resident experts. The first time that government salaries were disbursed, the CPO ran out of cash in the early afternoon while the lines were still long, and visiting IMF staff had to scrape together some more from travel advances to provide the CPO with a tem-

porary loan. Everything was rather primitive and done manually as the supply of electricity was erratic, but in the end it worked.

The CPO was the rudimentary start of what is today the Banking and Payments Authority of Timor-Leste, a well-functioning institution slated to become the country's first central bank.

**IMF SURVEY: How important is the currency and exchange rate in the period after a conflict?**

**LÖNNBERG:** Extremely important, and at least three early decisions must be made, which should be codified into new currency legislation. Regarding cash currency, it must be decided whether to use national banknotes from existing stocks, banknotes of another country, or multiple currencies for a transitional period. On exchange arrangements, a choice should be made between a freely convertible currency or one subject to various controls. Finally, on the exchange rate, a choice of system for exchange rate management must be made—free float, managed float, crawling peg, fixed exchange rate, or currency board.

In Kosovo, the choice was not very difficult because the deutsche mark was already widely used in parallel with the Yugoslav new dinar. Upon the IMF's recommendation, the United Nations Interim Administration Mission in Kosovo decided to denominate its budget in deutsche mark (and subsequently in euros) and to use that currency for disbursements from the budget. But it was still possible to use Yugoslav new dinars to pay taxes and other public services.

In Timor-Leste, the future currency was an immediate political issue—the Timorese leadership did not want to continue using the Indonesian rupiah. After intensive discussions, it decided to adopt the U.S. dollar as legal tender because the main Timorese export (coffee) was priced in dollars, and future oil revenue will also be invoiced in dollars.

In Afghanistan, the preferred choice was to continue using the national currency in combination with a banknote exchange during the fourth quarter of 2002. In the new series of Afghanis—the legal tender—the security features were much improved, three zeros were dropped, and Afghanistan got its first unified currency since 1996.

**IMF SURVEY: What about Iraq?**

**LÖNNBERG:** Since the early 1980s, Iraq's economy has suffered from the effects of three wars, political repression, intrusive state ownership and control, and international sanctions. These developments made it difficult to assess the economic situation in Iraq.

An IMF staff mission visited Baghdad in June 2003 to make an initial assessment and explore early priorities for advice and technical assistance. Since then, and despite the bomb attack on the UN headquarters in Baghdad on August 19, in which several IMF staff were injured, the IMF has provided technical assistance on the introduction of new banknotes; central bank legislation and bank licensing; budget execution and public expenditure management; options for tax policy (including a fiscal regime for the oil sector); and the compilation and dissemination of economic statistics. As for macroeconomic policy, the IMF is assisting the authorities to develop a macroeconomic framework—including a fiscal budget for 2004 and a monetary and exchange rate policy regime—to ensure that macroeconomic stability is quickly restored and growth resumes.

**IMF SURVEY:** Is Iraq in for a post-Soviet-style period of economic shock?

**LÖNNBERG:** There are some similarities but also important differences. The price controls in the Iraqi command economy resemble those of the Soviet system, and the freeing of the price system will no doubt have major effects on the whole economy. This will allow markets to function better and promote an efficient allocation of resources. But the issue of freeing prices cannot be separated from the level of wages and the need for a social safety net for weaker groups. The combination of a targeted safety net and wage increases should protect people from the sharp increase in prices for basic necessities.

A special problem in Iraq is that the economy is already in a state of shock, not so much because of the recent war or the subsequent widespread looting but because of decades of neglect. War and related military activities had priority at the expense of

investment in infrastructure, education, health care, and society as a whole. This seems to have gone further in Iraq than in the former Soviet Union. So a tremendous future agenda is before Iraq and the international community.

**IMF SURVEY:** What is Iraq's potential, considering that it has oil and a relatively well-educated population?

**LÖNNBERG:** In many ways, the country is potentially very rich. But there are also factors suggesting that it will take longer and be much more costly to fulfill that potential than many may have been expecting. Until around 20 years ago, Iraq could rightly be proud of having one of the better-educated populations in the region. But with the costly wars and the increasing militarization, resources were siphoned away from education, health care, and other productive uses. In addition, the departure of highly skilled Iraqis has had a great impact. This has affected the oil and natural gas sectors, which are in dire need of massive investments. Also, in the prevailing security situation, the road to recovery is likely to be complicated and very demanding for both policymakers and the population.

**IMF SURVEY:** What are the main lessons from other postconflict countries that you have been in, in terms of training and advice?

**LÖNNBERG:** A key lesson is that local ownership of reforms is absolutely essential for success. Without local counterparts, capacity building will be much slower. IMF advice must be presented in such a way that local staff can use it and develop further without continuous, detailed external assistance. The long-run objective must be to build the foundation for countries to make their own decisions.

Another lesson is that technical assistance in postconflict situations must be closely coordinated among key donors. Working with the authorities and major technical assistance providers, we can bring change for the better in many places. In Iraq, that work has just started and may well be the biggest challenge to date. ■

Åke Lönnberg's paper "Building a Financial System in Afghanistan" was presented at a symposium in Bonn in June 2003 called "State Reconstruction and International Engagement in Afghanistan," jointly arranged by the Crisis States Program of the Development Research Center of the London School of Economics and Zentrum für Entwicklungsforschung, Universität Bonn. The paper is available online at [www.afghanistan-rg.de.vu/arp](http://www.afghanistan-rg.de.vu/arp).

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### Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
October 20	1.55	1.55	2.05
October 27	1.58	1.58	2.09

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website ([www.imf.org/cgi-shl/bur.pl?2003](http://www.imf.org/cgi-shl/bur.pl?2003)).

General information on IMF finances, including rates, may be accessed at [www.imf.org/external/fin.htm](http://www.imf.org/external/fin.htm).

