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IMF–World Bank spring meetings

Ministers to explore ways to stoke recovery, prevent financial crises, and reduce poverty

Uncertainty about oil prices is one element fueling worries about the economic outlook.

For key financial and monetary officials meeting at IMF headquarters on April 12, the top priority will be finding ways to reignite the global economic recovery, which has been sputtering in recent months amid uncertainty surrounding military conflict in Iraq and its effects on oil prices, equity markets, and business confidence.

The seventh meeting of the International Monetary and Financial Committee (IMFC) will also focus on strengthening the international community's capacity to prevent and resolve the types of financial crises that have buffeted emerging market economies since the mid-1990s and on accelerating the fight against world poverty. The IMFC, which will be chaired by U.K. Chancellor of the Exchequer Gordon Brown, comprises 24 IMF Governors, who are finance ministers, central bank governors, or others of comparable rank representing the IMF's 184 member countries.

In its discussions of the global economy and financial markets, the IMFC is expected to focus on the outlook, risks, and needed policy responses. In introductory remarks to the IMFC, IMF Managing Director Horst Köhler is most likely to suggest the policy actions that member countries should take to ensure that a lasting recovery of growth can resume later this year. He is also expected to outline how the IMF can help Iraq rebuild its economy and lay the groundwork for recovery, and *(Please turn to the following page)*

Global Financial Stability Report

Markets poised for recovery, but uncertainty clouds outlook

The global financial system has remained resilient despite heightened geopolitical tensions and a hesitant and uneven global economic recovery, according to the latest issue of the IMF's Global Financial Stability Report. *The weakness of the recovery is due, in part, to the continued efforts of financial markets and the real economy to work off excesses in the wake of the bursting of the equity price bubble in 2000 and corporations' reluctance to boost capital spending. Investors' doubts about the pace of recovery in output and corporate earnings have weighed on mature equity markets, but high-yielding bonds, including those of emerging markets, have attracted investors seeking higher yields.*

Household balance sheets in the United States appear to have stabilized, U.S. corporate balance sheets have strengthened somewhat, and mature market financial institutions appear to be less hesitant to take on risk. Accommodative monetary policies in the major economies have helped institutional and retail investors build up sizable cash positions. Indeed, a partial mobilization of these cash positions in the *(Please turn to page 83)*

Uncertainty is also affecting stock market movements.

Ministers to weigh global outlook

(Continued from front page) help other member countries suffering the economic consequences of the conflict.

On the IMF's policy agenda, Köhler is likely to draw on reports to the IMFC on recent efforts to strengthen IMF surveillance and crisis prevention; ways of improving crisis resolution (including a concrete proposal for a sovereign debt restructuring mechanism for countries with unsustainable debt problems, as well as efforts to promote the adoption of collective action clauses in sovereign bonds, and proposals for a voluntary Code of Good Conduct); and on the implementation of initiatives to support low-income countries. The IMFC will also receive progress reports on combating money laundering and the financing of terrorism; IMF quotas and governance; the IMF's transparency policy; and the activities of the IMF's Independent Evaluation Office.

Ministers and other senior officials of the Group of 24, representing developing country members, will meet on April 11, under the chairmanship of Fuad Siniora, Lebanon's Minister of Finance. The meetings will conclude on April 13, with a meeting of the Development Committee, a joint committee of IMF and World Bank Governors. It will be chaired by Trevor Manuel, South Africa's Finance Minister. Besides joint IMF–World Bank reports on poverty, debt relief, and money laundering and terrorist financing, ministers are expected to review reports detailing progress to date in achieving the Millennium Development Goals and on enhancing the voice and participation of developing and transition countries in the Bretton Woods institutions. ■

More funds for Latin America

On March 21, the IMF approved a 13-month, $205 million loan for Ecuador to support its reforms through March 2004. That action makes $41 million available immediately. The IMF also approved the authorities' request to extend by one year the repayment schedule arising from an April 2000 loan.

On March 19, Argentina received an additional $307 million under the seven-month, $2.98 billion loan approved on January 24.

The IMF announced on March 18 the release of a $303 million credit installment for Uruguay. It also extended financial assistance by one year, until the end of March 2005, and agreed to shift about $178 million in repayments scheduled for this year to 2004. Uruguay's loan agreement was initially approved in March 2002 in the amount of $823 million and was increased by $1.6 billion in June and by another $521 million in August 2002.

With regard to other Latin American economies, the IMF completed on March 14 the second review of Brazil's performance under the $31.4 billion loan approved last September. Completion of the review, the first since President Luiz Inácio Lula da Silva took office in January, provides Brazil with $4.1 billion in additional funds. After completing its annual assessment of Brazil's economy, the IMF praised the new government's decisive actions to deal with economic uncertainties and vulnerabilities but urged Brazil to set ambitious fiscal targets over the medium term to better shield its economy from external shocks.

For further information on these developments, please see Press Release No. 03/39 on Ecuador, Press Release No. 03/38 on Argentina, Press Release No. 03/37 on Uruguay, and PIN No. 03/38 and Press Release No. 03/36 on Brazil. All are available on the IMF's website (www.imf.org).

IMF seeks to improve external relations

On March 5, the IMF's Executive Board reviewed the organization's external communications strategy and concluded that a better public understanding of the IMF's work and enhanced credibility of its policies were key objectives—more so than increasing the IMF's popularity. Directors observed that, while the IMF's work is inherently controversial, efforts to improve understanding of, and support for, the IMF could succeed, even if modestly and incrementally.

Directors identified the following steps that would improve the IMF's image and relations with member countries and, therefore, its effectiveness.

- IMF material must be clear, coherent, and presented in plain English.
- Outreach and dialogue must go beyond informing and persuading interlocutors to include listening to and learning from them.
- The IMF's image and accountability can benefit from its willingness to learn from its experience and openly acknowledge its mistakes. But the IMF should also respond promptly and vigorously to biased or inaccurate media reports on the IMF and its activities.
- The reach of IMF communications can be broadened. The external website will continue to be developed, with a focus on the quality of information and the ease and speed of access.
- Efforts should be made to distribute print publications more widely, especially in developing countries and in languages other than English, including local languages and the most widely used international languages.

For the text of PIN No. 03/33 and the full text of the review of the IMF's communications strategy, see the IMF's website.

More reforms are needed in mature markets

(Continued from front page) fourth quarter of 2002 helped fuel a short-lived stock market rally, led to a narrowing of credit spreads on mature and emerging market bonds, and contributed to an increase in flows to emerging market borrowers.

Normally, a gradual strengthening of balance sheets in mature markets suggests the potential for a rebound in the real economy and financial markets once investor sentiment turns and the large pool of risk capital waiting on the sidelines is reallocated to risk taking. This potential, however, is currently being overshadowed by uncertainty about the course of the war in Iraq and its repercussions for growth and stability. Markets appear to have priced in a short and decisive war, but any adverse departure from this scenario would weaken confidence further. Even with a reasonably short and decisive military conflict, however, uncertainty may persist for some time, owing to the potential for continued geopolitical instability and tangible threats of terrorism. In addition, fundamental imbalances from the bubble period remain, despite recent progress.

Prolonged uncertainty associated with geopolitical conditions could, the *Global Financial Stability Report* cautions, extend the period in which cash is sidelined and strengthen the head wind against global economic recovery.

In mature markets . . .

The major financial markets have made some progress in correcting past excesses, but more needs to be done. The mature markets have benefited from the apparent stabilization of U.S. household sector balance sheets and the gradual improvement in the balance sheets of U.S. corporations (reflected in a sharp increase in the ratio of broad liquid assets to short-term debt).

