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IMFC meeting

Ministers to discuss global slowdown, ways to combat money laundering, financing of terrorism

When key financial officials meet in Ottawa on November 17, the global economic slowdown and measures needed to revive growth in the world economy will top the agenda. The gathering, the fourth meeting of the International Monetary and Financial Committee (IMFC), was originally scheduled for late September at IMF headquarters but was postponed in the wake of the September 11 terrorist attacks.

Ottawa's Government Conference Center will serve as the venue for the IMFC and Development Committee meetings.

The IMFC, which will be chaired by U.K. Chancellor of the Exchequer Gordon Brown, will also focus on stepped-up efforts to fight money laundering and the financing of terrorism. The IMFC comprises 24 IMF Governors, who are ministers, central bank governors, or others of comparable rank, representing the IMF's 183 member countries. It was established at the 1999 Annual Meeting of the IMF's Board of Governors, when a resolution was adopted transforming the former Interim Committee into the IMFC (see *IMF Survey*, October 11, 1999, page 317).

(Please turn to the following page)

Interview with Häusler

IMF sharply steps up its dealings with international capital markets and private sector

In August, Gerd Häusler, a German national, joined the IMF staff as Counsellor and Director of the newly created International Capital Markets (ICM) Department. The IMF created this department to enhance its surveillance of international capital markets and to strengthen its work on crisis prevention and crisis management (see box, page 343).

Gerd Häusler

Häusler brings a wealth of private and public sector experience, including as a member of the Directorate and the Central Bank Council of the Deutsche Bundesbank. More recently, he was a board member of Dresdner Bank as well as Chair of Dresdner Kleinwort Benson, its investment banking arm. He spoke recently with the IMF Survey *about the state of the world's capital markets and his plans for the new department.*

IMF SURVEY: Your early days as Director have been extremely eventful: financial crises in Argentina and Turkey, followed by the September 11 terrorist attacks. What is the state of the world's capital markets? Have the declines in the equity markets this year been a necessary correction or a more worrying sign?

HÄUSLER: The markets in a technical sense have held up remarkably well, especially after September 11, if you bear in mind that some of the infrastructure in lower Manhattan was demolished. Those involved in "restructuring" did a great job. I especially want to congratulate the Federal Reserve in Washington and in New York and the many

(Continued on page 343)

(Continued from front page) The IMFC is expected to discuss the global economic situation and the policies needed to address current risks and vulnerabilities and strengthen global growth. IMF Managing Director Horst Köhler will make introductory remarks on the international community's policy response to the current situation. Consideration of ways to sustain poverty reduction in low-income countries, particularly in light of the impact of the global slowdown on the heavily indebted poor countries, will form an integral part of this discussion. The Managing Director's introductory remarks will build on his October 5 statement sent to the IMF's 183 Governors, which urged the international community "to respond with sound policies to reduce the likelihood of a sustained slowdown, and make sure we are ready to deal with a deeper and longer downturn if it does emerge—thereby limiting the disruption and attendant human costs" (see *IMF Survey*, October 22, page 325).

The committee is also expected to discuss the role that the IMF can play in tackling money laundering and the financing of terrorism, a topic that has taken on new urgency in the wake of the tragic events of September 11. The discussion will be based partly on a report prepared by a task force of IMF staff chaired by Deputy Managing Director Eduardo Aninat.

In addition, Köhler is expected to report on progress in reforming the IMF. Here he will draw on reports to the IMFC on crisis prevention initiatives, private sector involvement in crisis prevention and resolution, streamlining IMF conditionality and enhancing country ownership of policy programs, and progress in implementing the poverty reduction strategy based on poverty reduction strategy papers and the IMF–World Bank debt initiative for the poorest countries. The committee will also receive a report on the IMF's Independent Evaluation Office, which was established earlier this year. A press conference by Brown and Köhler will follow the IMFC meeting.

Prior to the IMFC meeting, on November 13, ministers and other senior officials of the Group of 24, representing the developing country members of the IMF, will meet in Paris. Nigeria's Minister of Finance, Adamu Ciroma, will chair the meeting. On November 17, ministers and other senior officials of the Group of 20, which comprises the major industrial countries plus a number of other advanced and emerging market countries, will meet in Ottawa. The meeting will be chaired by Canada's Minister of Finance Paul Martin.

The Ottawa meetings will conclude on November 18 with a meeting of the Development Committee, a joint committee of IMF and World Bank Governors. Yashwant Sinha, the Indian Finance Minister, will serve as chair of the meeting. ■

Doha trade meeting

Köhler, Wolfensohn call for new trade round centered on needs of developing countries

On the eve of the World Trade Organization (WTO) meeting in Doha, Qatar, November 9–13, IMF Managing Director Horst Köhler and World Bank President James D. Wolfensohn issued the following statement:

"We urge trade ministers meeting in Doha to seize this opportunity to launch a new round of multilateral trade negotiations, one that is inspired by a desire to use trade as an engine for global economic growth and poverty reduction.

"At this critical juncture for the world economy, a strong commitment to continue opening world markets will provide a much-needed boost to market confidence and global growth prospects. Such a commitment will also send a clear signal that governments reject trade restriction and protectionism and see it as particularly damaging in current circumstances.

"We welcome the intention to place the needs and interests of developing countries at the heart of the World Trade Organization's (WTO's) work program. International trade has a vital role to play in promoting economic development and reducing poverty. Providing the poorest countries with unrestricted market access, including for their agricultural and textiles and clothing exports, would be a decisive breakthrough in the fight against poverty.

"We pledge that the IMF and the World Bank, in their respective areas of competence, will continue to support the efforts of developing countries, particularly the poorest, to integrate more deeply into the global economy. In particular, our institutions are devoting increased attention to a large agenda, complementary to the work of the WTO, which includes strengthening countries' capacity to negotiate and implement agreements, improve the investment climate, and reduce internal impediments to trade. Our aims are to support development of a trading system that works for the benefit of all and to help the poorest countries adopt development strategies that use trade as a mainspring for growth."

The full text of this statement, released as IMF News Brief 01/111, is available on the IMF's website (www.imf.org). ■

Häusler pushes for better market insights

(Continued from front page) unsung heroes in the back offices of the private sector financial institutions.

As for the markets, we have seen a considerable drop in equity prices, but they have come down from a very high level. Perhaps the levels were assuming evaluations and price-earnings ratios for the next year or two that were overoptimistic—extrapolating developments from a long bull market. Considering that the outlook for the world economy is certainly much less optimistic than it was a year ago, equity markets have held up remarkably well. In fact, they may already be looking ahead toward the upturn that many of us expect to occur next year; rightly or wrongly, only time can tell.

IMF Survey: Should we be surprised by the resilience of the markets in the face of such uncertainty?

Häusler: I don't know if surprise is the right word. We should feel reassured because this resilience shows that the markets have become very professional and have learned not to panic, even though present valuations are still high in a historical perspective.

IMF Survey: Did the existence of your new department enable the IMF to react differently to recent financial crises than it would have in the past? Can we expect to see the IMF responding differently to future crises because of your department's existence?

Häusler: With the new department barely created, we should not claim credit prematurely. I had just started to put its components together and to hire additional firepower. As to the future, we hope to enhance the IMF's understanding of current developments and systemic trends in international capital markets, so that the IMF can be in a position to respond in a timely fashion to market events leading to financial crises.

