

IMF SURVEY

International
Monetary Fund
VOLUME 33
NUMBER 20
NOVEMBER 8, 2004

www.imf.org/imfsurvey

De Rato advises Middle Eastern economies to diversify

In late October, IMF Managing Director Rodrigo de Rato wound up a four-day visit to the Middle East after consulting with policymakers in Saudi Arabia, Lebanon, and Egypt. During the visit, he also inaugurated the Middle East Technical Assistance Center (METAC) in Beirut (see box below). The center has been set up by the IMF to facilitate technical assistance to the region, especially to help meet the massive institution-building needs of countries like Iraq, Afghanistan, Sudan, and the West Bank and Gaza that have been suffering from conflict. Throughout the visit, he urged Middle East leaders to seize the opportunity provided by the global economic recovery and higher oil prices “to build stronger macroeconomic foundations and enlarge savings for the future generations, while at the same time creating an environment that promotes sustained economic growth and job creation by the private sector to meet the rapidly rising employment

needs.” He pledged the IMF’s readiness to work closely with all countries in the region to achieve these goals.

During the first leg of his trip, de Rato consulted with ministers of the six-nation Gulf Cooperation Council (GCC) in Jeddah, Saudi Arabia, where he wel-

comed the GCC’s firm commitment to help maintain stability in the oil market by increasing production in response to growing demand—a move, he said, that will help sustain the current global economic expansion.

In recent decades, the GCC countries have witnessed unprecedented economic and social transformation. Their improved financial positions, relatively low external debt levels, and modernized infrastructure, he said, “reflect positively on management of oil wealth and

show the fruits of opening borders to trade, capital, and labor.” The Middle East region—particularly the GCC countries—has also benefited *(Please turn to next page)*



IMF Managing Director Rodrigo de Rato (left) with Lebanon’s outgoing Minister of Finance Fouad Siniora in Beirut.

METAC to bolster region’s financial sector stability, modernize institutions

On October 25, IMF Managing Director Rodrigo de Rato and outgoing Minister of Finance of Lebanon Fouad Siniora inaugurated the Middle East Technical Assistance Center (METAC) in Beirut, Lebanon. The office—the IMF’s fifth regional technical assistance center—will serve Afghanistan, Egypt, Iraq, Jordan, Lebanon, Libya, Sudan, Syria, West Bank and Gaza, and Yemen. The center is being established to help countries in the Middle East strengthen their capacity for effective macroeconomic management and to support the region’s integration in the world economy. Targeted capacity building will be provided in areas such as public expenditure management, revenue administration, bank restructuring, banking supervision, and multisector statistics. The center will also help postconflict countries restore

macroeconomic stability and develop basic institutions for policymaking.

At the METAC opening, Siniora said that he saw the center as an opportunity for member countries to share successful experiences on macroeconomic and financial reforms and to work together to benefit from these experiences. De Rato noted that “the key role of IMF technical assistance is to transfer knowledge and experience that helps countries in the region strengthen their own ability to design and implement economic policies, promote financial sector stability, and modernize institutions.” The ultimate objective is to raise economic growth to “levels sufficient to meet the needs of a rapidly expanding labor force and to achieve real and sustained improvements in the standards of living,” he added.

At its first meeting on October 26, METAC’s Steering Committee reviewed the center’s preliminary work program. That program will be finalized in the coming months as assessments are made of country needs.

In this issue

313
De Rato visits
Middle East

315
Trade Research
Conference

317
Why globalization
works

319
Labor unions
hold dialogue with
IMF, World Bank

320
Tanzania legislators,
civil society meet
with IMF

321
Europe’s productivity

324
Asia and capital
flows

327
Market for
distressed debt

and...

322
Recent publications

326
New on the web

327
Selected IMF rates

from the recent global rebound, which has contributed to higher demand for oil and other exports.