Data: IMF Finance Department

## Policymakers should start worrying now



(Continued from front page) and whether they will principally affect industrial countries or have broader implications. And finally, I wanted to learn whether and how governments take account of long-term issues in thinking about budget policies. The project essentially evolved into a book.

**IMF SURVEY:** You seem anxious to raise public awareness and rouse policymakers from complacency. What should we be most worried about?

**HELLER:** Clearly, we should be worrying about the big demographic trends that will affect all countries. Climate change will inevitably have economic and, possibly, political consequences. Globalization will constrain the fiscal situation in many countries. Rapid technological change, which I believe will contribute, in net terms, to the rising costs of medical care, is likely to have significant fiscal implications. Regional tensions, particularly over religion and scarce resources (such as water), and terrorism are all troubling. And the possibility of persistent, even growing, income disparities between the poorest countries of the world and middle- and upper-income countries is also a concern.

Policymakers should start worrying now! Why? First, we're already at the point where capital markets are starting to take account of some long-term factors. In the past year and a half, most major investment banks have appraised the economic implications of demographic change in industrial countries. Second, these issues are best handled while there is still sufficient time to make adjustments in the fiscal framework and in the behavior of households. Acting now will allow us to foster policies that reduce potential tensions, create incentives to increase appropriate investment, finance research and development to encourage adaptation to relatively certain developments and to narrow uncertainties, and take preventive measures to minimize potential fiscal costs. It will also allow households to begin to adapt their behavior to the financial benefits they can genuinely expect from the government in the future. Third, some of these issues, such as health care, are going to be very difficult to address. There will be troublesome ethical and political dimensions that will take some time to resolve.

Fourth, many fiscal uncertainties remain. Governments typically accept the need to respond to unanticipated shocks even when there is no legal obligation to do so. They need sufficient fiscal leeway, yet we have created enormous fiscal rigidities that will be much harder to tackle if we wait much longer. These

issues will have to be dealt with. We're not going to have tax ratios rising to 70 or 80 percent of GDP, so the question is, how do we deal with problems that we can readily foresee, despite obvious uncertainties? Will they be dealt with smoothly or abruptly, in a way that precipitously changes the positions of households and individuals?

Finally, these are not costs that bear only on remote generations. Those alive today will bear much of the burden: you and I could conceivably live another 40–50 years. While 2050 might seem a long way off, what will happen then is not irrelevant to our welfare and is certainly not irrelevant to that of our children and grandchildren.

**IMF SURVEY:** How likely is it, though, that politicians and policymakers will take up what are, effectively, medium- and longer-term concerns? Can the media, academia, policy analysts, and the public help raise awareness?

**HELLER:** That's a really hard question to answer because these groups tend to be myopic. But there are things multilateral institutions can do to elevate these issues on the agenda. We can foster research and analyses that take account of long-term scenarios, and, though it's more difficult, we can examine the way in which aspects of the economy, like savings and investment, might be influenced by how major blocs of countries are aging earlier or later than others.

The IMF has already started, in its annual surveillance discussions with member countries, to do some analyses of fiscal sustainability that look at long-term fiscal dynamics. These have related mostly to demographic issues rather than a broader composite of possible developments. I also believe that other multilateral institutions—the World Bank, the World Health Organization, the United Nations, the UN Environmental Agency—have a responsibility to take a long-term view in their assessments of global trends and to push hard for greater public awareness of their implications.

We in the IMF could also do more. For example, in our public assessments of fiscal transparency practices, we could underscore more strongly that countries, as a matter of course, must explore and assess alternative long-term fiscal scenarios and carry out long-term risk assessments of their balance sheets. In our research, we could pursue some of the more sophisticated techniques of economics that try to gauge the effects over time of demographic trends and large external shocks, such as climate change.

It would seem there is obvious room for cooperation through migration (both real and virtual!) from developing to industrial countries.

—Peter Heller

**IMF SURVEY:** If quick or one-shot fixes are unlikely, are there smaller, more feasible steps that could help build momentum for broader reforms?

**HELLER:** Addressing long-term issues requires a multi-pronged strategy. The first thing is to build a long-term focus into the way in which budgets and fiscal frameworks are constructed. That means carrying out analyses of long-term trends and doing scenario analyses; it would also be desirable to apply more sophisticated techniques to assess the probability of more adverse outcomes. These long-term projections and assessments should become annexes of the overall budget documentation.

It means getting away from thinking only about stable, linear scenarios and focusing also on the possibility of adverse shocks and their fiscal consequences. What would be the consequences of several adverse scenarios occurring in a roughly similar time frame? How would we address such situations, and what would be the impact on the fiscal framework?

The challenging question you raised earlier was “how do you make governments think about these things?” Another policy approach involves, essentially, institutionalizing an independent perspective on the long-term fiscal situation. I have already argued that budget laws should require governments to prepare long-term scenarios. I believe that it is vital to have some kind of independent national mechanism (perhaps analogous to the U.S. Congressional Budget Office) to evaluate the long-term assessments that a government makes. Such a body should raise questions and force debate on whether governments have adequately addressed significant future risks and challenges.

I also believe that fiscal rules, such as the euro area’s Stability and Growth Pact (despite its shortcomings), have a very beneficial role to play because they can implant some fiscal discipline in a government, reducing public debt ratios substantially over the long term. Finally, there is no substitute for detailed assessments of how expenditures will evolve over time, taking account of long-term structural factors. When a particular program is likely to become a source of fiscal pressure over the long term, policy reforms to affect the likely time path of expenditure are warranted. We have already begun to see such pension reform initiatives in a number of Western European countries.

**IMF SURVEY:** With regard to demographic and other changes, isn’t it fair to say that developing and industrial countries will be confronting different problems with different causes and solutions?