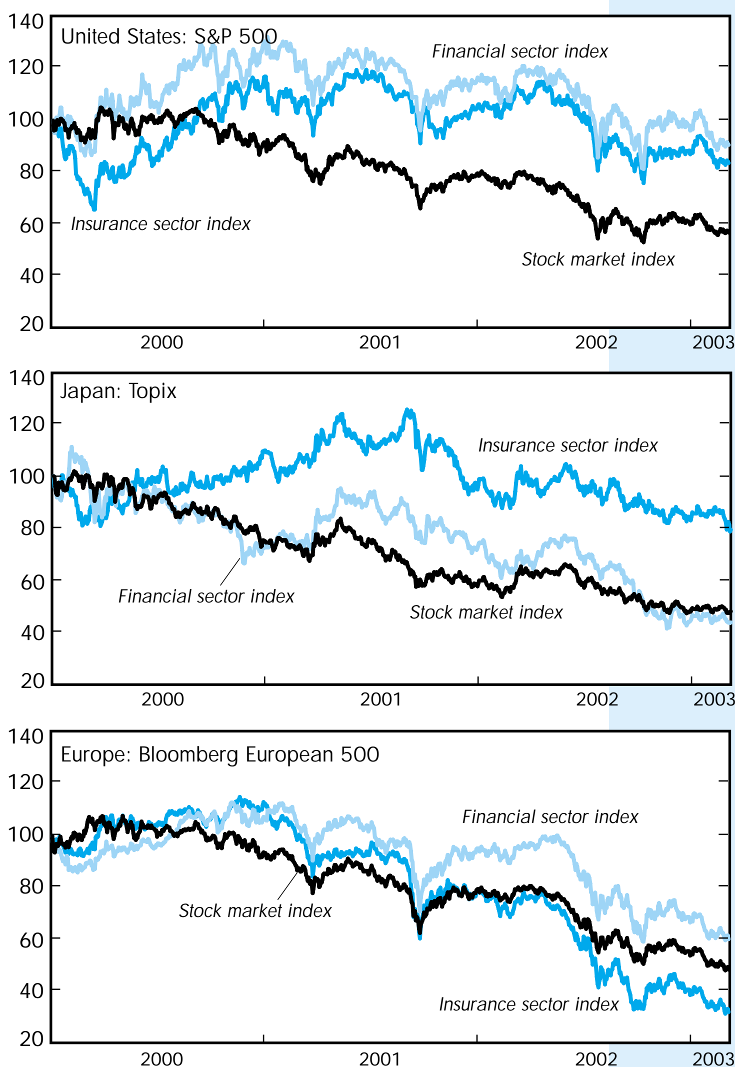
In addition, large internationally active banks have remained reasonably well capitalized and liquid and are not now likely to pose systemic risks. But a deteriorating global economy or further revelations of hidden corporate losses could pose problems for these banks. Most European banks appear to be well supported by the underlying earning power in their home markets. German wholesale banks, however, need to bolster their financial condition, and Japan's banking system has deteriorated in an environment of continued deflation and limited corporate restructuring, despite recent efforts to raise capital. Corporate and financial sector restructuring in Japan continues to be urgently needed.

The report advises paying increased attention to a number of matters, notably insurance companies, pension funds, exchange rates, and financial sector risks. It notes that some European insurance companies have been substantially weakened because of declines in equity and corporate bond prices (see chart, this page). Problems are particularly acute in the United Kingdom, Germany, the Netherlands, and Switzerland, where life insurance companies have reduced their equity holdings into declining markets to preserve their capital strength. And Japan's life insurance companies have been under intense pressure for some time.

Corporate defined-benefit pensions in the United States, the United Kingdom, the Netherlands, and Japan appear to be experiencing sizable funding gaps. Such gaps are likely to exist elsewhere in Europe as

Equity markets moved sideways on lower-than-expected corporate earnings

(January 3, 2000=100)



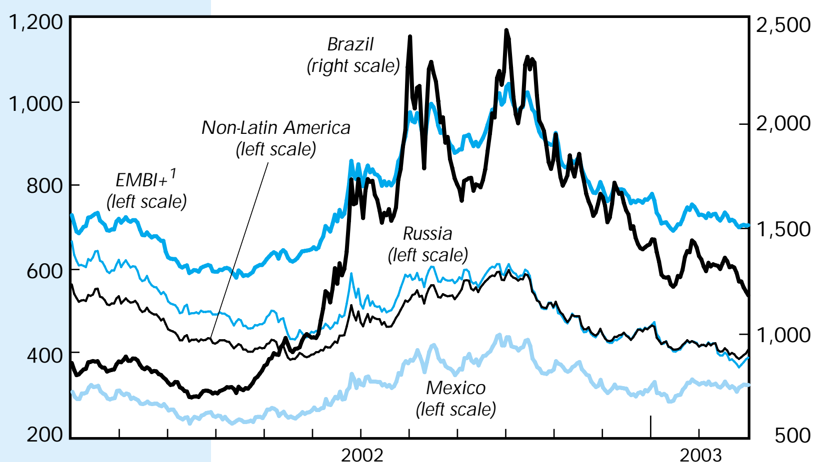
Data: Bloomberg L.P.

well. Until equity and corporate bond markets recover, these funding gaps are expected to weigh on corporate profitability and contribute to market uncertainty in estimating future earnings.

The U.S. dollar has weakened against major currencies, but its decline to date has been orderly and generally welcome, given the large U.S. external deficit. Still, a precipitous fall in the dollar cannot be ruled out, and the report cautions that this could have potentially destabilizing consequences, given substantial foreign holdings of U.S. financial assets.

Sovereign spreads in emerging markets differ by region

(basis points)



[1]Emerging Markets Bond Index Plus.

Data: J.P. Morgan Chase

Accommodative monetary policies and the accumulation of cash balances have helped improve balance sheets, and the sizable cash holdings can be deployed as uncertainties abate and investor sentiment improves. Yet this situation, too, calls for caution. Financial institutions have invested substantially in long-term U.S. treasury and agency securities and funded their investments with low-cost, short-term money. As most of these positions appear to be unhedged, some investors could face sizable losses when growth prospects improve and interest rates rise. Further heightening the risk is investor accumulation of large amounts of mortgage-backed securities, which, because of their embedded prepayment option, are more sensitive to interest rate changes than conventional bonds.

. . . and in emerging markets

The feast-or-famine dynamic of emerging market financing reasserted itself in 2002, as countries at the low end of the credit-rating spectrum—especially in Latin America—faced difficult access to capital markets and high funding costs (see chart, this page). An easing of global financial market conditions in the fourth quarter led to a reopening of capital markets to many, but not all, issuers.

In 2002, investor decisions were largely influenced by the sustainability of policies in individual countries, which contributed to considerable tiering by credit quality. For example, concern that a new administration in Brazil might not sustain existing policies contributed to mounting investor anxiety and rising credit spreads in the run-up to elections there. Initial cabinet appointments and the new government's policy pronouncements helped ease these fears, and investor sentiment toward Brazil subsequently improved markedly. Domestic borrowing costs remain high, however, and the bond spreads have not yet fallen to a level that permits renewed sovereign access to the primary market.

Financial markets continued to differentiate by perceived credit quality. Some Latin American countries faced high yield spreads, while Asian and Eastern European borrowers benefited from near record-low credit spreads. Asian markets, except for the Philippines, are supported by strong growth and other macroeconomic fundamentals, regional liquidity, and a solid investor base. Similarly, Eastern European countries attracted investor interest in anticipation of further credit upgrades stemming in part from their progress toward European Union accession. Investor confidence in Russia has continued to improve as a result of its strong fiscal position and growth performance, both of which have been aided by high oil prices.