IMF Survey: Why was ICM created, and how does it fit into the broader work of the IMF?

Häusler: It was created because private capital markets have become so much more important for our members. We need to thoroughly understand how to assist members to access them, how to retain access, and, where necessary, how to regain access. Thus, our job is to help ensure that the area departments have all the necessary expertise available in their dealings with member countries.

IMF Survey: Was ICM created mostly to deal with the industrial countries or also to help the emerging market countries?

Häusler: The way I see the mission, the IMF intends to pay attention equally to emerging market countries as the recipients of private sector flows and to mature markets as the source of such flows. There are considerable interlinkages between the two. The IMF's surveillance mission implies that the IMF is also looking at mature financial markets, not only as the origin of private sector capital but also as a potential source of instability.

IMF Survey: What exactly can the IMF do to lessen the extraordinary volatility evident in markets since the 1980s?

Häusler: First of all, we have to recognize that a certain volatility in financial markets will always be there. Financial markets deal with expectations about the real economy and, because expectations by definition are more volatile than the real economy itself, financial markets will always be more volatile than the real economy. By the way, we should not overlook certain

Häusler: "The IMF intends to pay attention equally to emerging market countries as the recipients of private sector flows and to mature markets as the source of such flows."

ICM's terms of reference

- Gather and assess information on developments in international capital markets, and make this information readily available to area and other IMF departments, as a vital part of the IMF's surveillance work and of the design and monitoring of its lending programs.
- Develop analytic and operational approaches to systemic issues, including capital account liberalization; assess systemic risks stemming from international capital markets developments; and conduct policy-oriented and analytical research on issues related to international capital markets.
- Develop and maintain a management information system designed to provide continuous surveillance of capital markets, with a view to strengthening the IMF's early warning capabilities of potential financial crises, in cooperation with other IMF departments.
- Serve as the IMF's main point of contact with official and private forums dealing primarily with international capital markets issues by establishing and maintaining systematic liaisons with private capital market participants, national authorities responsible for financial system policies, and official forums dealing with international capital markets issues; this includes having the responsibility for the preparation and follow-up to meetings of the Capital Markets Consultative Group and regional gatherings with capital market participants.
- Advise area departments and members on all aspects of access to international capital markets and relations with creditors in the context of both bilateral surveillance and the use of IMF resources; this would include external debt management strategies, prospects for capital market access, promoting constructive relations between debtors and their creditors, and, if necessary, the restructuring of external debt; and develop and advise on all aspects of the implementation of the IMF's policy on the involvement of the private sector in the resolution of financial crises.
- Support the IMF's work on multilateral surveillance.
- Produce periodic reports on developments in international capital markets.

positive aspects of volatility. The only advice I can give is the old-fashioned conservative advice that, in the end, reducing volatility will hinge on getting the fundamentals right—that is, sound fiscal and monetary policies—as well as progress in developing robust institutions for a market economy that is flexible enough to absorb certain exogenous shocks.

IMF SURVEY: Any words of advice for countries that are beginning to tap the markets? What steps can they take to protect themselves from the markets' inherent volatility?

HÄUSLER: Countries that have just recently accessed the markets have to be very cautious and conservative, because the markets will scrutinize their behavior probably more closely than they will scrutinize the behavior of countries that have been in the capital markets for much longer. So, again, conservative policies, and cushions in terms of financing and reserves, will always suit them very well. A consistent and well-executed investor relations policy can also be helpful in conveying the right message.

IMF SURVEY: How about capital controls?

HÄUSLER: I think any retreat from capital account liberalization, or even convertibility, into capital controls would pose a very delicate shift of policy. That said, how soon a particular country should go to full capital account liberalization in the first place needs to be debated very carefully. The markets will not easily forgive going backward, but they will understand countries moving toward liberalization cautiously.

Accessing the markets after crises

On September 19, the IMF's Executive Board explored the determinants and prospects for the pace of capital market access for countries emerging from financial crises. They found that "past experience suggests that countries that lose market access as a result of adverse developments in global financial markets, or minor spillover from crises elsewhere, generally regain market access quickly as the effects of such developments pass." But some Directors noted that "in view of the time lags involved, interim financing by the IMF and other IFIs [international financial institutions] is an important element to help facilitate regaining market access, in particular, by ensuring temporary financing while corrective policies are being implemented."

The Directors agreed "that the adoption of credible corrective policies is the single most important determinant of a country's prospects for regaining market access," although much more research needs to be done in this area. They also agreed that "a clear indication of how a country will meet its gross financing requirements is an important factor in the restoration of market access, particularly when the country is emerging from a major crisis or relies heavily on international capital markets."

The full text of IMF Public Information Notice No. 01/110 is available on the IMF's website (www.imf.org).

"Unlike in the corporate sector on the national level where there are workout procedures, in an international sovereign case, there are no such workout procedures. In my mind, that is a serious deficiency."
—Häusler

IMF SURVEY: There has been a lot of talk about early warning systems. When might we expect to see such early warning systems in action, and how will the IMF communicate these warnings? Just how transparent is healthy?

HÄUSLER: We all agree that early warning systems are important. But we all know as well that they have their weaknesses—that they may not catch every vulnerability, every weakness, every crisis. And they may ring a bell when there is no crisis. Therefore, they must be used with great caution. I sometimes compare these early warning systems to school grades. There is a clear correlation between school grades and final exam grades. But this correlation is certainly not perfect. Some people have good grades and fail the exam, and others have bad grades and still pass the exam.

As to giving out information on country weaknesses, I think the IMF must be extremely cautious—not only because these are our members but also because the IMF must not be seen as having triggered a crisis where one could have been avoided. So the answer is yes, these systems are already in action, but any communication of their results will have to be handled delicately and without going public.

IMF SURVEY: One of Managing Director Horst Köhler's first initiatives was to set up the Capital Markets Consultative Group (CMCG) last year to engage the private sector in a well-informed and wide-ranging dialogue with IMF management and staff. The group's third meeting took place on October 18. What was discussed and what was achieved?

HÄUSLER: First, we had all agreed that the findings of this meeting would be private, so if we expect the other side to hold to that agreement, we must keep our promises as well. I can just say that we covered a wide range of issues, potential vulnerabilities, and weaknesses in all areas of financial markets. That said, I would like to add that, in general, the IMF—like all other public institutions—must be careful not to overestimate the number of secrets it has. In reality, there are relatively few secrets. This is why I think a frank exchange of views with the private sector is helpful and warranted.

IMF SURVEY: Do you believe this group is helping the private sector better understand IMF measures and initiatives?

HÄUSLER: Yes, very much so. But it is not just the CMCG, with its twice a year meetings, that can be a transmission mechanism. You have to put this also in the context of a whole host of private sector meetings at all levels, where the aim is for us not just to gain insights into the private sector but also to explain ourselves to the private sector and garner support from it.

IMF SURVEY: Can the IMF hope to compete with the private sector in recruiting skilled personnel?

Häusler: The short answer is yes, because I have already hired a few people from the private sector. We cannot always compete financially, but there is a reasonably large group of people out there who have an interest, at some point in their career, in working on public policies. But to tell you the truth, the problem is not the money. The more crucial issue is having a working climate where private sector people feel that they have meaningful responsibilities. There needs to be a careful balance between preserving the IMF's integrity and cohesion on the one hand and delegating enough responsibility, on the other hand, to attract first-class people.