**HELLER:** We all know about the aging populations in industrial countries, but less attention has been paid

to demographic trends for emerging market economies and developing countries. Most emerging market economies are likely to confront the same demographic trends as industrial countries, only lagged by about 15 to 20 years. We will see the graying of the populations of China, Thailand, Singapore, Taiwan Province of China, and Korea within a couple of decades. Even developing countries are going to see a fairly significant increase in the share of their elderly. You won’t see 30 percent of the population over 65, but you might see the share of this age group grow from 3 percent to 10 percent—still a low number, but with significant economic effects. Another major demographic change is that while populations are going to be stabilizing, if not shrinking, in much of the industrial world and China, populations will continue to grow in Africa, the Middle East, and parts of south Asia. This will be reflected in a significant youth bulge. Creating jobs will be an enormous challenge, and the risks of failure are high.

**IMF SURVEY:** Is there scope for greater cooperation and potentially complementary solutions? Or will two different sets of priorities simply exacerbate tensions between the two groups of countries?

**HELLER:** Industrial countries risk dampening the pace of global economic growth if they fail to tackle the fiscal issues associated with aging populations. This would adversely affect developing countries. One obvious point of cooperation would be for industrial and developing countries to narrow their prospective outstanding primary fiscal gaps. Also, industrial countries have shrinking and aging labor forces, while many developing countries have very young populations. It would seem there is obvious room for cooperation through migration (both real and virtual!) from developing to industrial countries. This is inevitable. Borders are porous, especially in Europe and the United States, so the question is how to facilitate migration in a way that addresses the needs of both developing and industrial countries. The more that these countries can work together on how migration takes place, the better off we’ll all be. We are already starting to see calls for a more coherent policy framework for managing migration.

Another potential area of cooperation would involve strengthening the capital markets of emerging market economies and developing countries. The IMF has focused on this issue in the past several years. If we can promote and facilitate flows of capital to these economies where there is the potential for higher rates of return on investment, we’ll all be better off. It’s a win-win solution. But it requires far greater strengthening of governance in the capital

**Industrial countries risk dampening the pace of global economic growth if they fail to tackle the fiscal issues associated with aging populations.**

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markets of these countries to mitigate and reduce the risks investors now face.

Addressing global disparities in income is a third area of cooperation. Industrial countries and their populations can lose only if massive income disparities persist in 15 to 20 years. Large parts of the world where people are desperately poor will be a source of global instability. It's very shortsighted of us not to recognize that the greatest risks we confront are these sources of political instability, which foster terrorism and disruptions to economic activity. A scaling up of official development assistance is long overdue.

Beyond promoting development in the poorer countries through mutually beneficial investment, there's an equal imperative for industrial countries to promote solutions to long-festered political crises. This means the Israeli-Palestinian conflict, the India-Pakistan dispute over Kashmir, and the North Korean situation. One can also foresee potential tensions associated with the scarcity of water in the Middle East, south Asia, and elsewhere, as well as competition for oil resources in the South China Sea and the Caspian region. The world community must address these issues. The events of September 11 and the SARS epidemic showed that problems arising in one region can quickly have global economic ramifications.

Finally, climate change is something that we're all very aware of. The Intergovernmental Panel on Climate Change has provided reasonably conclusive evidence that it will happen—affecting precipitation patterns, the sea level, and the frequency and impact of extreme weather events. There is a small probability that such changes will occur abruptly rather than gradually over the century. Industrial countries could sponsor research and development to narrow existing areas of uncertainty on the dimensions of climate change and to develop new technologies that will facilitate adaptation and prevent excessive costs from being borne by affected countries.

**IMF SURVEY:** Should developing countries worry about fiscal burdens that will not arise until the distant future? And, if so, which issues are particularly important?

**HELLER:** Developing countries should think now about the long-term challenges they will confront. How much? For the poorest countries, I accept that the highest priority should be to increase per capita incomes as fast as possible. But that still doesn't let them off the hook of thinking about potential long-term challenges, which will obviously differ depending on the demographic and geologic environment. For some countries, for example, there may be a large payoff to adapting to foreseeable long-term climate trends. They should be investing in research and development in new varieties of crops that are resis-

tant to reduced precipitation or creating incentives for populations to shift from agricultural regions that are going to be adversely affected by climate change.

Clearly, too, developing countries should explore preventive steps. Large coastal cities are likely to be vulnerable to extreme weather events and a rise in the sea level. This suggests the need for policies to discourage further coastal infrastructure development and to encourage infrastructure and population settlements in less exposed areas.

Thinking long term is also likely to require a stronger emphasis on human capital development because it can increase a country's options for economic development. It also argues for taking account of the experience of industrial countries and learning from their mistakes, such as in the area of social insurance systems. This means being aware of how demographic change can alter the financial viability of a policy program and the dangers of excessive precommitments of budget resources.

**IMF SURVEY:** Are you optimistic or pessimistic about the future?

**HELLER:** That's a very difficult question to answer. There's much to be optimistic about. We certainly have, today, a far greater capacity to look ahead and identify the big trends on the horizon. Our scientific capacity and data available are extraordinary. We also know that many of the challenges we face can be addressed if the political will is present. Put all those things together, and there are grounds for optimism.

But there are also obvious grounds for pessimism—take, for example, the events of the last couple of years. There's political disorder in many regions, growing disparities of income, and the prospect of large parts of the world remaining in a kind of "fourth" world state—not privy to the medical care or technologies available even in middle-income countries. There are many uncertainties of climate change that are scary, and we have to worry about them. The myopia of politicians and the public with respect to long-run challenges is also worrying, as is the prospect of a shortsighted, graying electorate. All these issues can make one very pessimistic.

But, on balance, I would rather dwell not on optimism or pessimism but on the stance we take in approaching the future. In working for the international community, I have cast my lot with trying to promote an intelligent response to future challenges. ■

Copies of *Who Will Pay? Coping with Aging Societies, Climate Change, and Other Long-Term Fiscal Challenges* are available for \$28.00 from IMF Publication Services (please see page 325 for ordering details).