Major emerging markets have also recorded a mixed performance in their banking sectors in recent years. Financial health indicators improved significantly in Europe's emerging markets, helped by considerable bank restructuring efforts and the entry of foreign banks in several of these countries. Asian banking sectors showed similar improvement, but progress has been slower and weaknesses have been persistent in some countries, mainly because of lagging bank and corporate restructuring. In contrast, banks in some Latin American countries remain distressed, with long-standing weaknesses aggravated by recent economic and financial turmoil. In other Latin American countries, banks have achieved stronger financial results, reflecting more favorable initial conditions and better economic performance.

Boosting market confidence

As financial markets and the real economy continue to work off the excesses of the bubble years, policies must stay focused on bolstering consumer, business, and investor confidence. Improved market confidence would allow financial conditions to strengthen gradually and support investment, which

would in turn underpin recovery in both financial markets and the real economy. Subject to geopolitical developments, confidence can best be enhanced, the report states, through continued sound macroeconomic policies and a flexible response to renewed signs of an economic downturn.

Both mature and emerging market countries need to take specific measures to address weaknesses and spur recovery. They should include the following steps.

Macroeconomic measures. The major economies' current accommodative monetary policies are appropriate and have facilitated a gradual improvement in the financial conditions of key sectors and a buildup in the liquidity positions of households and financial intermediaries. Specifically in Europe, the steepening of the yield curve would help financial intermediaries improve their earning power and ability to digest losses in various segments of their businesses. The report calls for more decisive action in Japan to reverse years of economic decline and falling prices.

Corporate and financial sector reforms. Japan urgently needs to renew corporate and financial sector reforms to allow its financial institutions to improve their earnings. Many Japanese financial institutions must address their loan-loss provisions more resolutely and their high cost base more generally, as well as strengthen their capital positions. In Germany, a better capitalization of small and medium-sized companies would help reduce the large loan-loss provisions on the balance sheets of financial institutions. More important, a number of financial institutions must improve their earning power and reduce bloated cost bases through consolidation. In Japan and, to a lesser extent, Germany, the general legal and regulatory framework needs to be adapted to support these restructuring efforts.

Insurance and pension funds. To foster a more stable insurance market in the mature economies, regulators must intensify efforts to encourage sounder asset-risk management at the micro level and to realign incentives, including regulatory rules for solvency and liquidity.

With regard to weaknesses in the funding of corporate pensions, falling equity prices underscore the need to address the long-standing mismatch between pension assets (typically tilted toward equity investments) and pension liabilities (whose behavior typically mimics that of a bond). For many large U.S. corporations, for example, the ratio of pension assets to market capitalization is more than 2 to 1; this illustrates a still-high degree of leveraging in the U.S. corporate sector, where companies are responsible for their pension obligations. A number of issues in pension accounting also warrant attention, notably using realistic actuarial assumptions to measure funding adequacy. Caution should be exercised, however, to avoid an immediate large drain on company earnings that could trigger a self-reinforcing decline in equity markets.

Corporate governance, accounting, auditing, and other investment banking practices. Improvements are under way in the United States and other countries, but the reforms must be sustained. Investors need to be reassured that they face a level playing field and will have access to full and accurate information on the health of publicly traded firms.

Unwinding of cash buildups. The recent buildup of cash balances requires vigilant risk management by private market participants to ensure that the mobilization of these balances and the unwinding of positions now encouraged by the steep yield curve occur in an orderly way. A speedy return of market confidence and risk appetite would expose a significant amount of unhedged long positions in the markets for long-term government securities, creating a potential for large losses. National supervisors should ensure that the risk positions of financial institutions in their jurisdictions—and those of their hedging counterparties, irrespective of location and business sector—are well managed.

Emerging market access and self-insurance. The feast-or-famine dynamic in emerging market financing and persistent credit tiering underscore the need for sound and sustainable macroeconomic policies to facilitate access to capital at reasonable cost. This need is all the more compelling now, as many sovereign borrowers continue to face unfriendly external financial conditions.

Many emerging markets are also taking additional measures to self-insure against volatile capital flows and asset prices. Most prominent is the effort to develop local securities and derivatives markets. These markets—especially local bond markets—have grown substantially over the past five years, but they have not yet developed enough to provide full insurance against the closure of banking or international markets.

The report encourages emerging markets to continue their development efforts, noting that they could eventually provide an alternative source of financing and help act as a buffer against changing global financial conditions. It also suggests a focus, in particular, on steps to strengthen market infrastructure, develop benchmarks and local institutional investors, and improve corporate governance and transparency. ■

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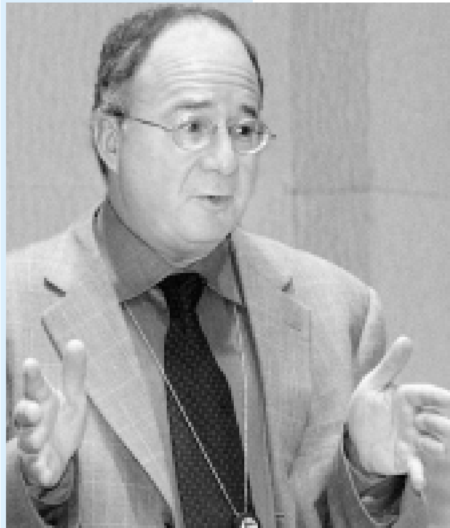
Copies of *Global Financial Stability Report, March 2003* are available for $49.00 each ($46.00 academic rate) from IMF Publication Services. See page 93 for ordering information. The full text is also available on the IMF's website (www.imf.org).

Interview with Bordo and Jeanne

Is "benign neglect" the right response to asset price booms?

Over the past two decades, monetary policymakers in many countries have achieved general stability in the prices of goods and services, as measured by consumer price inflation. At the same time, however, stock and property prices have experienced enormous boom-busts. Like the 1920s stock market boom and the 1929 crash, these wide price swings have had serious economic repercussions, including slowdowns in growth and, in some cases, recessions and deflation, most markedly in Japan following the bursting of its asset price bubble of the 1980s. Can monetary authorities manage the consequences of asset market busts more successfully? And what role, if any, should they play in trying to prevent future asset price boom-busts? In a new IMF Working Paper, Michael D. Bordo of Rutgers University and Olivier Jeanne of the IMF's Research Department consider these issues and speak to the IMF Survey *about their findings.*



Bordo: "We believe that financial stability is an important policy issue that should not be treated as independent of overall macroeconomic stability."

IMF SURVEY: What are the main features of recent asset price booms and busts?

BORDO: We looked at asset price boom-busts in 15 OECD countries since 1970 and found a considerably lower incidence of stock market boom-busts than property price booms and busts. Out of 24 boom episodes in stock prices, only 4 were followed by busts: Finland (1989), Italy (1982), Japan (1990), and Spain (1990). Out of 20 booms in property prices, 11 were followed by busts. Thus, the probability of a stock market boom leading to a bust was 17 percent, but the probability of a property price boom leading to a bust was 55 percent. According to our measure, the United States, as a whole, never experienced a boom-bust in property prices. Such boom-busts tend to be more prevalent in small countries where the real estate market is more concentrated in the capital or major cities. We also found that banking crises tended to be associated with asset price boom-busts.

We also looked at the behavior of consumer price inflation, the output gap, and domestic credit during the boom-bust episodes. All three variables declined with, or following, the bust. This, we suggest, provides evidence that asset price boom-busts have significant and deleterious effects on the macroeconomy.

IMF SURVEY: Should central banks be concerned about stock and property price inflation as well as inflation in the price of goods?