IMF Survey: Will the IMF's relationship with the capital markets, especially private investors, change? Will we be taking a more active role or a "watching brief"?

Häusler: Given the globalized nature of financial markets and given the importance of private sector capital flows, the IMF has no choice but to interact regularly and frequently with many segments of the capital markets.

IMF Survey: One area where progress seems extremely slow is in figuring out how to keep the private sector engaged when financial crises do occur, instead of running for the exits. Why can't the IMF and the private sector reach agreement?

Häusler: The private sector does remain engaged in many areas, and we should not prematurely discount this factor. Where we certainly have a significant problem is during an actual crisis. Unlike in the corporate sector on the national level where there are workout procedures, in an international sovereign case, there are no such workout procedures. In my mind, that is a serious deficiency.

IMF Survey: There have been calls to monitor highly leveraged institutions more closely. Do you see the IMF responding to such calls?

Häusler: Various groups have studied the issue, with the IMF's involvement, and we would remain involved if there were reason to discuss it again. But at this time, hedge funds are much smaller than they used to be, and they are also much less leveraged, because this is what investors want. Investors take the first hit if such a highly leveraged institution goes belly up. ■

IMF Institute seminar

Aid alone will not help poor countries grow out of poverty

There is renewed interest among the industrial countries in stepping up aid to developing countries to bolster growth. But in a new book, The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics *(MIT Press, 2001), the World Bank's William Easterly cautions that the results of such aid may be disappointing. In an IMF Institute seminar on October 10, Easterly discussed why aid has failed in the past and how things could be done differently in the future.*

The developed world has poured a trillion dollars of aid into the developing world since the 1960s. What do we have to show for all the foreign aid and advice? Not much, according to Easterly, a senior advisor at the World Bank. Much of sub-Saharan Africa remains mired in poverty, growth in Latin America has been erratic, and countries in the Middle East have failed to convert oil riches into sustainable development. Countries that could be called economic "miracles" remain the exception rather than the rule.

Aid mislaid

In the 1960s, the mere provision of money was considered enough to boost growth in developing countries, which were considered to have a "financing gap." Bridging this gap with foreign aid would lead to an increase in investment and, thereby, growth. That was the theory.

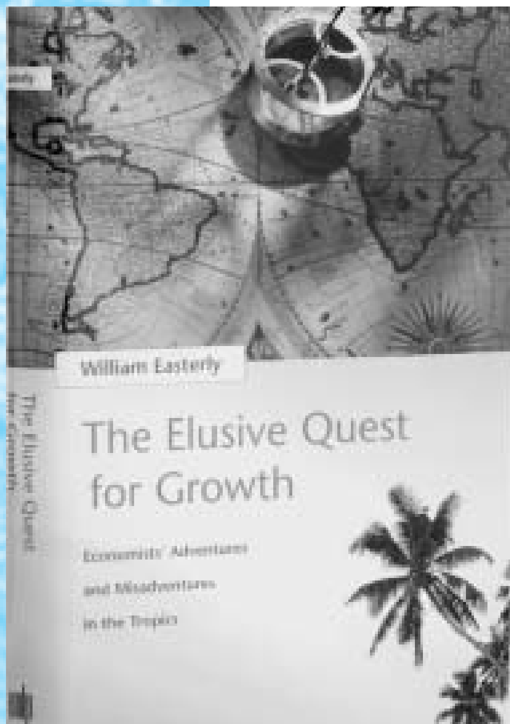
But in practice, Easterly said, two major problems have made aid unproductive. First, much aid money has ended up in the pockets of corrupt politicians and vested interests rather than in investment. Second, even the part that has gone into investment has not helped to the extent that was anticipated because machines cannot generate growth in environments where the institutions are poorly developed and the work force has inadequate skills.

Easterly: "Prosperity happens when all players in the development game have the right incentives."

Take Zambia, for example. Easterly calculates that the amount of aid Zambia has received over the past 40 years should, according to development economists, have propelled the country into the ranks of the industrial countries. Instead, average income in Zambia is no higher today than it was in 1960. Such failure is pervasive: the per capita growth rate of the typical developing country between 1980 and 1998 was zero.

IFI response: iffy, at best

The international financial institutions (IFIs) have attempted to fix both of the problems but with limited success, according to Easterly. Their efforts to tie aid to countries' progress in fighting corruption tend to fail because they have only a marginal effect on governments' very strong incentive to dispense patronage to powerful elites or certain ethnic groups or regions. In many cases, the IFIs themselves do not have the incentive—or sometimes the freedom—to walk away from corrupt governments and repeat offenders. For instance, Easterly noted, the six developing countries considered most corrupt on the basis of commonly used rankings of corruption had received 46 adjustment loans from the World Bank and the IMF.



The IFIs have also tried to make aid more productive by asking countries to carry out structural reforms before releasing aid money. This too has proved difficult, Easterly said, because the IFIs have often acted as though growth could be raised simply by transferring to the developing world certain "magical objects" that are associated with prosperity in the West, including such institutions or practices as schools, health clinics, family planning, and independent central banks. The returns in terms of increased growth have been paltry. To take one example, sub-Saharan Africa's growth performance has been disappointing even though its educational capital grew faster than that of East Asia between 1960 and 1985.

Another world is possible

Although there are no magic elixirs to make aid more effective, Easterly said, past experience suggests that "prosperity happens when all players in the development game" (aid agencies, recipient governments, and private individuals in developing countries) "have the right incentives." This means that the IFIs and bilateral aid agencies should be rewarded on the basis of positive outcomes in the recipient countries rather than on the volume of their lending or the number of their programs. Unless this is done, the act of making loans will be rewarded rather than the act of helping the poor in each country.

To motivate recipient governments to implement reforms, they should be rewarded more on the basis of achievements than promises. Easterly suggested that aid agencies could use past experience in deciding which governments are likely to have the right incentives to deliver reforms and which are likely to steal from and repress private business. Polarized and undemocratic governments, where interest groups based on class or ethnicity are competing for loot, are not very likely to deliver genuine reforms, whatever their promises. Easterly advocated having "beauty contests" in which countries vie for a common pool of aid money on the basis of a track record of effective use of past aid.

Curbing expropriation by governments would go a long way toward giving private individuals and businesses in developing countries the right incentives to invest in the future. But curbing governmental expropriation may not be enough, particularly to help the very poor. Even when society-wide incentives for growth are good, the poor have fewer incentives because often "productivity depends on one's fellows, and the fellows of the poor are other poor people." The poor may need more targeted subsidies to help them escape such poverty traps.

Because we do not know exactly what kinds of subsidies will work, it is best to experiment with different solutions, reallocate resources toward solutions that appear to be working, and rely to the extent possible on the strong desire the poor have to better their lot. Easterly concluded that "we can envision a world in which the poor are given the benefit of the doubt that they will respond to incentives just as much as the rich do." ■

Prakash Loungani
IMF External Relations Department

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
October 22	2.56	2.56	3.01
October 29	2.52	2.52	2.96
November 5	2.43	2.43	2.86

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?2001).