## IMF lends support to Bangladesh's reforms aimed at boosting growth, improving investment climate

**O**n October 14, IMF Deputy Managing Director Shigemitsu Sugisaki addressed a dinner gathering of senior policymakers and opinion leaders hosted by Bangladesh's Finance and Planning Minister Saifur Rahman. This followed a day of meetings with Prime Minister Khaleda Zia, opposition leader Shaikh Hasina, and senior government officials. In his remarks, Sugisaki focused on the outlook for Bangladesh, which recently entered into a Poverty Reduction and Growth Facility (PRGF) Arrangement with the IMF. Following are edited excerpts from his remarks. The full text is available on the IMF's website ([www.imf.org](http://www.imf.org)).

In my capacity as Deputy Managing Director, I have been seeking since 1997 to establish a closer working relationship between the IMF and Bangladesh. It is only now, under the current government, that we have been able to successfully conclude a PRGF Arrangement. This reflects our support for the direction of economic reforms that the Bangladeshi government is pursuing. Credit for this effort must go to the current economic team, which has worked so hard to make this possible.

The benefits of these policies are already becoming apparent. The economy is showing renewed vigor. Industrial activity and exports are rebounding. Inflation is being held in check, even after needed adjustments in key prices. A smooth transition to a floating exchange rate has been achieved, and international reserves today are two and one-half times the level when the government took office. For this fiscal year, a projected real GDP growth of 5.5 percent is well within reach, given continued supportive fiscal and monetary policies and further progress with structural reforms.

### Raising the growth rate

The key challenge now for Bangladesh is to move to a higher growth path to help create jobs and, over time, lift the country out of poverty. The government is moving forward with a homegrown strategy to raise growth to 7 percent and to halve poverty by 2015. The IMF shares this vision and is supporting it with

funding and technical support. At the center of this strategy are reforms to boost private sector growth, improve the investment climate, and diversify exports. This is a pro-growth and pro-poor strategy that grapples squarely with the structural flaws of the economy. And this is a strategy that, we understand from our discussions, enjoys broad support across society.

### Decisive actions needed

What must be done to boost investment and diversify exports? Despite low-cost labor, Bangladesh is a high-cost place to do business. Impediments to investment include an unreliable power supply, high real interest rates, corruption, and weaknesses in law and order. These factors have resulted especially in lower foreign direct investment than in other fast-growing countries in east Asia. The government's strategy is tackling these problems through a package of reforms. I want to stress four decisive and steadfast actions that will be crucial to success:

- **Increasing spending on education, health care, and infrastructure.** The IMF supports the government's strategy of accommodating a larger budget deficit for the next few years to permit increased government spending on human capital development and physical infrastructure. Such spending should help strengthen skills and boost productivity. But at the same time, sustained improvements in revenue will be essential. Tax administration, in particular, requires modernization to improve the collection and the fairness of existing taxes.

- **Reforming the nationalized commercial banks to lower interest rates and stem new nonperforming loans.** If this reform succeeds, the nationalized commercial banks should become more efficient and should be able to cut their lending rates. Moreover, all banks should see their funding costs and lending rates fall if the government can rein in its own domestic borrowing needs to a prudent level and if adequate external assistance is assured.

- **Reforming the state-owned enterprises,** especially in the energy sector. Inefficient state-owned enterprises have been a serious drain on the budget.



Sugisaki: "This is a pro-growth and pro-poor strategy that grapples squarely with the structural flaws of the economy."

**Photo credits:** Denio Zara, Padraic Hughes, Michael Spilotro, and Eugene Salazar for the IMF, pages 313, 315, 320–23, and 328; Chriss Ison for Reuters, pages 313–14; Peter Josek for Reuters, page 314; Rafiqur Rahman for Reuters, pages 321–22; and Roger Nord for the IMF, page 327.

Realistic pricing that reflects the cost of production is a first step. But for these enterprises to become viable, their operations will need to be restructured to reduce waste and improve bill collection. For the power sector, in particular, the investment required to upgrade infrastructure is enormous, and it is right that the World Bank gear up its lending program to support the government's own efforts. The Asian Development Bank is also playing an important role in this sector.

- **Strengthening governance.** Building institutions to improve governance and strengthening efforts to enhance law and order are essential to reducing the costs of doing business and thereby creating a more enabling environment for private sector investment. Curbing corrupt practices that allow, for example, tax evasion or loan default will also give the Bangladeshi

people a fairer deal, as well as help enhance Bangladesh's image in a competitive world. The IMF therefore very much welcomes the ongoing efforts to set up an independent anticorruption commission, and we look forward to its early functioning in an effective manner.

We recognize that this is a challenging reform agenda that will require vigorous debate to build national consensus and political courage to carry out. Broad support, both financial and technical, from the international community will also be vital for success. The IMF is fully engaged in Bangladesh. We are supporting this effort through the recently approved loan under the PRGF and through our program of technical assistance to build capacity. I can assure you that the IMF is committed to supporting your country. ■

## PEFA urges stronger collaboration on budget assessment and reform

**D**evelopment institutions and donor agencies require a growing number of studies and reports before they release aid money. But many reports cover the same ground. The Public Expenditure and Financial Accountability (PEFA) Program Secretariat in Washington has proposed a new approach to enable diagnostic assessments to be shared among donors. Jeremy Clift of the IMF's External Relations Department spoke to PEFA's Richard Allen about the proposal.