JEANNE: This question increasingly preoccupies central bankers—rightly so in our view, after the Japanese experience of the 1990s and the recent slide in stock markets worldwide. Our answer is that, yes, in principle, there might be circumstances in which central banks should respond to asset prices and, more specifically, should restrict monetary policy preemptively in an asset price boom.

The right way to think about this question, we believe, is in terms of insurance. Restricting monetary policy in an asset market boom can be viewed as insurance against the risk of real and financial disruption induced by a later bust. This insurance obviously does not come free: restricting monetary policy implies a sacrifice of immediate macroeconomic objectives. But letting the boom go unchecked entails the risk of even larger costs down the road. It is the task of the monetary authorities to assess the relative costs and benefits of a preemptive monetary restriction in an asset price boom.

Some argue that monetary authorities should adopt a wait-and-see attitude and deal with the real and nominal consequences of a crash if and when one occurs, in the same way the authorities respond to other demand or supply shocks. But there is an important difference between external shocks and financial crises. Financial crises, unlike earthquakes, are in part inherent to monetary policy. Their severity is determined by the imbalances that build up in the boom phase, which, in turn, depend on the more or less accommodating stance of monetary policy. As a matter of logic, it is not optimal for the monetary authorities to ignore the risks inherent in their own actions.

IMF SURVEY: But it is difficult to assess whether an asset market boom will end up in a bust. Should this deter monetary authorities from restricting monetary policy preemptively?

JEANNE: It is a difficult task, but it should not deter the monetary authorities from trying. Obviously, this assessment must be based on an estimation of probabilities—we cannot demand that the authorities exhibit a significantly higher degree of prescience than the market. But taking again the insurance perspective, it seems clear that uncertainty about the sustain-

ability of the boom is not in itself a reason for inaction—no more than a homeowner needs to be certain that his house will burn to take out fire insurance.

Of course, the monetary authorities may choose not to restrict monetary policy preemptively in an asset price boom. This would be the case, for example, if the monetary restriction required to contain the asset price boom were too severe. It is not a good idea to generate a recession now to reduce the risk of a recession later! This would also be the case if the problem can be better dealt with by other policies, such as banking and financial regulation. For example, raising the interest rate in response to a real estate boom may not be a good idea if the problem can be dealt with through more targeted measures in the mortgage market. So, inaction may sometimes be the best course of action, but this is not a justification for inattention. One should not take for granted that, as a rule, monetary authorities should ignore developments in asset prices and focus exclusively on inflation in the prices of goods.

IMF SURVEY: There is a growing debate about the links between monetary policy, asset prices, and financial stability. Where do you stand?

BORDO: The consensus view—presented in several papers by Ben Bernanke and Mark Gertler, and nicely summarized in a recent speech by Bernanke, in his new capacity as a Governor of the U.S. Federal Reserve—is that benign neglect is the preferred course. This view holds that asset price booms do not need the special attention of the monetary authorities. If the authorities follow the conventional inflation targeting approach based on the Taylor rule (where the interest rate is set as a function of deviations of forecasted inflation from its target and the output gap), asset price run-ups—to the extent they are captured by the inflation forecast and the output gap—will be offset by setting interest rates according to the rule. Moreover, if asset price busts do occur, they can easily be handled by reactive, lender-of-last-resort policy. A variant of this view by Stephen Cecchetti, Hans Genberg, and others says that, in the event of an asset price bubble, the central bank might want to explicitly incorporate asset prices into its policy reaction function.

Photo credits: Christian Charisius for Reuters, Page 81; Chip East for Reuters, page 81; Pawel Kopczynski for Reuters, pages 85; Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 86–87, 94–95; Cynthia Mar for the World Bank, page 89; STR for Reuters, page 89; Georges Gobet for AFP, page 91; and Claro Cortes IV for Reuters, pages 95–96.

Andrew Crockett, General Manager of the Bank for International Settlements, and Claudio Borio and Philip Lowe, economists there, oppose this view. They see asset price booms as a symptom of a fundamental macroeconomic imbalance common to episodes of stable prices, such as prevail today. In such an environment, credit booms can arise that will inevitably be followed by busts. This view holds that such booms, and especially asset price run-ups, should be dealt with through tight monetary and regulatory policy before they lead to a bust.

We place ourselves between these two positions. We see asset price boom-busts as low-probability events that can produce serious real consequences when the bust occurs. This, we argue, makes the case for preemptive policy in very special circumstances when it can be ascertained with a reasonable probability that the benefits of preemption (in terms of preventing a future costly bust) outweigh the costs of killing the beneficial effects of the boom (to the extent that it is a real productivity boom). When to do this, as Olivier mentioned, is a difficult empirical question. We feel that this issue should be addressed and resources should be devoted to doing so. We also believe that financial stability is an important policy issue that should not be treated as independent of overall macroeconomic stability.

Jeanne: "Restricting monetary policy in an asset boom can be viewed as insurance against the risk of real and financial disruption induced by a later bust."

IMF SURVEY: What is the optimal monetary stance in an asset market boom?

JEANNE: This question is much more difficult to answer in practice than in theory. In theory, the monetary authorities should weigh the cost of the monetary restriction to their immediate macroeconomic objectives against the benefits of reducing the risk of a crisis later. But what does this mean in practice?

In our paper, we explore the implications of this general principle in a very stylized two-period model. The model looks at an economy in which investors believe in the "New Economy" (a high rate of productivity growth) but still attribute some probability to an "Old Economy" scenario with lower productivity growth. If it turns out that the New Economy is an illusion, there is a market crash. The question is how the monetary authorities should respond to this situation in the boom phase, when it is still uncertain whether a crash will occur.

Although the model is quite simple, we find that the optimal monetary policy depends on economic conditions in a complex, nonlinear way. The preemp-

tive monetary restriction seems to be optimal for an intermediate level of market optimism—when the boom is already visible but before it has too much wind in its sails.

This simple example is special in some ways, but it suggests a more general lesson. The optimal policy cannot be described in terms of a basic rule. The circumstances in which a preemptive monetary restriction is warranted cannot be summarized in the standard macroeconomic indicators, such as inflation or the output gap. They involve imbalances in the balance sheets of the private sector, as well as market expectations.

Complexity is not a good reason to ignore the issue, however. Well, let me take that back. Maybe it's a good reason most of the time. But there might be times when the risks are too large to ignore. In other words, we are not saying that monetary authorities should routinely target the price of assets the same way that some central banks target consumer price inflation. But exceptional developments in asset markets may require occasional deviations from the rules that should prevail in normal times. That's true not only in a crash but also in a boom.

IMF Survey: Are your model's conditions for a proactive monetary policy met in the real world?
Jeanne: That's an important question that deserves further research; in other words, you won't find the answer in our paper! The evidence suggests that, historically, there have been many booms and busts in asset prices and that they are associated with a great deal of economic disruption. So this problem should certainly be of concern to policymakers. Calling for more research on this question is as far as we go in our policy recommendations.

Why didn't we go further in developing the practical implications of our analysis? To a large extent, the reason is technical. We would need to simulate and compare alternative monetary rules in realistic models of the economy. And we think it is important for these models to involve the kind of nonlinearity and low-probability events that we emphasize in our study. Now, this raises serious technical difficulties: nonlinear dynamic models are technically challenging. To be realistic, the models cannot be too simple, and even simplistic models can give rise to very complex dynamics once they are nonlinear. However, nonlinearity seems difficult to abstract from when it comes to financial crises, so some ways must be found to solve or circumvent these technical difficulties. We hope our paper will encourage more research on this.