“New challenges, however, are emerging,” de Rato cautioned. To deal with intensifying unemployment pressures, the GCC countries will need to achieve higher sustained growth in their non-oil sectors and reduce their financial dependence on volatile oil export receipts. He welcomed the authorities’ efforts to address these challenges by accelerating reforms. Increased regional integration, culminating in an efficient monetary union, would also strengthen the region’s economic prospects. Significant progress toward regional integration has already been achieved, he said, but “the road to monetary union will require intensified efforts to ensure political consensus on critical economic issues and development of relevant convergence criteria, common data standards, and development of relevant institutions.” GCC nations set up a unified customs union early last year, and plan a common market by 2007 and a single currency three years later.

Saudi Arabia: critical for region

Meeting with Saudi Arabia’s Crown Prince Abdullah in Riyadh on October 24, de Rato noted the important role that Saudi Arabia plays in ensuring oil market stability and in furthering economic progress in the region. He commended Saudi Arabia’s decision to increase oil production, take steps to boost capacity, and enhance coordination between producers and consumers.

De Rato also lauded Saudi Arabia’s role in providing economic and financial support to Iraq and other countries in the region. “The Kingdom’s support has been critical,” he said, “in achieving substantial progress toward regional integration, including the elimination of most barriers to the free movement of goods, services, capital, and national labor, and in fostering economic liberalization policies in other non-GCC countries, thus contributing to the sustained growth and stability in the entire area.” He encouraged Saudi Arabia to continue to play a leadership role in easing regional tensions, promoting policies that foster liberalization and integration, and helping Iraq strengthen its financial position and restore its place in the regional economy. “The Saudi government’s decision to consider debt relief for Iraq,” de Rato said, “would go a long way in improving that country’s economic viability.”

On the domestic front, Saudi Arabia has witnessed unprecedented economic and social transformation in recent decades. To help tackle rising unemployment, the authorities have taken steps to diversify the economy and improve private sector participation. But that strategy needs to be reinforced, de Rato said. “There is a need now to focus on the development of the private sector, particularly the growth of the

small and medium-sized enterprise sector to provide job opportunities for the growing Saudi workforce.”

Lebanon: reducing vulnerabilities

On October 25, de Rato traveled to Lebanon to inaugurate METAC, where he said that Lebanon had come a long way to reestablish itself as a thriving economy and as an important regional hub. In meetings with President Emile Lahoud, Speaker of Parliament Nabih Berri, Prime Minister-designate Omar Karameh, and outgoing Finance Minister Fouad Siniora, he underscored the IMF’s support for the significant fiscal adjustment achieved in recent years. But de Rato also underlined the need for further reforms to reduce the country’s public debt—which currently exceeds \$35 billion—mainly through further fiscal consolidation. “Efforts have to continue on the path of reforms,” he said, primarily with respect to long-awaited privatization projects.

Egypt: improving the business climate

De Rato visited Egypt on October 26 for the final leg of his trip, where he met with President Hosni Mubarak, Prime Minister Ahmed Nazif, Minister of Finance Youssef Boutros-Ghali, Central Bank Governor Farouk El Okdah, parliamentarians, and other senior officials. De Rato said he was greatly encouraged by their renewed commitment to liberalizing Egypt’s economy and to removing impediments to private sector growth (such as recent decisions to lower tariffs, cut taxes, and privatize public enterprises) and by their plan to restructure the country’s financial sector.

At the same time, de Rato encouraged Egypt to press forward with measures to spur growth and reduce unemployment. Sustained higher growth, he said, will require close integration into the global trading and investment community through continued opening up under Egypt’s multilateral and bilateral trade agreements. “Additional efforts,” he suggested, will be needed to “strengthen the climate for business and eliminate remaining impediments and restrictions.” Encouraging a further expansion of the private sector will, in turn, help meet the needs of Egypt’s rapidly growing labor force, where faster job creation will be necessary to reduce unemployment, particularly among youth. Among Egypt’s main challenges will be to contain the fiscal deficit and arrest the growth of public debt; to this end, de Rato urged the authorities to maintain a prudent fiscal policy in the short and medium term. ■

The Saudi government’s decision to consider debt relief for Iraq would go a long way in improving that country’s economic viability.

—Rodrigo de Rato

IMF Trade Research Conference

Do trade agreements and trade openness help developing countries?