**IMF SURVEY:** What led to the creation of PEFA, and what are its aims?

**ALLEN:** The World Bank, the IMF, the European Commission (EC), and other donor institutions do a huge amount of work with developing countries on public expenditure-related issues—diagnostic work, assessment of institutional capabilities, and suggested reforms—but it is not very well coordinated. This has led the Executive Boards of the IMF and the Bank to stress the importance of closer collaboration. There was also a persistent problem of overlapping and duplicating diagnostic missions by the Bank, the IMF, the EC, and other agencies that created extra work and increased costs for the governments concerned. PEFA was

established to create a more integrated, coordinated approach to assessing public expenditure needs and to encourage donors to work together more closely. This

is part of a wider agenda of international donor harmonization that finds its voice in many forms—for example, the Rome Declaration of February 2003; the work of the multilateral development banks to harmonize procedures on financial management, procurement, and other areas; and collaboration between the World Bank and the Development Assistance Committee of major donors.

**IMF SURVEY:** What progress have you made?

**ALLEN:** We recently completed a large report that the Bank has just published on the diagnostic instruments being used by the major donor institutions. There are a lot of them. The World Bank has its Country Financial Accountability Assessments (CFAAs), Country Procurement Assessments (CPARs), and Public Expenditure Reviews (PERs); the IMF has its fiscal Reports on the Observance of Standards and Codes (fiscal ROSCs); the Bank and the IMF are working together on the Public Expenditure Management Tracking Assessments and Action Plans for Heavily Indebted Poor Countries (HIPCs); the EC does its own assessment and audit work; and so on. The aim of PEFA was to document the coverage and scope of these instruments, identify overlaps and gaps, and assess how well these instruments are being applied in the field in operational terms.

We are also doing a lot of work on performance measurement of public expenditure management systems and developing a framework under which countries and donors can measure performance and moni-



Richard Allen, a senior staff member of the World Bank, heads the PEFA Secretariat.

tor and track changes in the way these systems work. And we are funding activities in several countries to test new approaches to assessment and reform work.

**IMF SURVEY:** Are these different assessments a problem, and is a more streamlined approach practical?

**ALLEN:** The large number of diagnostic instruments is part of the problem, and there's a need to rationalize and streamline the ways they work together. In the World Bank, for example, you have three instruments in the public expenditure field—the PER for public expenditure; the CFAA, which looks at accounting and audit; and the CPAR procurement review. All of them overlap to some degree although the last of these is a somewhat specialized instrument for one particular area. There is considerable scope for streamlining these instruments to minimize the overlap and maximize the focus. However, this is not as simple as it sounds—changes in the World Bank's organizational structure, operational practices, and internal incentives may be required. There is also ongoing scope for strengthening the collaboration between the Bank and the IMF on public expenditure issues—a topic the two Executive Boards considered earlier this year.

**IMF SURVEY:** Are you suggesting a sort of building-block approach of cumulative information so that different institutions could share the information they get?

**ALLEN:** That is one idea being discussed. It needs a lot more work, and there may not be ultimate agreement. But one idea is to create some kind of standardized assessment, which would be a bit like the public expenditure management assessments carried out under the enhanced HIPC Initiative. It would be a relatively short report, with some high-level performance indicators, that identifies key areas of fiduciary risk and provides a framework for measuring progress. It would be a basic assessment on which a program of further work—both diagnostic analysis and support for capacity building—could be built.

**IMF SURVEY:** Who would coordinate work on the standardized assessment?

**ALLEN:** The standardized assessment would be essentially a summary of existing diagnostic information collected through the PER, the CFAA, the fiscal ROSCs, and other instruments. It could be prepared by a group of donors pooling information. The information would be updated periodically, perhaps annually. The assessment would have to include a quality review process, involving the various donors, to

ensure that the information is credible, accurate, timely, and coherent. Maybe PEFA could be involved in the process in some capacity. These practical questions need to be resolved. We are proposing to do some desk reviews of the information available for one or two countries to see what the standardized assessment would look like in practice. But the essential point is, it would be a commonly available document that summarizes fiscal and fiduciary risks, with supporting performance information. Such information is not presently available in a single document.

**IMF SURVEY:** Who would use this assessment?


**ALLEN:** Recipient governments could use it to review or prepare their strategies for public expenditure reform, identify gaps, and request donor assistance. The Executive Boards of the Bank and the IMF and the equivalent management boards in other donor agencies could use it to judge countries' fiduciary soundness, as background for making decisions on budget support. Country teams could use it to identify gaps in existing information, plan work schedules, and develop country assistance strategies (or the equivalent). Technical assistance providers and funders could use it to assess progress in improving public expenditure management. And investors, civil society groups, and other stakeholders would find it a convenient source of information on public expenditure issues.

**IMF SURVEY:** How likely is it that you can get an alliance of very different donors together to use the same instrument?

**ALLEN:** Well, the PEFA steering committee endorsed this broad approach in June, so there is a commitment to it. The World Bank and the IMF are recognized as leaders in this field, and the other donor institutions are looking to the Bank and the IMF to develop the basic framework. But more work needs to be done.

**IMF SURVEY:** Why is there so much concern about the quality of budget processes in developing countries?

**ALLEN:** Increasingly, multilateral and bilateral development agencies are concerned about the risk that aid resources can be stolen, diverted to activities other than those budgeted, or wasted. More aid is now being channeled directly into adjustment lending or budget support operations. In the 2003 fiscal year, about 50 percent of the World Bank's lending was in the form of adjustment lending, paid directly into the budget, rather than project lending. This means it is very important for the donor institutions,



Increasingly, multilateral and bilateral development agencies are concerned about the risk that aid resources can be stolen, diverted to activities other than those budgeted, or wasted.

—Richard Allen

The development of integrated financial management information systems is a good example of a fashionable concept in which donors invested heavily but with mixed success.

—Richard Allen

and indeed for the recipient countries themselves, to have confidence that the budget systems are robust and delivering reasonable-quality public services. A good budget system means a good system for preparing, executing, monitoring, controlling, reporting on, and overseeing the budget. This explains why donors place so much emphasis on helping countries assess the quality of their public expenditure management systems and reforming those systems and building up capacity.