IMF Survey: And other implications for policymaking?
Jeanne: We believe that our analysis has important implications for monetary policy. It suggests flexibility is needed to account for extreme events and especially severe financial instability. We see these as nonlinear events that cannot simply be dealt with by the conventional inflation targeting framework followed by most advanced countries. We see financial stability as a potential Achilles' heel for the current central bank paradigm, and we caution against complacency by central bankers who may believe that inflation targeting is all they need to do. ■

Copies of IMF Working Paper No. 02/225, "Monetary Policy and Asset Prices: Does "Benign Neglect" Make Sense?" by Michael D. Bordo and Olivier Jeanne, are available for $15.00 each from IMF Publication Services. See page 93 for ordering information. The full text is also available on the IMF's website (www.imf.org).

Available on the web (www.imf.org)

Press Releases

03/34: Statement of IMF Managing Director on the Assassination of Serbian Prime Minister Djindjic, March 12

03/35: Participation of Banco Central de Chile in the New Arrangements to Borrow, March 13

03/36: IMF Completes Second Review of Stand-By Credit with Brazil, Approves $4.1 Billion Disbursement, March 17 (see page 82)

03/37: IMF Completes Second Review, Extends and Modifies Uruguay's Stand-By Credit Arrangement, March 18 (see page 82)

Public Information Notices

03/29: IMF Concludes 2002 Article IV Consultation with Costa Rica, March 7

03/30: IMF Concludes 2002 Article IV Consultation with the United Arab Emirates, March 11

03/31: IMF Concludes Discussion on Recent Economic Developments and Regional Policy Issues with the West African Economic and Monetary Union, March 12

03/32: IMF Concludes 2002 Article IV Consultation with Israel, March 13

03/33: IMF Reviews Its External Communications Strategy, March 14 (see page 82)

03/34: IMF Concludes 2002 Article IV Consultation with Norway, March 18

Speeches

"Sustaining Global Growth and the Way Forward for Latin America," Horst Köhler, IMF Managing Director, at the Bank of Spain, Madrid, March 11

Köhler meets with parliamentarians

On March 9–10, 140 members of parliament from around the world gathered in Athens for the fourth annual conference of the Parliamentary Network on the World Bank—a group formed to help the international organization and parliamentarians understand each other better. This informal network of about 400 legislators in 60 industrial, developing, and transition countries focuses on development issues in general and the work of the World Bank in particular. This year, however, the network's members wanted to hear from the Bank's sister organization as well. In response to an invitation, IMF Managing Director Horst Köhler addressed the meeting and participated in a question-and-answer session.

The Athens meeting of legislators, which also drew participants from nongovernmental organizations and think tanks, focused on a range of development-related issues—including trade, aid, and the Millennium Development Goals—and the role of parliaments in identifying and implementing more effective solutions. There was a general feeling that parliamentarians could play a bigger role than they had in the past. But participants voiced their frustrations, too, commenting on a lack of information about country negotiations with the World Bank and the IMF and complaining that executive branches typically did not share information, especially on the budget. (Several legislators, in fact, appealed to the heads of the Bretton Woods institutions for help in getting more access to information from their governments.) Developing country parliamentarians also noted that their small staffs and scant resources made research and analysis difficult and prevented them from playing a more effective role in complex policy debates.

Listening and learning

Köhler's active participation in the Athens meeting is in keeping with recent IMF efforts to reach out to parliamentarians and engage in two-way exchanges of views. The IMF recognizes that, in all democratic countries, parliaments are asked to pass budgets and approve major economic reforms, notably those undertaken in the context of IMF-supported adjustment programs. More dialogue between the IMF and parliaments helps the IMF better understand country constraints and enables legislators to better appreciate the trade-offs implicit in economic policy choices.

In his remarks, Köhler stressed that the IMF is a learning institution. It has no illusions, he said, that it holds all the answers to globalization's many challenges. He also called upon parliamentarians and others not to discount the goodwill of the institution and its staff.

In an hour-long question-and-answer session, Köhler fielded queries and comments on a range of topics. A Ugandan parliamentarian complimented the Managing Director on his frankness and commitment to a "more flexible, learning IMF." But what you say, he noted, does not correspond with reality. He cited an example of his own government's telling parliament that a specific offer of grant aid could not be accepted for HIV/AIDS because the IMF viewed it as a risk to macroeconomic stability. That simply is not true, Köhler said. He observed that governments, for reasons of their own, often used the IMF as a scapegoat.

Others wanted to know why, in times of crisis, the IMF appears to focus on fiscal deficits, when citizens want improved conditions. Specifically, one legislator asked if there was a disconnect between the IMF's insistence that Brazil maintain a large primary surplus and the wishes of the people who elected Lula da Silva to deliver on social programs. Köhler said he was deeply impressed with Brazil's new president; Lula da Silva understands that sound institutions, the rule of law, and macroeconomic stability are important. The challenge for Brazil, Köhler said, will be to restore economic growth with social equity. The country can rely on the IMF's support during these difficult times.

More broadly, other legislators wondered how the IMF took into account political realities facing countries. There is no one-size-fits-all approach to problems, Köhler emphasized, and too often political reality is used as an excuse for lack of political will or action. There must be an appropriate balance, he said, between the IMF's willingness to listen to a country and to take into account practical constraints, and a country's political will and commitment to tackle reforms.

Monica Frassoni, Member of the European Parliament, chaired the session with the IMF's Managing Director.

Köhler also expressed sympathy for the widely expressed complaint that parliamentarians were often asked to pass budgets with little hard data on which to base decisions. He urged legislatures to press executive branches to adopt the IMF's Code of Good Practices in Fiscal Transparency. Transparency is vital for good policymaking, he said, but so, too, is responsible legislating. Parliamentarians need to consider the wider and longer-term economic implications when they vote to increase spending.

Sabina Bhatia
IMF External Relations Department

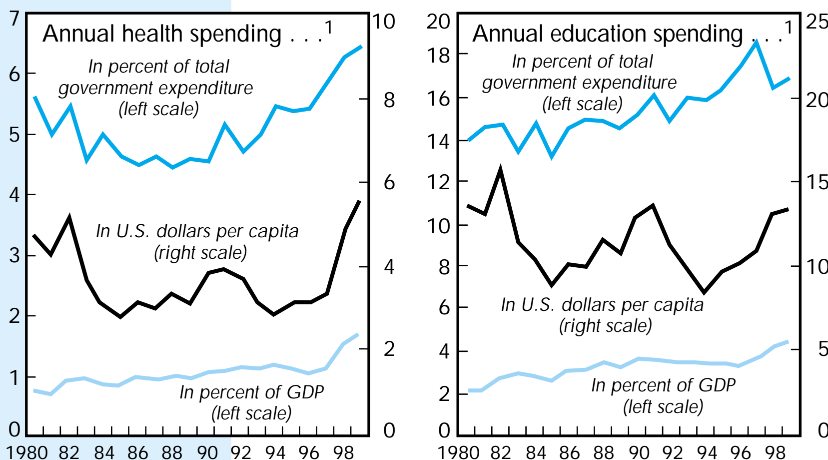
The videotaped sessions of portions of the Athens annual conference are available on the Parliamentary Network on the World Bank's website (www.pnowb.org). The text of Horst Köhler's remarks, as prepared for delivery, is available on the IMF's website at imf.org/external/np/speeches/2003/030903.htm.

IMF Working Paper

Higher shares of social spending do not guarantee better social conditions in sub-Saharan Africa

Sub-Saharan Africa remains one of the poorest regions of the world, showing little improvement in average living standards despite decades of financial and technical assistance. Increasingly, the focus of international development assistance to sub-Saharan Africa has shifted to improving social conditions, leading to greater interest in government spending policies and how they affect social priority areas. In a recent IMF Working Paper, Paulo Silva Lopes (Senior Economist, African Department) analyzes trends in regional social indicators and their correlation with measures of government spending and discusses underlying policy implications.