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

Early warning systems: fad or reality?

Since the eruption of financial crises in Mexico and Asia in the mid- to late 1990s, there has been a growing demand within the international community for a system that could help predict the onset of such crises. But how realistic is this goal? Do existing models have a good track record? Even if we develop a system that looks as if it would have been successful in the past, can we be confident that it will work in the future?

To tackle these questions, the IMF hosted an Economic Forum on early warning systems on November 1. The panelists were Peter Garber, Global Strategist with Deutsche Bank; Kristin Forbes, Professor, Massachusetts Institute of Technology; and Eduardo Borensztein, Division Chief in the IMF's Research Department. Carmen Reinhart, Senior Policy Advisor in the IMF's Research Department, served as moderator for the panel.

The general consensus among participants was that, although such systems still need to be further refined, they can provide a useful starting point for anticipating the onset of financial crises. However, some speakers were more enthusiastic than others.

Crystal ball?

Garber opened the discussion with a perspective from the private sector, where early warning systems offer the hope of higher profits and lower risks. He said investment banks are busily devising in-house models that attempt to predict currency crises to help clients craft effective foreign currency trading strategies or assess values and risks in emerging market currencies.

How are these models doing? He said that one of the newer economic models—Deutsche Bank's "Alarm Clock" (DBAC)—estimates simultaneously the probabilities of exchange rate and local interest rate "events" in 19 emerging markets on a monthly basis. The DBAC defines separate exchange rate and interest rate events as depreciations greater than a certain size (estimated separately for levels ranging from 5 to 25 percent) and increases in the money market interest rates of more than 25 percent in a month. The methodology for the model jointly estimates the probability of these two types of events, allowing the probability of a simultaneous increase in interest rates to influence the likelihood of an exchange rate crisis and the probability of a depreciation to affect the predictions of an interest rate crisis. Summarizing the results of some 360 observations over a 20-month period, he said the model's overall performance was "reasonably good."

Good for what?

But Forbes, taking an academic perspective, had some reservations about the work being done on early warning systems. First, she asked, were the findings of the early warning systems consistent? To answer this question, she examined three private sector models, including the DBAC, covering predictions for 16 countries, including the least and most vulnerable ones, over a 10-month period (January–October 2001).

The result: a troubling absence of consistency in the findings. Using one measure, for example, she found that while there was, within each model, some consistency in prediction, there was virtually complete disagreement across the three models for any given month. "They are not sending a consistent message," said Forbes, noting that the alarm clock did not always ring at the same time.

Second, she asked, did the models predict relative vulnerabilities for given countries? Here, the answer was more positive. One might have assumed that vulnerability had increased over this period. But in fact, the reverse occurred in a number of potentially vulnerable economies, including Argentina, Brazil, Mexico, and Taiwan Province of China, and the models captured this. The reason, she said, was that the models correctly predicted a series of substantial currency devaluations that subsequently took place.

"For what they were designed to do—predict currency depreciations—these models are not bad," she acknowledged. But was predicting exchange rate movements the most important function of early warning systems? Not in her opinion. Proponents of such systems, she suggested, should direct their energies instead to addressing more pressing, policy-laden issues, such as external financing difficulties and financial system vulnerabilities.

Peter Garber

Kristin Forbes

Eduardo Borensztein

Ultimate value

For the IMF's Borensztein, however, the advantages of these models were already compelling for a number of reasons.

• They are objective and mechanical and thus avoid the biases that may sometimes cloud analysts' views. For example, the impressive economic growth record of Korea

over the previous decades led many observers to overlook the country's short-term external vulnerability in 1997.

- The models are capable of processing several vulnerability indicators (such as the short-term ratio of debt to reserves and the current account balance) into a single figure that measures the probability of crises over some future time period. Watching a large number of indicators may prove inconclusive when they are not all moving in the same direction.

While far from perfect, the models seem far superior to some of the alternative indicators often used by markets and analysts, including bond spreads and sovereign rates issued by the major agencies. Despite many false alarms, the models helped anticipate potentially dangerous pressures at work in foreign exchange markets that did not develop into a full-blown crisis, thanks to appropriate policy responses or good luck.

Thus, while the use of early warning systems has a compelling logic for both policymakers and the private sector, research on crisis definition and model specification and more experience in "real time" application of the models are needed to fully develop this tool for crisis prevention. ■

John Starrels
IMF External Relations Department

Photo credits: Royal Canadian Mounted Police, page 341; Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 341, 343, 345–47, 350, 354, and 356; and Tony Ranze for AFP, page 355.

Available on the web (www.imf.org)

Press Releases

01/43: Romania: $383 Million Stand-By Credit, October 31

01/44: IMF Reviews Noncompliant Credit Drawing by Bosnia and Herzegovina, November 5

News Briefs

01/104: IMF Statement on Pakistan, October 23

01/105: Yemen: $21 Million Disbursement Authorized Under PRGF and EFF, October 24

01/106: Georgia: $11 Million Under PRGF, October 26

01/107: IMF Sending Mission to Turkey, October 29

01/108: Caribbean Regional Technical Assistance Center to Be Officially Inaugurated, November 2

01/109: IMF Completes Review Under Benin PRGF Arrangement and Approves $5 Million Disbursement, November 5

01/110: IMF Completes First Review of Stand-By Arrangement with Croatia, November 5

01/111: IMF and World Bank Heads Call for a New Round of Multilateral Trade Negotiations at Doha, Qatar (see page 342)

Public Information Notices

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01/118: IMF Executive Board Informally Discusses Quota Formulas, November 7

01/119: Saudi Arabia, November 7

Transcripts

Press Briefings, Thomas Dawson, External Relations Department, October 17, November 1

Address by IMF Managing Director Horst Köhler Inaugurating Caribbean Regional Technical Assistance Center, November 5

Press Briefing by Alessandro Leipold and Luc Everaert, European I Department, on France's 2001 Article IV Consultation, November 5

Press Briefing by Michael Deppler, European I Department, on Euro Area 2001 Article IV Consultation, November 6

Statement by Daniel Citrin, Asia and Pacific Department, on Consultative Group Meeting for Indonesia, November 7

Press Briefing by Susan Schadler and Robert Corker, European I Department, on Germany's 2001 Article IV Consultation, November 7

Letters of Intent and Memorandums of Economic and Financial Policies*

Yemen, October 25

Honduras, October 26

Report on the Observance of Standards and Codes*

Uruguay, October 18

IMF Staff Assessments of Offshore Financial Centers*

Panama: Banking Sector Assessment, August 2001 (October 23)

Other

IMF Financial Activities, October 19

Independent Evaluation Office (update), October 22*

September 2001 Progress Report on the Bank–Fund Financial Sector Liaison Committee, October 22*

IMF Staff Papers, Vol. 43, No. 3

IMF Financial Activities, October 26

Heavily Indebted Poor Countries Initiative:

Status of Implementation, November 2*

Poverty Reduction Strategy Papers—Progress in Implementation, November 2*

Schedule of Public Engagements of IMF Management and Senior Staff, November 2

*Date posted

Future of globalized markets will depend on institutions capable of sustaining them, says Soros

On October 25, financier and philanthropist George Soros came to the Institute for International Economics in Washington armed with a draft report on globalization and a message: if global markets are to prevail, there must be international institutions capable of sustaining them.