Another PEFA interest is why a budget system does or does not work well. A country may have very good regulations on financial management, but the system just doesn't work properly, and that is usually because of deep-rooted institutional problems such as corruption, inefficient management practices, and weak incentives. For example, some African countries have had a lot of donor attention for many years and lots of aid money, but efforts to strengthen their budget systems don't seem to have been very successful: indeed, in some countries systems may even have deteriorated in the last 20 or 30 years.

**IMF SURVEY:** You mentioned not just overlaps but gaps. What gaps have you found in the diagnostic assessments?

**ALLEN:** Some important areas that could be strengthened are the revenue side of the budget, including tax administration, debt management, the management of government records, and the management of physical assets by governments. These areas are not as systematically covered by existing instruments. Municipalities, local government, and off-budget government agencies can also be important sources of fiscal risk. So we suggest that where the donors and governments are exposed to such risk, these areas should be brought into the framework.

**IMF SURVEY:** Why is it so difficult to improve budget processes in some countries?

**ALLEN:** There are a number of reasons. For example, when the government has little or no commitment to reform and where there is a high level of corruption, you are unlikely to witness substantial improvements in that system. Even though the country may (with the assistance of aid money) invest in an ultra-modern, technologically sophisticated budget system, it simply won't work.

**IMF SURVEY:** So what you're really saying is that lots of money has been wasted.

**ALLEN:** Donor agencies have sometimes tended to emphasize reforms that were perhaps too complex

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- 03/171: IMF Completes Fourth Review Under Stand-By Arrangement for Romania, Approves \$158 Million Disbursement and Grants Waivers, October 15
- 03/172: IMF Completes First Review Under Stand-By Arrangement for the Former Yugoslav Republic of Macedonia and Approves \$5.7 Million Disbursement, October 17
- 03/173: Second Regional Conference on Poverty Reduction Strategies Communiqué, October 16–18, 2003, Phnom Penh, Cambodia, October 20
- 03/174: IMF Completes in Principle First Review of Malawi's PRGF Arrangement, Approves in Principle \$9.2 Million Disbursement, and Approves \$6.6 Million in Interim Assistance under the HIPC Initiative, October 20
- 03/175: IMF Completes Third Review of Nicaragua's PRGF-Supported Program, Grants Waivers, and Approves Additional Interim HIPC Assistance, October 20
- 03/176: Establishment of the International Advisory and Monitoring Board, October 24

### Public Information Notices

- 03/121: IMF Executive Board Discusses the Status of Implementation of the Enhanced HIPC Initiative and Update on Financing of PRGF and HIPC Operations and

Subsidization of Postconflict Emergency Assistance, September 24

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03/123: IMF Concludes 2003 Article IV Consultation with the Dominican Republic, October 14

03/124: IMF Concludes 2003 Article IV Consultation with Finland, October 17

03/125: IMF Concludes 2003 Article IV Consultation with Oman, October 22

03/126: IMF Concludes 2003 Article IV Consultation with the Socialist People's Libyan Arab Jamahiriya, October 23

03/127: IMF Concludes 2003 Article IV Consultation with the Republic of Estonia, October 27

### Transcripts

Press Briefing by Thomas C. Dawson, Director, External Relations Department, IMF, October 23

### Statements at Donor Meetings

Statement on the IMF Staff Macroeconomic Assessment of Iraq, Delivered by Lorenzo Perez, IMF Mission Chief for Iraq, to the International Donors' Conference for the Reconstruction of Iraq, Madrid, October 23

The IMF Stands Ready to Help Iraq—Statement by Horst Köhler, Managing Director of the International Monetary Fund, to the International Donors' Conference for the Reconstruction of Iraq, Madrid, October 24 (see page 313)

or sophisticated for the capacity of some countries to absorb. The development of integrated financial management information systems is a good example of a fashionable concept in which donors invested heavily but with mixed success. In some countries that are ready for them, they've been useful. In other countries, expensive technology has degraded after a few years, and there's been little progress. The question is why.

It is possible that donors have been, to some degree, guilty of promoting blockbuster reforms. Such reforms may provide large rewards to consulting companies for work on design, implementation, and maintenance, but they have generally had a limited impact. One reason for this is that the reforms tend to give too little attention to the institutional environment and incentives or are too technocratic.

Another area where the donors may have been culpable to some extent is in promoting medium-term expenditure frameworks—another fashionable idea. In principle, these frameworks are the right way to go, but they require a participatory approach to budget making and other preconditions that require a level of development and capacity that are beyond many countries' immediate scope. In short, a lot more thinking has to be done on sequencing reforms and carrying them out and on establishing

a more basic platform on which development can take place.

This is getting rather beyond the scope of the PEFA program, but I think it's an important point—it relates to the question of how to create a sustainable program of reform. How can the donors assist countries to build capacity and move forward with the reform agenda in a slow but sustainable way? And that is fundamentally important. The donors have not always been very good at advising on the sequencing and prioritization of reforms or on the change management process needed to deliver satisfactory outcomes. The Bank is investing heavily in learning activities to identify reasons for past successes and failures in these areas, but more work needs to be done. And the development agencies need to invest in new skills—governance, communications, change management, and so on—to equip themselves to provide such support. ■

*Assessing and Reforming Public Financial Management: A New Approach*, by Richard Allen, Salvatore Schiavo-Campo, and Thomas Columkill Garrity, will be available in November from the World Bank, Washington, D.C.

Donor agencies have sometimes tended to emphasize reforms that were perhaps too complex or sophisticated for the capacity of some countries to absorb.