Some social outlays appear to be rising but show considerable volatility



[1]Excluding Mauritius, South Africa, and Seychelles, where considerably higher levels of social spending distort typical trends for sub-Saharan African countries.

Data: World Bank, *World Development Indicators, 2001*; and IMF, *Government Finance Statistics, 2001*, and World Economic Outlook database

In the mid-1990s, international development assistance to sub-Saharan Africa began to address social priorities more explicitly. While continuing to emphasize policies designed to generate growth and correct financial imbalances, the IMF, too, has acknowledged poverty reduction as the central objective of policy, to which growth is the key. Particularly since the establishment of its Poverty Reduction and Growth Facility in 1999, the IMF has begun encouraging African countries to pay closer attention to the composition of government spending and to expand or at least preserve shares of social spending in their budgets from year to year. Although usually a step in the right direction, this approach cannot guarantee that actual spending will be adequate to improve social conditions in a meaningful way.

"A Comparative Analysis of Government Social Spending Indicators and Their Correlation with Social Outcomes in Sub-Saharan Africa" supports the case for increased scrutiny of social spending in the region by highlighting actual connections between social spending indicators and social outcomes using the most comprehensive data available for the region. The working paper also suggests some policy responses that are relevant not only for governments in the region but also for the international donor community in its role in supporting social programs.

How is social spending measured?

Identifying public spending that is truly social is a difficult exercise because there is no gauge of social merit that applies to every individual situation. Based on a functional classification of government expenditure, social spending is usually understood as funding for public health care, education, housing, and other social services. For most analytical purposes, social spending is therefore often proxied by budgetary outlays on health care and education, which tend to be the most representative and easily identifiable categories of such spending.

Social spending is usually measured in one of three ways: in U.S. dollars per capita, as a percentage of GDP, or as a percentage of total government expenditure. Each measure has both merits and shortcomings in its ability to gauge the adequacy of social spending. Per capita spending allows international comparisons of absolute spending; percentages of GDP give an idea of spending relative to the size of the economy; and shares of government spending—a more discretionary indicator—give some sense of policy direction and potential. But the policy assumption underlying the use of all these measures is that the higher the social spending, the better the social outcomes.

Higher spending, better outcomes?

Key health and education indicators in sub-Saharan Africa have generally improved over the past 20 years. For example, infant mortality declined from about 115 deaths per 1,000 live births in 1980 to about 93 deaths in 1999. In some areas, improvements have been more dramatic: illiteracy among youths aged 15 to 24 declined from 45 percent in 1980 to almost 23 percent in 1999; and the share of infants under 12 months who were immunized rose from 23 percent in 1980 to almost 59 percent in 1999. But there have been setbacks as well. For example, life

expectancy increased from almost 48 years in 1980 to about 50 in 1990 but then dropped to about 47 in 1999. This and other adverse developments in health and education indicators vary significantly between countries and are often associated with armed conflicts or HIV/AIDS.

Although the generally improving trends reflect the increasing access to social services in the region, it is not evident that access can be attributed primarily to more generous government social spending policies. If it could be, one would expect to see a parallel rising trend in social spending. Although the evidence is not as clear-cut, the trends in health and education spending appear to be rising over time (see chart, page 90), but with more or less volatility depending on the indicator. Interestingly, at the end of the survey period, all the indicators of social spending rose sharply, suggesting that the heightened emphasis on social spending in development assistance since the mid-1990s may indeed have led to greater social spending in sub-Saharan African countries. It is also possible that, as suggested by the higher frequency of data reporting in the more recent years, the greater interest in social expenditures may have led to their more comprehensive tracking and reporting.

Are social spending, outcomes linked?

To evaluate the relationship between social spending and social indicators in sub-Saharan Africa, the study relied on comprehensive regional data for 48 countries during 1980–99, looking for correlations between 10 social indicators (5 each for health and education) and each of the three measures of relevant government spending (in either health or education). The objective was to determine the relative raw explanatory power of the three specifications in terms of each of the three measures.

The results confirmed some correlation between social outcomes and social government spending in U.S. dollars per capita and in percent of GDP, but not in shares of government spending. Spending indicators were better at explaining education outcomes than health outcomes, but, with the exception of female secondary enrollment, none of the spending indicators was by itself very powerful in explaining social outcomes.

This should not come as a surprise given that social conditions depend on significantly more than current levels of social spending. The fact is that prevailing socioeconomic levels will determine social indicators in the immediate future more than any changes in social spending. Indeed, it may take a generation or longer for higher spending to have a significant impact on social indicators that cover individuals too old or handicapped to change their health or education status.

To improve the results, the study therefore controlled for national welfare, as proxied by income per capita in U.S. dollars. The addition of this variable confirmed the explanatory strength of the two specifications of government social spending previously shown to be more significant—that is, U.S. dollars per capita and percent of GDP. It did not statistically improve the specifications in terms of shares of government spending, which remained all but insignificant.

Schoolchildren in Côte d'Ivoire eat at a public school canteen. The government is aiming to provide each school with a subsidized canteen to improve literacy rates and child health.

What are the policy implications?

The econometric and survey results suggest that absolute levels of social spending matter the most for social outcomes and that budgetary allocations may be misleading. The lack of evidence that higher shares of government spending go hand in hand with better social indicators suggests that increasing such shares is helpful only to the extent that it results in an actual increase in absolute spending. This can be expected in a stable context of rising annual government budgets, which cannot be taken for granted in sub-Saharan Africa, where budgets are frequently affected by, for example, swings in commodity prices or variations in external assistance. Thus, policymakers should not treat rising shares of government spending as evidence that more resources are being channeled to priority social sectors or as a sign that social indicators can be expected to improve.

The recognition that absolute social spending allocations are paramount in determining social outcomes also has major implications for international assistance to sub-Saharan Africa, where many public social programs depend directly on financing from bilateral donors, multilateral agencies, or nongovernmental organizations. This dependency is all the more crucial since the decline in per capita external assistance to the region

in line with global reductions in aid budgets. According to the World Bank, total net official development assistance fell, on a per capita basis, from $36 in 1990 to $20 in 1999. Although spending has not fallen correspondingly, those reductions may have taken a toll, or may do so with a lag, on regional social indicators.

Against this background, donors deciding nominal assistance levels and their regional distribution should take into account alternative measures of social spending and their likely impact on social indicators. More generally, by considering alternative measures of social spending, government officials, donors, and other policymakers might gain useful insights that allow them to choose between competing social programs. For example, by understanding better how social indicators respond to changes in spending, they may be able to identify