The draft report, which focuses on globalized markets, provides a follow-up to Soros's earlier book *Open Society: Reforming Global Capitalism,* but with a greater emphasis on prescriptions. His audience of current and former policymakers in international and national organizations, think-tank analysts, nongovernmental activists, and others was invited to comment on his diagnosis—a globalization process imperiled by its imbalances—and his remedies, which emphasized carrots rather than sticks. The gathering provided the spirited exchange he was looking for.

Lopsided development

Soros opened his remarks with a cautionary note. If the nineteenth century is any guide, the heady globalization of financial markets over the past two decades is not impervious to reversal. Globalized markets have accelerated economic development—but at a cost. A sharply lopsided development has, in Soros's view, created three key imbalances: considerable private wealth but limited public goods; international institutions constrained by national sovereignty and crucially unable to deliver global public goods; and arrangements that favor established markets (the "center") at the expense of emerging markets (the "periphery").

This lopsidedness, Soros argued, is no accident. The political forces driving globalization over the past two decades are working to reduce the influence of the state and curb its intervention in the economy. A more balanced system, however, could use globalization's substantial benefits to correct its drawbacks, and international institutions can play a crucial role in this regard. But Soros fretted that an unwitting alliance between the far right and the far left seems intent on sinking or shrinking international financial and trade institutions. "My aim," he said, "is to create a different coalition" to bolster globalization by strengthening existing institutions and creating new means to provide global public goods.

Three controversial goals

Atop his "to-do" list are three goals that Soros himself labeled controversial—addressing unstable financial markets; leveling the playing field for emerging markets; and improving governance in those countries lagging behind in economic, social, and political development. Market fundamentalists, he said, will oppose the first two because they view them as interventionist, and the antiglobalization movement has been "strangely blind" to the impact of bad governance, although Soros believed much of the world's poverty and misery could be traced to failed states, repressive regimes, corruption ("state capture"), and the inability of poor countries to deliver needed services.

According to Soros, internal conditions have been at the epicenter of recent crises, but international financial and trade institutions are "really not very well designed to interfere in the internal affairs of countries because they are subject to the sovereignty of the states." What can international institutions do given the constraints of sovereignty? And how should they do it? Incentives figured prominently in his suggested reforms.

Institutional opportunities

Soros singled out the World Trade Organization (WTO) as the most developed and best honed of the international financial and trade institutions. It has created international law, to which states subordinate their sovereignty; it has a judicial function; and, most important, it has developed a means of enforcing its judgments, permitting countries to take countervailing measures if an infraction does not cease.

Soros was not about to give the WTO a clean bill of health, though. He sided with its critics, who saw a bias in favor of its dominant country members, and he chided the organization for its involvement in enforcing intellectual property rights. This, he said, had "let the genie out of the bottle" and opened the way for other nontrade demands.

How can the world address a pressing concern like child labor without resorting to punitive WTO measures? Soros suggested that a much more effective route would be to provide resources for universal primary education. This, he said, was a prime example of how a voluntary compliance-based system for providing public goods might complement the rules-based WTO system.

As for the World Bank, Soros credited President James Wolfensohn with moving the institution away from big projects and toward the provision of human capital and public goods. But he saw an organization still seriously constrained by its constitution, as it must make loans guaranteed by recipient governments and still relies heavily on lending rather than grant-giving. But Soros believed now was not the time to embark on a major reform of the Bank.

The only way the IMF can exert more influence on a country before a crisis occurs is by offering incentives.
–Soros

Soros: The markets now have a new, and too-little-discussed, problem—inadequate capital for emerging markets.

Turning to the IMF, Soros noted two asymmetries that had, until recently, characterized the way the IMF functioned: a disparity in its treatment of debtors and creditors (to the detriment of debtors) and a preference for crisis intervention rather than crisis prevention. Both problems have now been recognized, though he argued that market discipline made it easier to correct the moral hazard created by treating lenders more favorably. He also noted that "curing" moral hazard had a steep price. There will be no repetition of the boom-bust sequence of the late 1990s because "we are not going to have a boom." The markets now have a new, and too-little-discussed, problem—inadequate capital for emerging markets.

In Soros's view, the only way the IMF can exert more influence on a country before a crisis occurs is by offering incentives. His report cited the IMF's progress on Contingent Credit Lines (CCL) and suggested that the IMF could rate countries, with the highest rating making countries automatically eligible for the CCL. He also suggested opening up the discount windows of the central banks of the United States, the United Kingdom, Japan, and the euro area to countries, such as Brazil, that face high risk premiums as a result of crises elsewhere. If the bonds could be discounted, the risk premium could be substantially lower and the margin required could be varied "to keep the moral hazard problem at bay."

Missing link

Existing international finance and trade organizations can be strengthened, but how is the need for more global public goods to be met? Where's the financing? Who delivers the goods? Traditional foreign "aid" has become a "bad word," he admitted, and with good reason. Poorly administered and often counterproductive aid may have met the needs of donors but did little for recipients. Expanded global public goods will require more money and less donor interference.

While remaining open to other options, Soros professed a preference for a special issue of SDRs to finance more aid. Such an SDR allocation could provide a mechanism for rich countries to donate their share to a "common pot." They would control where "their chips" are used, but eligible projects would have to meet certain criteria and ensure that they serve recipient interests.

This process, to be overseen by an independent board that would monitor and evaluate projects but have no powers to allocate resources, offers "a market-like interaction between donors and recipients" that would enhance competition for funds, increase efficiency, and fund three types of programs: the provision of global public goods (such as the HIV-AIDS fund), worthy government-sponsored programs, and matching funds for social entrepreneurship (a category of nongovernmental assistance that should be particularly valuable in countries plagued by poor governance).

Audience feedback

Soros sought, and got, a lively response to his draft proposals. His focus on global public goods found support, as did his desire to forge a new alliance between international institutions and groups anxious to make globalization a fairer process. Virtually everyone agreed on the need for greater resources, but the devil, as always, was in the details.

Michael Mussa and J.J. Polak, former directors of the IMF's Research Department, strenuously objected to using the SDR as a funding device. Mussa labeled the SDR route "extremely complicated" and "nontransparent" and strongly suggested that Soros would do better fighting with national legislatures over their "miserably low" aid allocations. Polak warned that an SDR allocation may commonly be misunderstood as a cheap financing mechanism, but countries like the United States know full well that contributing SDRs is just like contributing dollars.

Soros insisted the SDR allocation held special attractions. It provided a means of "avoiding donor control" and could also serve, if the allocations were annual and larger, as an instrument of monetary policy in controlling global money supply. Given what he saw as a potential for global deflation, these allocations were attractive because they both created money and ensured that it would be spent.

Mussa was also sharply critical of the proposal for central banks to open a discount window. Very risky business, he said. This would jeopardize responsible monetary policy and open the door to all deserving clients seeking a means of soft finance. Keep this proposal completely off the table, Mussa advised.

Stanley Fischer, recently retired First Deputy Managing Director of the IMF, argued that the different treatment accorded "center" and "periphery" countries may reflect market awareness of good and bad policies rather than biases about which group they fall into. For instance, if a country's underlying fiscal position was strong enough, it could use countercyclical fiscal policy. Markets did not look askance when East Asian countries with strong track records used fiscal stimulus as a response to crises there.