—Richard Allen

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**Stand-By, EFF, and PRGF Arrangements as of September 30**

Member	Date of Arrangement	Expiration date	Amount approved	Undrawn balance
(million SDRs)				
<b>Stand-By</b>				
Argentina	September 20, 2003	September 19, 2006	8,981.00	7,151.00
Bolivia	April 2, 2003	April 1, 2004	85.75	32.15
Bosnia and Herzegovina	August 2, 2002	November 1, 2003	67.60	12.00
Brazil <sup>1</sup>	September 6, 2002	December 31, 2003	15,211.43	5,621.48
Bulgaria	February 27, 2002	February 26, 2004	240.00	52.00
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Croatia, Rep. of	February 3, 2003	April 2, 2004	105.88	105.88
Dominica	August 28, 2002	February 27, 2004	3.28	0.62
Dominican Rep.	August 29, 2003	August 28, 2005	437.80	350.24
Ecuador	March 21, 2003	April 20, 2004	151.00	90.60
Guatemala	June 18, 2003	March 15, 2004	84.00	84.00
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
Macedonia, FYR	April 30, 2003	June 15, 2004	20.00	16.00
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Romania	October 31, 2001	October 15, 2003	300.00	110.22
Turkey	February 4, 2002	December 31, 2004	12,821.20	2,041.20
Uruguay <sup>1</sup>	April 1, 2002	March 31, 2005	1,999.60	652.40
<b>Total</b>			<b>50,135.21</b>	<b>18,197.41</b>
<b>EFF</b>				
Indonesia	February 4, 2000	December 31, 2003	3,638.00	688.12
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	350.00
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
<b>Total</b>			<b>4,432.40</b>	<b>1,161.85</b>
<b>PRGF</b>				
Albania	June 21, 2002	June 20, 2005	28.00	16.00
Armenia	May 23, 2001	May 22, 2004	69.00	29.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	51.48
Bangladesh	June 20, 2003	June 20, 2006	347.00	297.50
Benin	July 17, 2000	March 31, 2004	27.00	1.35
Burkina Faso	June 11, 2003	June 10, 2006	24.08	20.64
Cameroon	December 21, 2000	December 20, 2003	111.42	47.74
Cape Verde	April 10, 2002	April 9, 2005	8.64	4.95
Chad	January 7, 2000	January 6, 2004	47.60	5.20
Congo, Dem. Rep. of	June 12, 2002	June 11, 2005	580.00	106.63
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Ethiopia	March 22, 2001	July 31, 2004	100.28	20.86
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	January 12, 2001	January 11, 2004	108.00	58.50
Ghana	May 9, 2003	May 8, 2006	184.50	158.15
Guinea	May 2, 2001	May 1, 2004	64.26	38.56
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Guyana	September 20, 2002	March 19, 2006	54.55	43.03
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	28.68
Lao People's Dem. Rep.	April 25, 2001	April 24, 2005	31.70	13.58
Lesotho	March 9, 2001	March 8, 2004	24.50	7.00
Madagascar	March 1, 2001	November 30, 2004	79.43	34.04
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mauritania	July 18, 2003	July 17, 2006	6.44	5.52
Moldova	December 21, 2000	December 20, 2003	110.88	83.16
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Nicaragua	December 13, 2002	December 12, 2005	97.50	76.61
Niger	December 22, 2000	December 21, 2003	59.20	13.52
Pakistan	December 6, 2001	December 5, 2004	1,033.70	516.84
Rwanda	August 12, 2002	August 11, 2005	4.00	2.86
Senegal	April 28, 2003	April 27, 2006	24.27	20.80
Sierra Leone	September 26, 2001	September 25, 2004	130.84	42.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	49.00
Tanzania	August 16, 2003	August 15, 2006	19.60	16.80
Uganda	September 13, 2002	September 12, 2005	13.50	10.00
Vietnam	April 13, 2001	April 12, 2004	290.00	165.80
<b>Total</b>			<b>4,568.00</b>	<b>2,532.00</b>

<sup>1</sup>Includes amounts under Supplemental Reserve Facility.

EFF = Extended Fund Facility

PRGF = Poverty Reduction and Growth Facility

Figures may not add to totals owing to rounding.

Data: IMF Finance Department

Members drawing on the IMF "purchase" of other members' currencies or SDRs with an equivalent amount of their own currency.

## Capitalism: critics and champions

**D**id Adam Smith launch the antiglobalization movement? Not quite, though he and many of capitalism's other staunch supporters have also been its most perceptive critics, according to Jerry Muller, a professor of history at Catholic University. The inaugural IMF Book Forum, held on September 9, featured a presentation by Muller based on his book *The Mind and the Market: Capitalism in Modern European Thought*. Ann Florini of the Brookings Institution and Johan Norberg, author of *In Defense of Global Capitalism*, related the themes of Muller's book to the concerns of today's antiglobalization movement.

There is "a remarkable recurrence of fears, laments, and condemnations" when contemporary arguments against capitalism are compared with ones stretching back over 250 years, Muller said. The most fundamental condemnation of capitalism is its championing of the pursuit of self-interest. The "idea that collective good can arise from the pursuit of self-interest is not only counterintuitive to most people but morally scandalous," he said.

Even Voltaire's defense of economic self-interest was grounded in his belief that it was a less dangerous pursuit than other goals, such as religious zealotry. Voltaire's position is evident, according to Muller, in his description of the London stock exchange as "a place more respectable than many a court. You will see assembled representatives of every nation for the benefit of mankind. Here, the Jew, the Mohametan, and the Christian deal with one another as if they were of the same religion, and reserve the name 'infidel' for those who go bankrupt."

### Köhler awarded honorary professorship

On October 16, Eberhard Karls University in Tübingen honored one of its graduates, IMF Managing Director Horst Köhler, with an honorary professorship. In remarks on the occasion, Köhler urged his audience to work for "better globalization."

Globalization is hardly a new phenomenon, he observed, with roots at least as far back as the eleventh century. The first great wave of trade and financial integration in the second half of the nineteenth century was interrupted by two world wars and the Great Depression. But these tragedies, he said, also yielded a new spirit of international cooperation—including the creation of the IMF—that helped spur a second great wave of global economic integration and prosperity. And now the world is witnessing a third wave, with the transformation of "new globalizers," such as Brazil, China, India, and Mexico.