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

Stand-By, EFF, and PRGF arrangements as of February 28

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina[1]	January 24, 2003	August 31, 2003	2,174.50	1,427.50
Bosnia and Herzegovina	August 2, 2002	November 1, 2003	67.60	36.00
Brazil[1]	September 6, 2002	December 31, 2003	22,821.12	18,256.90
Bulgaria	February 27, 2002	February 26, 2004	240.00	130.00
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Croatia	February 3, 2003	April 2, 2004	105.88	105.88
Dominica	August 28, 2002	August 27, 2003	3.28	1.23
Guatemala	April 1, 2002	March 31, 2003	84.00	84.00
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
Lithuania	August 30, 2001	March 29, 2003	86.52	86.52
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Romania	October 31, 2001	April 29, 2003	300.00	165.33
Turkey	February 4, 2002	December 31, 2004	12,821.20	2,892.00
Uruguay[1]	April 1, 2002	March 31, 2004	2,128.30	1,016.60
Total			**42,720.68**	**26,079.58**
EFF				
Indonesia	February 4, 2000	December 31, 2003	3,638.00	1,376.24
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	550.00
Total			**4,288.00**	**1,926.24**
PRGF				
Albania	June 21, 2002	June 20, 2005	28.00	24.00
Armenia	May 23, 2001	May 22, 2004	69.00	39.00
Azerbaijan	July 6, 2001	July 5, 2004	80.45	64.35
Benin	July 17, 2000	March 31, 2004	27.00	8.08
Cameroon	December 21, 2000	December 20, 2003	111.42	47.74
Cape Verde	April 10, 2002	April 9, 2005	8.64	6.18
Chad	January 7, 2000	December 6, 2003	47.60	10.40
Congo, Dem. Rep. of	June 12, 2002	June 11, 2005	580.00	160.00
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Ethiopia	March 22, 2001	March 21, 2004	100.28	31.29
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	January 12, 2001	January 11, 2004	108.00	58.50
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	September 19, 2005	54.55	49.00
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Rep.	December 6, 2001	December 5, 2004	73.40	49.96
Lao People's Dem. Rep.	April 25, 2001	April 24, 2004	31.70	18.11
Lesotho	March 9, 2001	March 8, 2004	24.50	10.50
Madagascar	March 1, 2001	November 30, 2004	79.43	45.39
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2003	51.32	12.90
Moldova	December 21, 2000	December 20, 2003	110.88	83.16
Mongolia	September 28, 2001	September 27, 2004	28.49	24.42
Mozambique	June 28, 1999	June 27, 2003	87.20	16.80
Nicaragua	December 13, 2002	December 12, 2005	97.50	90.54
Niger	December 22, 2000	December 21, 2003	59.20	25.36
Pakistan	December 6, 2001	December 5, 2004	1,033.70	689.12
Rwanda	August 12, 2002	August 11, 2005	4.00	3.43
São Tomé and Príncipe	April 28, 2000	April 27, 2003	6.66	4.76
Sierra Leone	September 26, 2001	September 25, 2004	130.84	56.00
Tajikistan	December 11, 2002	December 10, 2005	65.00	57.00
Tanzania	April 4, 2000	June 30, 2003	135.00	15.00
Uganda	September 13, 2002	September 12, 2005	13.50	12.00
Vietnam	April 13, 2001	April 12, 2004	290.00	165.80
Zambia	March 25, 1999	March 28, 2003	278.90	41.38
Total			**4,442.63**	**2,414.39**

[1]Includes amounts under Supplemental Reserve Facility
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Note: Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

implementation constraints, improve delivery strategies, or, in the case of the IMF, enhance program design. For sub-Saharan Africa, any such increased insight into how social conditions can be ameliorated can only help with the decisions that may, eventually, allow the region to overcome its harsh social realities.

Paulo Silva Lopes
IMF African Department

Copies of IMF Working Paper 02/176, "A Comparative Analysis of Government Social Spending Indicators and Their Correlation with Social Outcomes in Sub-Saharan Africa," by Paulo Silva Lopes, are available for $15.00 each from IMF Publication Services. See below for ordering information. The full text is also available on the IMF's website (www.imf.org).

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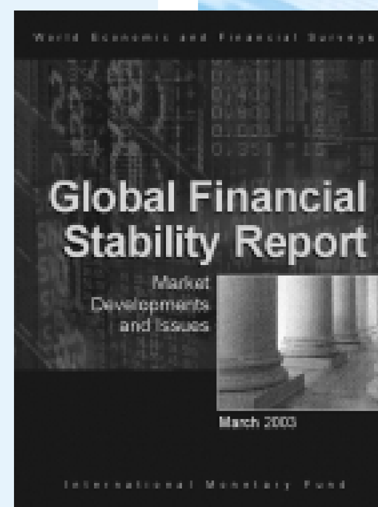
Global Financial Stability Report, March 2003 ($49.00; $46.00 academic rate)



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Interview with Ehtisham Ahmad

Recentralization in China?

A new administration in China will soon take up the reins of one of the world's most dynamic economies. But it will also confront rising disparities between its wealthy (and aging) and more backward (and more youthful) provinces and the growing urgency of addressing education, health care, pension, and industrial restructuring needs. Increased revenue, a rationalization of tax authority, and improved accountability will be key. In a recent IMF Working Paper, Ehtisham Ahmad and coauthors Li Keping, Thomas Richardson, and Raju Singh examined China's fiscal reform efforts over the previous decade and its future priorities. Ahmad talks to the IMF Survey *about why recentralization may also provide an effective strategy for decentralization.*

IMF SURVEY: The title of your working paper—"Recentralization in China?"—suggests several interpretations. Should it, can it, will it recentralize? Why is China weighing such a move?

AHMAD: Our title is a bit provocative. People tend to think of China as centrally planned with a monolithic administration. In fact, until recently, China has never really had a central tax administration. The center has traditionally relied on revenues transferred up from the provinces.

In the late 1970s and early 1980s, Deng Xiaoping initiated a series of reforms, including in the way provinces used retained revenues. These reforms initially gave local governments a lot of flexibility to invest resources, and some researchers credit this, in part, with spurring China's phenomenal growth. In aggregate terms, though, China saw a precipitous drop in the overall ratio of tax revenues to GDP from the early 1980s until the mid-1990s. Local governments had incentives to hang on to the money they collected. But the center realized that this severely compromised its ability to redistribute revenue among provinces. It also recognized that it had to develop levers to control the macroeconomic situation. So, in 1994, the country undertook major reforms that, for the first time, established a central tax administration. The reforms dramatically raised the center's share of revenues—to around 55 percent from 35 percent—and reversed the decline in the overall revenue-GDP ratio.

With its entry into the WTO, China will have to take an urgent look at its production-based VAT, which does not provide credits for the taxation of capital goods.
—Ehtisham Ahmad

IMF SURVEY: But your paper also suggests that the 1994 reforms left a number of issues unsettled.

AHMAD: The 1994 reforms did not go far enough. They helped stem the decline in total tax revenues but were essentially incremental. As part of a compromise, the center agreed that a significant, though declining, portion of the revenues would be returned to the provinces that generated them, and this solution left very little scope for real redistribution.

Also, significant expenditure responsibilities remained at the local levels. Traditionally, state-owned enterprises provided cradle-to-grave benefits, but as China modernized, responsibility for many of these services shifted to local governments. Most of China's educational and health care services, for example, are now delivered at the city and county levels, but the local governments have very little flexibility to raise additional revenues legally. They do not have the authority, for example, to increase tax rates within a specified range.

In addition, local governments—in most cases, cities and counties—are responsible for providing pensions and unemployment insurance. China does not have a national social security system, and there are significant risks in having a county try to provide unemployment insurance—especially if it has a concentration of enterprises that need to be restructured.

It makes greater economic sense for pension and unemployment insurance needs to be pooled at a wider level—at least at the provincial level. But if China is going to redistribute among provinces, it will also have to reassess appropriate expenditure responsibilities for the provinces. The coastal provinces in particular will want to keep their revenues if they retain responsibility for pensions.

IMF SURVEY: Does the argument for centralizing pensions and unemployment insurance hold for the delivery of health care and education?

AHMAD: Decentralized service delivery is appropriate, but the problem is ensuring an adequate level and quality of services when local governments lack the ability to collect needed additional revenues. Some governments have attempted to impose illegal nuisance fees and charges. These have led to considerable unrest in some rural areas and have spurred central government attempts to reform local taxation.

IMF SURVEY: In terms of tax reform, what do you think the government's approach should be?