Fischer also cited concerns about rating countries and announcing policies that provided strong ex ante incentives for good behavior but that could be difficult to apply ex post. Soros suggested that the IMF should announce that it would lend only to low-rated countries in a crisis if there was explicit private sector involvement. But that meant that any risk of a crisis in such countries would accentuate capital outflows; then when the crisis came, however serious the country's condition, the IMF might find itself unable to lend. He doubted the international community would want to be in such a position, punishing the country's citizens, especially if the government was willing to implement the measures needed to deal with the crisis. ■

IMF SURVEY

Dominican Republic makes dramatic progress in boosting economic growth and reducing poverty

After suffering a decade of economic stagnation in the 1980s, the Dominican Republic took off in the second half of the 1990s and, with output growing at nearly 8 percent a year, became one of the world's fastest growing economies. The severe monetary and fiscal imbalances, pervasive price controls, financial sector rigidities, multiple currency practices, and restrictive trade regime of the 1980s have given way to declining unemployment, modest inflation, and a generally manageable external position. The Dominican Republic is a textbook case of a small economy with limited natural resources that, by opening itself to trade and financial flows, has been able to turn its economy around.

How was this remarkable turnaround accomplished? The answer lies in impressive and wide-ranging economic reforms launched in the early 1990s that featured liberalization and greater integration with the global economy. The authorities tackled domestic imbalances by strengthening public finances, improving monetary control, and reducing distortions in financial markets. They removed many exchange and trade restrictions. And, toward the end of the 1990s, they reduced the role of the state in the economy through the private capitalization, leasing, or outright sale of state-owned enterprises. The restoration of stable macroeconomic conditions and the initiation of structural reforms coincided with a resumption of strong economic growth. Whereas in the early 1980s growth had averaged less than 2 percent a year, by the end of the 1990s this average had climbed to nearly 8 percent a year (see table). This strong growth has helped reduce the poverty rate—from about 32 percent of the population in 1992 to less than 26 percent in 1998.

Sources of growth

What accounts for this dramatic growth? The impetus has come largely from the tourism, telecommunications, and industrial free-trade-zone (FTZ) sectors—which represent one track of a dual production structure that has developed in the Dominican Republic over the past 30 years. This part of the economy is characterized by strong competition, close links with the world economy, and special administrative arrangements that often shield it from state intervention. In contrast, the more traditional sectors of the economy, such as agriculture and some subsectors of industry, remain subject to state intervention, including protectionism, red tape, and uncertain property rights.

Growth in the FTZs, in terms of employment, export value, and number of firms, has been particularly impressive. In 2000, there were 46 industrial parks, containing around 500 enterprises, employing almost 200,000 people (8 percent of total employment), and providing possibly twice as many jobs outside the FTZs. The FTZs have attracted important amounts of foreign direct investment and generated an estimated $5 billion in gross exports in 2000, accounting for over four-fifths of total exports.

The FTZs' rapid growth can be attributed to three factors. First, the regulations governing operations and activity are generally regarded as stable and transparent, in contrast to the legal framework applying to "domestic" exports. Second, FTZ enterprises receive attractive tax incentives—including exemptions from the corporate income tax, the value-added tax (VAT), and standard import duties. Finally, the country's proximity to the United States and Puerto Rico, coupled with its participation in several preferential regional trade arrangements, has boosted growth. These arrangements have allowed the Dominican Republic to strengthen the competitive advantage of its FTZs through regulated market access, but have resulted in a strong orientation of FTZ exports toward the U.S. market and a potentially heavy dependence on the U.S. business cycle. However, other sources of foreign exchange (such as tourism, which derives mainly from Europe) partially offset this dependence.

Dominican Republic shows dramatic improvement

	1981–85	1986–90	1991–95	1996–2000
	(annual percent changes, averages)			
Real GDP	1.9	2.9	4.2	7.7
Real GDP per capita	–1.3	0.9	2.5	5.4
Consumer prices (during the period)	18.0	39.5	7.9	6.9
Money and quasi-money (M2)	16.5	43.2	22.6	20.1
	(percent of GDP, averages)			
Consolidated public sector balance[1]	–5.4	–5.4	–1.2	–2.2
Consolidated public sector primary balance	–3.8	–3.3	0.5	–1.2
Inflation tax[2]	1.7	4.3	0.9	0.8
External current account balance	–3.7	–3.7	–3.9	–2.7
Foreign direct investment	0.6	1.6	2.2	3.1
External debt (end-period)	64.7	72.2	33.0	18.6
External debt service	7.5	9.2	4.2	2.6

[1]Includes quasi-fiscal losses of the central bank. This information is not available for 1990–93, and the central bank's losses are assumed to be zero for those years.
[2]The inflation tax is calculated as CPI inflation during the year times the stock of base money at the end of the previous year.

Data: Central Bank of the Dominican Republic; and IMF staff estimates

Sounder fiscal footing

On the fiscal front, a lack of discipline was the Achilles' heel of the Dominican economy in the 1980s. Between 1981 and 1990, the consolidated public sector deficit,

The 1990s saw a dramatic change, with public finances kept broadly under control despite occasional slippages.

which averaged more than 5 percent of GDP, was a substantial burden for monetary policy. An increasing monetization of the overall public sector deficit fueled inflation and exchange rate pressures.

Why was fiscal performance so poor? First, tax administration was weak, and government revenues, which depended strongly on international trade and domestic fuel taxes, were low and volatile. Second, public spending was highly discretionary and inflated by sizable public enterprise losses, large increases in wages and employment, and excessive public investment programs. Finally, corrective measures were frequently ineffective and lacked continuity.

But the 1990s saw a dramatic change, with public finances kept broadly under control despite occasional slippages, especially during election periods. The tax system went through two major reforms, in 1990–92 and then in late 2000. The first had to be comprehensive because the complex system had lost much of its ability to generate revenue as a result of high inflation in the late 1980s and in 1990. The reform gradually shifted the tax burden to the broad-based income tax and VAT, making the revenue base more stable and increasing its growth potential. As a consequence, total central government revenue rose from 12½ percent of GDP in 1990 to 16 percent in recent years, and the share of income tax and VAT revenue grew from about one-third in 1991–92 to almost one-half in 2000.

In the mid-1990s, tax reform slowed as the political climate became more difficult. But, after the 2000 presidential election, a deteriorating fiscal situation prompted the new administration to introduce a number of fiscal reforms. A new law converted the previous system of fuel price differentials into specific excise taxes (indexed to consumer prices), thus removing administrative discretion in setting domestic retail prices, and enabling a faster adjustment to changing international prices. The VAT rate was raised from 8 percent to 12 percent—closer to the average in Latin America—and its base was enlarged to include a number of services previously subjected to specific taxes. Selected excise taxes were also increased, and a minimum tax on gross sales was introduced.

Besides taking steps to reform the tax system, the authorities have made great strides in improving tax administration, such as merging the administrative agencies for domestic taxes and automating the customs administration. Tax administration is still hampered, however, by the existence of numerous small taxes and fees that generate little or no revenue.