The landscape of the world trading system is being altered by a proliferation of regional trade agreements (currently, over 200 are in place) and unilateral preference schemes granted to some developing country exports for select products. Are these changes, which are taking place against a general backdrop of on-off global trade liberalization and unilateral liberalization in some countries, good for developing countries? Does the IMF have a role to play in this process? A half-day conference on October 19 sponsored by the IMF's Research Department took a closer look at these issues.

An overarching theme of the conference was that preferential trade policies—whether in the form of trade agreements or tariff reductions for exports from developing countries—are not equivalent to trade liberalization. It is useful to remember, the IMF's John Romalis (Resident Scholar, Research Department) suggested, that these arrangements do not extend to every country's trading partner. It would be more accurate to call these “preferential” rather than free trade agreements, as they reduce trade barriers on trade flows among the member countries only.

While preferential access for developing country exports might seem like a good idea at first glance, the World Bank's Çağlar Özden (Economist, International Trade Division) emphasized that such schemes are riddled with problems. Somewhat surprisingly, low-income countries do not fully utilize these preference schemes—on average, the preference utilization rate is 35 percent. Furthermore, sectors of export interest to the recipient country are often “sensitive” sectors for the donor country and, thus, frequently exempted from preference schemes. In addition, these schemes often carry a fair amount of “strings,” requiring other steps to meet concerns about rules of origin, labor and environmental standards, and intellectual property rights. And, frequently, once the preferences are utilized, they are removed. A key test of the effectiveness of such schemes is whether they help create viable industries in the recipient countries; there is no clear evidence that they do. In effect, Özden saw preference schemes as having minimal impact and providing little incentive for recipient countries to liberalize their own trade policies.

From preferential to multilateral?

On the thorny issue of preferential agreements, the IMF's Hans-Peter Lankes (Division Chief, Policy

Development and Review Department) observed that such agreements are here to stay. He urged the World Trade Organization (WTO) to strengthen its oversight of these agreements and asked the IMF to devote greater attention to them, in the context of both surveillance and program negotiations, in an effort to ameliorate their undesirable effects.

But are these agreements beneficial? Romalis acknowledged that the evidence is ambiguous, but he did see some benefit where trade between the member countries is already large, which would lessen the possibility of trade diversion; when external tariffs are quite high; and when these agreements are made between developed and developing countries. On the larger question of whether agreements will hinder multilateral liberalization, he found the evidence mixed.

Other speakers were fairly unanimous in finding these agreements undesirable, given their potential for diverting trade. IMF First Deputy Managing Director Anne Krueger saw the proliferation of regional or preferential trade agreements as an obstacle to trade liberalization because once a country signed such an agreement, it cannot alter its trade policy without the consent of its partners. This, she said, provides a way for countries to “hide behind each other” and avoid liberalization.

T.N. Srinivasan of Yale University went as far as to say that such agreements “do not belong in a globally liberalized, multilaterally liberalized world, and the sooner we get away from them, the better off we all would be.” Srinivasan would support the formation of a regional trade agreement if it extended tariff reductions to nonmembers. But the World Bank's Alan Winters (Director, Development Research Group) did not think this feasible. Instead, he recommended that greater attention be paid to the fact that with so many regional agreements, every country is outside some of them, and outsiders typically lose.

David Richardson of Syracuse University took a somewhat more nuanced view, suggesting that these agreements could, in fact, be stepping stones to wider multilateral liberalization. Regional trade arrangements could become more palatable, he suggested, if they included a provision that bound participating members to harmonizing and reducing external tariffs over perhaps 10 to 20 years. Harmonization would solve the rules-of-origin problem, and a reduction in the external tariff would reduce the likelihood of trade diversion. Progress in implementing this



John Romalis



Çağlar Özden

reform, he added, could become a regular part of the trade policy reviews conducted by the WTO.

Winners and losers

Can developing countries afford trade reform, given that trade liberalization sometimes leads to a loss of tax revenue and, thus, a weaker fiscal position? The concern is a substantial one for some countries, especially in Africa, which derives one-quarter to one-third of its tax revenue from taxes on international trade. The IMF's Michael Keen (Division Chief, Fiscal Affairs Department) noted that in theory substituting indirect taxes for trade taxes should generate a welfare gain, as well as raise revenue.