AHMAD: Clearly, major decisions would be involved in reforming China's tax structure. The incoming administration will need time to think through these issues. Individual tax reforms would face difficulties because they would have a differential impact on the provinces. A more ambitious and well-sequenced reform may be needed to strengthen the country's investment climate—something that is critical to

providing for the welfare of 1.3 billion people over the medium term but also to ensuring sufficient resources for redistribution, meeting the minimum needs of pensioners, and offering provinces reasonably similar access to education and health care.

In 1994, the Chinese authorities did a very good job of reforming the revenue-sharing and transfer systems, but the center did not have the fiscal space to make regional redistribution work effectively. If China is to gain that fiscal space, it may need a more ambitious reform.

IMF Survey: Where does China start?

Ahmad: The key early decisions will be on the tax side. With its entry into the WTO [World Trade Organization], China will have to take an urgent look at its production-based VAT [value-added tax], which does not provide credits for the taxation of capital goods. This type of VAT places domestic producers at a disadvantage as the country complies with WTO requirements and removes tariff and nontariff barriers on competing goods. Moving to a consumption-based VAT is therefore a critical reform, but it will entail revenue losses in aggregate, with uneven revenue implications for the provinces.

China can opt to extend the VAT to cover services. This would raise revenue in the aggregate, although some provinces would gain and some lose as the business tax is removed. The increases in central revenue, however, should be sufficient to compensate the losers.

IMF Survey: Your paper also cites the need to rethink personal income and property taxes.

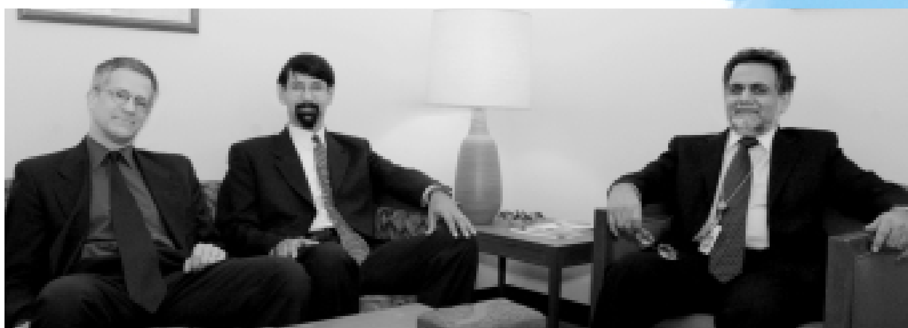
Ahmad: The 1994 reforms assigned the personal income tax to the provinces. The authorities have now recognized that the personal income tax is a potential major source of revenue, given rising incomes. In fact, since the first version of this paper was presented at the IMF's Conference on Fiscal Decentralization in 2000, the Chinese authorities have decided to share revenue from the personal income tax with the local governments.

However, sharing does not provide the provinces with any control, at the margin, over tax rates. Control is crucial if local governments are to become more accountable for the services they provide. It might be possible in the short term to allow the provinces to piggyback on the central tax or have some control over a portion of the total amounts. That would make them less dependent on either illegal fees or transfers from the center, which may or may not rise, and they would not find themselves with unfunded mandates that might lead to arrears or indirect borrowing.

Similarly, property taxes levied on a certain percentage of a properly assessed lease value could raise fairly substantial revenues, particularly for the large cities in the coastal region, and thus reduce the demand for revenue returns.

Such measures could serve a dual purpose—provide a little more fiscal space for the center to redistribute revenues to needy regions and individuals, and give local governments an incentive to be accountable for service delivery. This is the essence of effective decentralization.

Of course, accountability will also mean strengthening budget and treasury systems. China, like many transition economies, currently has a big program under way to set up a treasury system. That will take time, but the need is clearly recognized. In fact, since 1999, there has been a major shifting of gears. Chinese policymakers want assurances that public moneys are being spent for their intended purposes and that revenues collected are actually going into the treasury. This has been a major thrust of the outgoing administration. Zhu Rongji had been very tough on embezzling and cheating, but China has not had the instruments—the budget and treasury systems—to track the funds to spending agencies. This is beginning to be done through an array of well-thought-through and focused reforms. The bases for greater transparency and better governance are being laid now.



IMF Working Paper coauthors Thomas Richardson (left) and Raju Singh with Ehtisham Ahmad.

IMF Survey: And how does China begin to establish a national social security system?

Ahmad: China will have to make the link between social security reform and all the other intergovernmental reforms. Pooling pension funds at the provincial level is a start, but one that does not address the liabilities that Shanghai and the other rich provinces face. Many coastal provinces already have aging populations, and some provinces are now running arrears. A lot of work will need to be done, but some long-term efforts are already under way. For example, China has taken some of the proceeds from the sales of state-owned enterprises and reinvested them for future social security payments.

The authorities will still have to tackle structural reforms relating to expenditure assignments and

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taxation as well as transfer design, so that they can begin reforming the system of intergovernmental relations. There are linkages between several reforms, and while it is clear that China cannot move on all fronts simultaneously, it will be important for it to keep a medium-term goal in sight.

IMF Survey: **Are there pitfalls that China will need to be mindful of as it moves forward?**

Ahmad: The Chinese authorities have always carefully thought through their reform strategies. Any major reform has winners and losers, and balancing these will be the politically difficult part. But the interconnectedness of these measures suggests a sequencing of reforms together with some flexibility in the way that transfers are designed, so that there will be no major disruptions in incomes or production patterns.

The difficulty over the past few years has been impatience in the use of equalization transfers. There have been transfers for wage adjustments, and for western and underdeveloped regions. China could have better results putting everything through its overall equalization system, together with judiciously designed and monitorable special purpose grants. The issue remains whether the center will have the fiscal space to undertake redistribution. That may be feasible only if the country moves along several fronts simultaneously.

IMF Survey: **What has the IMF's role been in this reform process?**

Ahmad: The IMF has been seen as an impartial and valued advisor. It does not dictate policies but works with the authorities to assess particular issues and describe the pros and cons of alternate solutions.

In Shanghai, incomes and property values have risen, but so, too, has the need for revenue to meet the demand for health care, education, and other services.

In particular, relations between the IMF's Fiscal Affairs Department and its counterparts in the Chinese government have been exceedingly good. In the recent past, the department offered its advice in the context of a program that has provided technical assistance on tax policy and tax administration, budget and treasury, and intergovernmental fiscal relations. This program, financed jointly by UNDP and DfID, is coming to an end this calendar year, but there is a good chance it may be extended for a new term. In my view, compared with similar programs in other parts of the world, it's been phenomenally successful.

IMF Survey: **You are optimistic then?**

Ahmad: I am. China has some very wise and competent people. ■

Copies of IMF Working Paper No. 02/168, "Recentralization in China?" by Ehtisham Ahmad, Li Keping, Thomas Richardson, and Raju Singh, are available for $15.00 each from IMF Publication Services. See page 93 for ordering information. The full text is also available on the IMF's website (www.imf.org).

Members' use of IMF credit
(million SDRs)

	During February 2003	January–February 2003	January–February 2002
General Resources Account	**26.00**	**775.93**	**7,759.22**
Stand-By	26.00	773.00	7,483.98
SRF	1,141.06	9,044.73	13,240.71
EFF	0.00	0.00	275.24
CFF	0.00	0.00	0.00
EMER	0.00	2.93	0.00
PRGF	**0.00**	**0.00**	**50.72**
Total	**26.00**	**775.93**	**7,809.94**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
EMER = Emergency assistance programs for post-conflict countries and natural disasters.
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.
Data: IMF Treasurer's Department

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
March 17	1.76	1.76	2.25
March 24	1.75	1.75	2.24

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).

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

Data: IMF Treasurer's Department