Recently, the authorities have begun to reform the budget process, which still lacks transparency and accountability. At the end of 2000, the congress approved a technical cooperation loan from the Inter-American Development Bank to finance the Integrated Financial Management Program. To strengthen policy formulation and improve budget monitoring, policy decisions will be centralized, but the operational execution will be decentralized in the relevant public agencies.

Stronger monetary, financial policies

On the monetary front, traditionally the country has been hampered by limited central bank autonomy and a heavily managed exchange rate regime. The attempt to reconcile multiple objectives (concerning inflation, output growth, interest rates, and official reserves) led the monetary authorities, in the past, to freeze banks' excess reserves and impose credit ceilings. Gradually, the central bank has shifted toward a more market-oriented management of domestic liquidity by issuing certificates, which are its main instrument for controlling liquidity in the financial system.

The authorities have also put in place major reforms to strengthen the banking and financial system and eliminate distortions in credit markets. In the early 1990s, they liberalized interest rates, rationalized reserve requirements, and abolished selective portfolio requirements. The authorities have also improved banking supervision and prudential regulation. The Superintendency of Banks was restructured and modernized; norms on capital requirements were reviewed; rules on provisioning were clarified to ensure enforcement; and limits on lending were established to minimize concentration risk.

As the authorities enforced the new prudential regulations, some weaknesses of the financial system came to light. Insolvencies led the central bank to intervene in support of troubled institutions, a number of which were either merged or liquidated. Although these measures have helped improve the financial soundness of the banking system, the authorities recognize that in the rapidly changing financial conditions of today's capital markets, they cannot afford to be complacent. The authorities have thus volunteered to participate in the IMF and World Bank's Financial Sector Assessment Program (FSAP)—basically a health check of the country's financial system—and will continue to work toward bringing prudential norms and accounting practices closer to international standards.

Outward orientation

On the external front, the persistent and severe balance of payments deficits in the 1980s prompted the authorities to rethink their import-substituting development strategy. For many years, the Dominican Republic, like many other Latin American countries, had a system of multiple currency practices, foreign exchange restrictions, surrender requirements, import prohibitions, high import duties with discretionary exemptions, and export controls intended to foster domestic import-substituting industries. This system reinforced distortions in domestic markets, under-

mined the development of the export sector, and encouraged rent-seeking activities and, in some cases, outright corruption.

During the 1990s, the authorities began an important streamlining of the tariff system, with the process still under way. Effective January 1, 2001, the number of tariff bands was reduced from nine to five, and the maximum tariff rate was lowered from 35 percent to 20 percent. Further reductions are planned for 2002. Most import quotas, import licensing requirements, and import prohibitions have been eliminated, and export taxes have been abolished. However, some restrictive and interventionist elements have survived, including quotas (approved by the World Trade Organization (WTO)) on eight basic consumption goods and surrender requirements for selected exports of goods and services. Furthermore, although a freely determined interbank exchange rate was introduced in January 1991, the exchange market is still segmented, and large spreads between official and market exchange rates have occasionally emerged—at present, the spread is less than 2 percent.

As part of the outward reorientation of trade policy, the Dominican Republic has actively promoted closer formal trading relations in the region (Free Trade Area of the Americas, Caribbean Common Market, Central American Free Trade Area) and with the rest of the world. Its accession in March 1995 to membership in the WTO provided a particularly strong incentive to accelerate trade liberalization and pass new legislation, including on foreign investment and telecommunications. The Dominican Republic enjoys important preferential access to the U.S. market through the generalized system of preferences and the Caribbean Basin Initiative, which was introduced in 1984 to promote trade relations and foreign investment between the Caribbean and the United States. It also benefits from preferred access to the European Union through the Lomé Convention and its successor agreements. In October 2000, the Dominican Republic was granted parity with Canada and Mexico for access to U.S. markets. This is expected to give another boost to textile exports, in particular, which have faced strong competition from Mexico. However, negotiations between the United States and other countries for parity under the North American Free Trade Agreement may erode these competitive gains over time.

Better governance

As the Dominican Republic opens its doors further to the global economy, it will need to be able to compete with other countries, especially its Latin American neighbors, for foreign investment. Good governance will be vital for this goal, as well as for economic stability, high-quality growth, and the implementation of further reforms. Achieving good governance entails guaranteeing the rule of law; promoting the accountability, efficiency, and transparency of the public sector; and tackling corruption. According to the International Country Risk Guide, the Dominican Republic compares favorably with other Latin American countries in their indices for government stability, corruption, and law and order. It ranks the same in terms of democratic accountability as the average for other Latin American countries, whereas it compares less well on the quality of its bureaucracy.

Despite this favorable ranking, a key challenge for the Dominican authorities in the coming years will be to make policy design more transparent. To enhance fiscal credibility and permit a comprehensive assessment of the government's financial position, they will need to improve transparency in public sector operations, especially the execution and control of government expenditure. The central bank needs to be given more autonomy to improve transparency in monetary operations and, as is already happening, increase its reliance on indirect monetary instruments. Full unification of the exchange markets would also eliminate an important impediment to efficient resource allocation. These measures will help make the financial system deeper, sounder, and more resilient.

Financial deepening is fundamental to promoting domestic saving and channeling it toward the most productive investments. To this end, the Monetary and Financial Code and the Capital Markets Law would strengthen the institutional setting, promote competition, and enhance transparency in financial and securities markets. Reform of the social security system would provide additional stimulus to financial deepening. Besides improving the quality and effectiveness of social services, reforms should aim to promote private sector involvement through the development of privately managed pension funds. In addition, more competitive markets are crucial to fostering economic growth and development. The Market Order Code aims to remove impediments to competition in domestic markets for goods and services by establishing antitrust and unfair competition measures, protecting consumer rights, and regulating copyright and intellectual property rights.

In sum, the Dominican Republic made tremendous strides forward in the 1990s and has great economic potential, which it can realize by continuing with its ample reform agenda and meeting the various challenges described above. Given its past successes, the future looks quite promising. ■

Alessandro Giustiniani and Philip Young
IMF Western Hemisphere Department

For more information about the Dominican Republic's economy, see the forthcoming Occasional Paper, entitled *The Dominican Republic: Stabilization, Reform, and Growth.*

As the Dominican Republic opens its doors further to the global economy, it will need to be able to compete with other countries, especially its Latin American neighbors, for foreign investment.

Interview with Keen and Mani

IMF team keeps an eye on linkages between environment and macroeconomic policies

Next year in Johannesburg, world leaders will revisit the issues raised at the 1992 Rio Earth Summit on sustainable development and the protection of the environment. For more than a decade, IMF staff have been looking at the links between the environment and the macroeconomy. Michael Keen and Muthukumara Mani, Advisor and Economist, respectively, in the IMF's Fiscal Affairs Department and the current environmental team, explain why they are looking at the impact of climate change and resource depletion and how they are preparing for the Rio+10 Summit.

Mani: "On average, 60 percent of U.S. infrastructure is insured for natural catastrophes; in developing countries, less than 2 percent of the infrastructure is insured."

IMF Survey: To ask the first and most obvious question, why does the IMF—with its macroeconomic mandate—have an environmental team?