The great achievement of Adam Smith's 1776 book *The Wealth of Nations*, Muller said, was to show how self-interest could be channeled to achieve the collective good. Smith argued that properly structured markets would lead to universal opulence by providing competition and spurring greater productivity. Smith did not assume that markets would be naturally competitive. In fact, Muller noted, he argued that producers and merchants would try to restrain competition, internally and externally, through protectionist measures. "One leit-motif of *The Wealth of Nations*, then, might be called *saving capitalism from the capitalists*," he said.

### Other laments

Muller noted two other recurring fears about capitalism. One is that the development of markets, particularly at the global level, destroys indigenous ways of producing things and the social and political structures that go with them. This argument was prominent in the work of Justus Möser, a German contemporary of Adam Smith. Möser was concerned that the development of "tastes for imported goods" was destroying the guild system in Germany as well as the underlying political structures.

The second lament is that capitalism leads to inequality of incomes. This animus against the market, Muller said, dates back to Rousseau and is a platform of today's antiglobalization movement. But Adam Smith and other thinkers argued that, despite breeding inequality, capitalism can nevertheless be beneficial to the great mass of people. This line of argument, Muller noted, "appeals most to those of us who think that the real scandal is poverty, not inequality."

However, the 1.2 billion people still living in absolute poverty provide stark evidence, Köhler said, that many have yet to see benefits from globalization. And the severe financial crises of the 1990s provide further ample evidence of the risks that accompany global economic and financial integration. He proposed six guideposts toward building a better globalization: a clearer realization of the world's growing interdependence, greater national self-responsibility, an international regulatory framework for globalization, a recognition that the social dimension is crucial for social stability and a good investment climate, respect for human diversity, and a global ethic based on shared basic human values.

The full text of the Managing Director's speech is available on the IMF's website ([www.imf.org](http://www.imf.org)).





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The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 22 times a year, plus an annual *Supplement on the IMF* and an annual index. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Text from the *IMF Survey* may be reprinted, with due credit given, but photographs and illustrations cannot be reproduced in any form. Address editorial correspondence to Current Publications Division, Room IS7-1100, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to [imfsurvey@imf.org](mailto:imfsurvey@imf.org). The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged \$79.00 annually. Apply for subscriptions to Publication Services, Box X2003, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: [publications@imf.org](mailto:publications@imf.org).

November 3, 2003

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## What are antiglobalizers for?

There isn't much of an anti-capitalist intellectual movement in university departments today, according to Ann Florini, except perhaps in literary studies and, to some degree, in sociology departments. She said the book being hailed as the new *Communist Manifesto*—by Michael Hardt and Antonio Negri—entitled *Empire* was “largely incomprehensible,” but she added that “incomprehensibility is often not sufficient to derail bad ideas.”

Today's antiglobalizers, for the most part, are not against capitalism or even, in fact, against globalization. What they object to, Florini said, are “exactly the kinds of negative consequences of insufficiently fettered market forces that Muller talked about and that Adam Smith warned against very early on.” At the national level, she said, ways have been found of counteracting the negative effects of the capitalist system by embedding market forces within social and political contracts. Many countries now have systems in place consisting of representative national governments and civil society mechanisms that provide “reasonably effective control over the dangerous tendencies from monopoly and concentration of power against which Adam Smith warned.”

The antiglobalization movement is partly a protest against the absence of similar mechanisms at the global level, Florini said. Antiglobalizers feel that decision making at the global level consists of a few powerful countries making rules for everybody else. Moreover, the processes by which those rules are made are “so conspicuously undemocratic and unfair” that they eviscerate the legitimacy of the decisions that result. To address these grievances, she said, we need to develop effective channels for citizen voice and citizen participation at the global level. We also need to reform the governing structures of international institutions so that they are seen as more broadly legitimate. In short, she concluded, “we have to invent new ways to be vigilant about globalization in practice.”

## Easy to defend, hard to love

Norberg tackled the question of why, despite its many achievements, capitalism is treated with hostility or ambivalence. Why, he asked, is capitalism “easy to defend but hard to love”? This attitude, he said, reflects at heart “people's discomfort with a commer-



Muller: “The idea that collective good can arise from the pursuit of self-interest is not only counterintuitive to most people but morally scandalous.”



Florini: “We need to develop effective channels for citizen voice and citizen participation at the global level.”



Norberg: The focus of media attention is on the lost jobs in one location rather than on the jobs created later in other locations.

cial culture . . . with the fact that the source of our wealth is the constant discarding of old methods.”

Capitalism is based on creative destruction, and destruction makes for more “gripping” newspaper and TV stories than does creation. If a factory closes somewhere, Norberg said, “no reporter says, ‘Wow, this is fantastic! In the future we will see more efficient production with fewer workers. And the people laid off from this factory will surely end up in new sectors and in new careers, as we as a society grow richer and demand new goods.’” The focus of media attention is on the lost jobs in one location rather than on the jobs created later in other locations. Likewise, “when we see imports, we see the faces of our own people losing jobs, but we cannot tell the stories, at least not with the same drama, of other lives getting better or our own lives as consumers getting better as a wider array of goods becomes available at cheaper prices.”

Norberg expressed disappointment that politicians did not “explain to people why change is good, why new technologies are good, why trade liberalization is good.” The case for markets and capitalism was generally made in a very negative way, he said. Even Margaret Thatcher defended liberalization of the U.K. economy by claiming, “There Is No Alternative.” Similarly, developing countries today claim that they are carrying out trade liberalization because of pressure from the World Trade Organization rather than because trade is in their self-interest. All of this, Norberg said, is “like threatening that if your kids don't eat their salad or brush their teeth, a goblin will come and get them.” When politicians tell people that market reforms are being carried out under pressure rather than because the reforms are beneficial, the people will always look for an easy way out, Norberg observed. ■

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