In preliminary research, however, he found that, with some exceptions, low- and middle-income countries were able to recover only 30–50 percent of lost trade-tax revenue. There is also some evidence, he added, that replacement of revenue has decreased over time and is greater in Latin America and Africa than in the Middle East and Asia.

Keen's findings raised a number of questions about whether the observed revenue reductions were due to policy changes or shocks, and whether the results establish a causal relationship between changes in tariffs and revenue. Clearly, more work needs to be done on this important topic.

There has been a great deal of discussion, too, about the potential impact of agricultural trade liberalization on developing countries. The popular belief is that developing countries would reap large gains from the removal of agricultural support in the rich countries. But this may not be true, according to the IMF's Stephen Tokarick (Senior Economist, Research Department). He reported that estimates from a global model of world trade show that the gains from liberalization accrue mainly to rich, not developing, countries. And while estimates show that developing countries gain in the aggregate, some could lose, notably developing countries that import agricultural products.

However, the matter is complicated by the possibility that net-importing countries could become net exporters—and thus “winners”—if international prices for agricultural products rose following liberalization, which would increase production and reduce consumption in these countries. Furthermore, developing countries tend to tax, not subsidize, their agricultural sectors. An increase in international prices would cause output to expand and offset the tax on agricultural production. Nonetheless, even if developing countries face higher import costs, the size of the increases is likely to be relatively small: about 2 percent of affected imports (although about nine countries would experience an increase in costs up to

3 percent of imports). For these countries, some sort of financing mechanism, such as the IMF's Trade Integration Mechanism, might be needed.

The IMF's role

Does the IMF have a role in fostering trade liberalization? According to Raghuram Rajan (the IMF's Economic Counselor and Director of the Research Department), it will be important for the IMF to continue to emphasize the benefits of freer, more open trade—not just in goods but also in factors of production such as labor and capital. Indeed, the IMF's Articles of Agreement specifically call on the IMF to “facilitate the expansion and balanced growth of international trade,” observed the IMF's Shang-Jin Wei (Head of the Trade Unit in the Research Department), and IMF research has already helped dispel some misconceptions about trade-related issues, such as outsourcing.

Srinivasan saw the organization primarily as an advocate of trade liberalization, while others suggested a somewhat deeper, more engaged role. Krueger indicated that the IMF stands ready to work with countries in addressing the potential adverse effects of trade liberalization, particularly the loss of tax revenue, since this argument is sometimes used to forestall liberalization. Winters thought the IMF could also provide objective research and advice on the likely impact of trade liberalization, particularly the fiscal implications, and help persuade countries that “trade policy needs to be made consistent and coherent with countries' objectives on development.”

Richardson offered the intriguing suggestion that the experience of the World Bank and the IMF with weighted voting could help the WTO deal with governance problems that have plagued that institution.

Final thoughts

A main conclusion emanating from the conference is that preferential trade policies are not unambiguously beneficial; they may hurt the countries that enter into them. Recent research has brought us closer to understanding the nuances of the changing landscape in the world trade system. As that global landscape continues to change, however, the need for solid research goes on. ■

Stephen Tokarick
IMF Research Department



Michael Keen



Stephen Tokarick

Photo credits: Nabil Ismael, pages 313–14; Henrik Gschwindt De Gyor, Eugene Salazar, and Michael Spilotro for the IMF, pages 315–19, and 328; and Michaela Schrader, page 320.

Why globalization works

The debate on the merits of globalization continues, with one side arguing that it raises living standards and the other that it worsens poverty and inequality. At a September 22 IMF Book Forum, Martin Wolf, Associate Editor and Chief Economics Commentator at the *Financial Times*, offered a robust defense of globalization and an upbeat assessment of its prospects. In discussing his new book, *Why Globalization Works*, he rebutted claims that globalization undermines sovereignty, weakens democracy, intensifies inequality, favors “exploitative” multinational corporations, and devastates the environment.

Given economic instability, fears of terrorism, protectionist reactions to economic change, and the rise of new competitors—above all, China, and now India—opponents of economic integration could yet do grave damage, Wolf conceded. But the forces against globalization are not strong enough to cause its disintegration, he said, and it seemed implausible that global integration would collapse, as it had in the interwar years of the early 20th century as a consequence of international rivalries, economic instability, protectionist interests, and anti-liberal ideas.