Mani: Environmental factors can affect macroeconomic performance, and macroeconomic policies can affect the environment. A country that has not dealt appropriately, and quickly, with serious environmental degradation, for example, risks harming its economic performance and growth. Degrading natural resources at an unsustainable rate can jeopardize export prospects, posing problems for the trade balance. Severe air and water pollution can drive up public health expenditures, with ramifications for the fiscal position. And tourism can suffer major setbacks from, say, coastal erosion.

IMF Survey: What prompted the IMF's interest in environment issues?

Mani: In 1991, the IMF's Executive Board allocated staff to work on environment-related issues. Growing environmental awareness in the mid- to late 1980s raised serious issues about the impact of economic growth on the environment. That prompted governments and international organizations to take a closer look at the link between economic growth and the environment.

When a United Nations commission in the late 1980s concluded that development strategies could indeed conflict with environmental sustainability, a number of international organizations, including the IMF, began looking at these linkages in greater detail. In the IMF, we took steps to increase staff awareness of environmental issues and the research being done outside the IMF.

We do not deal with environmental issues as directly as, say, the World Bank. The Bank's project loans can often have a direct impact on the environment and thus require environmental assessments. The IMF set up its environmental team chiefly to act as a resource for the rest of the organization.

IMF Survey: Isn't an issue like climate change, for example, well beyond the IMF's customary time horizon?

Keen: It may seem paradoxical that a crisis-oriented organization like the IMF should be thinking about a seemingly long-term issue like climate change, but we are already dealing with the impact of what may be a key aspect of climate change—an apparent increase in the frequency and the severity of weather events. Hurricanes, typhoons, floods, and droughts have posed major problems for some of our member countries. If these events are indeed becoming more frequent or more severe, we are not talking about distant or abstract considerations.

One element of our work is to think through what the macroeconomic implications of climate change might be. More frequent, and more destructive, weather events can shape the advice we provide to our member countries and could have an impact on our lending programs. We are planning to look at a Hurricane Mitch type of event and ask what policy instruments can be designed to allow countries to mitigate the impact of such disasters.

We want to look at the market failures that arise in connection with extreme weather events and ask whether the IMF has any role to play in this aspect of crisis prevention and management. Presumably, there are insurance market failures here, but it's not clear that we should simply envision an enhanced role for the IMF or any other kind of institution without addressing, for example, potential moral hazard problems.

Mani: Look at the past 10 years and countries like Honduras or Nicaragua. These economies were completely devastated by hurricanes. Their GDPs fell dramatically. If there are countries that are going to be hit more frequently, we need to take a fresh look at how they can better prepare themselves.

A key tool in this regard is insurance. On average, 60 percent of U.S. infrastructure is insured for natural catastrophes; in developing countries, less than 2 percent of the infrastructure is insured. That's a big difference, and the gap should be closed to help alleviate adverse economic effects.

Keen: Climate change is also likely to have regional and cross-border implications. Current scientific pro-

jections, for example, suggest that the food supply problems of sub-Saharan Africa will worsen. These countries should be looking for ways to deal with these shortages, and the IMF should be thinking about how it can help.

Then you have a country like Bangladesh, which, largely through no fault of its own, could be facing increasingly severe flooding. There could be an awareness-raising issue that the IMF may be in a position to help address.

IMF Survey: What are the implications of climate change for industrial countries?

Mani: Almost all the developed countries—the United States is the exception—ratified the Kyoto Protocol. If they follow through on their obligations by 2012, these signatories will have to reduce their carbon emissions, put in place carbon taxes, or buy carbon rights from developing countries.

Of course, climate change may have winners as well as losers. Current scientific projections suggest that some regions of the United States and Canada, for example, may see extended growing seasons as a result of global warming.

IMF Survey: You also mentioned resource degradation as an issue with macroeconomic implications….

Mani: A number of countries are degrading their resources in an unsustainable manner. In some cases, they are not pricing their resources appropriately, and in other cases these pricing problems are compounded by market, policy, and institutional failures. Countries that are pursuing IMF-supported reform programs often tackle much-needed macroeconomic measures like lib-

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eralizing trade regimes and/or devaluing exchange rates. But these steps may intensify resource degradation if the countries lack the market mechanisms to price resources properly or if their property rights regimes are inadequate. A country like Indonesia, for instance, had real issues about the optimal rate at which its timber resources should be used. That question, in turn, had long-term implications for soil degradation and other aspects of the economy. In a case like that, the IMF would like to make sure that adequate mechanisms are in place to correct for the market failures.

IMF Survey: **How does your team work with the IMF's area departments—the departments that work directly with member countries?**

Keen: Our team is essentially a resource for the IMF's area departments. We track the issues that arise in IMF consultations with member countries. Sometimes area departments approach us with a particular environmental issue, and we certainly encourage this. We have also developed a website for IMF staff. This contains country reports on environmental issues, analytic and factual material, and links to other international organizations.

NGOs [nongovernmental organizations] also contact us with environmental issues, and we raise these with area departments to see if the IMF-supported reform programs in these countries can be designed more effectively. These are complex issues, because they hinge upon the interaction between macroeconomic policy changes and various kinds of market failures. We are keen to have area departments think through these issues and can help them contact the appropriate staff at the World Bank.

Mani: The country environmental fact sheets we are developing—one-page documents listing various issues and problems—help identify the links between the macroeconomy and the environment in these countries. Our first priority is developing fact sheets for countries in which the environment is known to be a major issue. Eventually, we want to make sure all IMF country desks have a good knowledge of existing environmental issues in their countries and, in the context of IMF-supported programs, that they understand the links between IMF programs and the environmental situation there.

IMF Survey: **Are we in danger of overloading country economists if we ask them to evaluate environmental and macroeconomic issues?**

Keen: IMF country economists have an awful lot on their plate already, but clearly environmental considerations can figure into the IMF's core mandate of pursuing macroeconomic stability and sustainable growth. Our team wants to make it as easy as possible for country economists to pay a little bit more attention to aspects of the environment that may be critical for the macroeconomy. For example, perhaps more use can be made of environmental taxes to raise revenue as a part of a well-designed fiscal strategy.

Keen: "Our team wants to make it as easy as possible for country economists to pay a little bit more attention to aspects of the environment that may be critical for the macroeconomy."

IMF Survey: **How do the IMF and the World Bank cooperate on environmental matters?**

Mani: The World Bank is a lead organization on environmental issues, so it is important that the IMF make good use of the Bank's comparative advantage. The World Bank has sectoral and country-specific knowledge that can be of enormous value to the IMF's work. Also, the Bank recently adjusted its environmental strategy. It intends to strengthen the environmental assessment of its adjustment programs and poverty reduction strategy papers. We are working closely with the Bank to see how this new methodology or framework would affect our own work.

For the Johannesburg World Summit on Sustainable Development—the "Rio+10" meeting—next year, we are working with the Bank to produce a joint document on financing for sustainable development. The paper will identify various sources for development finance and carefully examine how environmental taxes and resource fees can be used for environmental protection.

Keen: The Rio+10 conference gives us a valuable opportunity to review our work on the environment. Many NGOs now understand that the environment is not a core part of the IMF's work and that the World Bank takes the lead there. They understand that the IMF is often in crisis management mode and may not always have the time or the capacity to think through all the complex linkages between macroeconomic policy and the environment. But civil society will doubtless call the IMF to account for what our policies have meant for the environment. And they do believe the IMF should be thinking carefully about how its programs interact with the environment. ■