Today, the situation is different in four fundamental respects, Wolf explained. First, there is, for the moment, a single undisputed hegemon—the United States—and a war among great powers in the near future seems unlikely. Second, all the great powers seem to have abandoned the notion that prosperity derives from territorial gains and plunder rather than from internal economic development and peaceful exchange. Third, all the great powers now share a commitment to market-led economic development and international economic and political integration of some kind. And, fourth, global institutions and close international cooperation reinforce the basic stability of the political order.

Threats to globalization?

But against this, noted Wolf, there is one obvious parallel to the 1930s. The breakdown of the early 20th century order occurred in large part because of the pressures to accommodate rising powers in the global economic and political order. “If the United States remains wedded to notions of global primacy rather than of a shared global order, conflict with a rising China would seem almost inevitable,” he cautioned. In addition to these political pressures, China’s ascent will force uncomfortable economic adjustment on the

rest of the world—a phenomenon that is already fueling protectionist pressures in a number of countries. But a greater threat to the world’s commitment to open borders is megaterrorism, said Wolf. He called for global cooperation and improved security measures, rather than closing borders, as a means of controlling terrorists.

A second danger is economic instability. The decisive event, without doubt, in the collapse of the integrated economy of the late 19th and early 20th century was the Great Depression, and its related financial and exchange rate crises. In developing countries, over the past two decades, “financial and exchange rate crises have come with depressing frequency,” said Wolf. Substantial financial and exchange rate crises also erupted in advanced economies in the 1980s and early 1990s; Japan is still struggling with the aftermath of its bubble economy; and the United States experienced a huge stock market bubble that peaked in 2000. All these are signs of financial instability. “Yet it is almost impossible,” said Wolf, “to believe that the outcome will be anything like another 1930s.” The move to floating exchange rates has significantly reduced the risk of crises. And, he said, “it is striking that, despite recent crises, no significant country has reversed its commitment to liberal trade.”

Protectionist interests are also not as strong as they were historically, Wolf noted, and “the rise of the internationally integrated transnational company has reduced the ability and willingness of producers to wrap themselves in national flags.” In his view, “the concept of a purely national business sector has become, thankfully, increasingly irrelevant, diffusing protectionist lobbying.” Also, while many people in high-income countries express concern about the decline in relative wages and opportunities for skilled labor, the political clout of these critics has, for better or worse, diminished with the general decline of the industrial working class. A web of strong international commitments also makes it far more difficult for protectionist interests to capture legislatures as they once did.

The final element of the 20th century collapse began with the rise of anti-liberal ideas. There are parallels today, particularly in the groups united to protest



Wolf: “If we wish to make our world a better place, we must look not at the failures of the market economy but at the hypocrisy, greed, and stupidity—and worse—that so often mar our politics in both developing and developed countries.”

global capitalism. But these groups, which include environmentalists, development lobbies, populists, socialists, communists, and anarchists, are “vastly less intellectually coherent than the opponents of liberalism of a century ago,” Wolf said. They “are united only in what they oppose and offer no alternative way of running an economy.” A movement that offers only protest is unlikely to triumph, he concluded.

Making this world work better

In Wolf’s view, the biggest obstacle to a more even spread of global prosperity is neither global economic integration nor transnational companies, as critics allege. It is the multiplicity of independent sovereign states, vastly divergent in their capacities and qualities. The most important source of inequality and persistent poverty is the fact that humanity is locked into almost 200 distinct countries, some of which are prosperous, well governed, and civilized, while many others are, alas, poor, mal-governed, and, at present, apparently incapable of providing the basis for a tolerable existence. The principal challenge in development, thus, is getting around political fragmentation and its consequences.

How can the reality of a world divided into unequal sovereignties be reconciled with the opportunities afforded by integration? Some of the critics’ concerns need to be taken into account, Wolf said. There is, for example, a reasonable case for permitting some form of infant industry promotion—though not protection—in developing countries. There is also an overwhelmingly powerful argument for higher-income countries to open their markets in favor of the exports from developing countries.

“But the most hysterical complaints of the critics of integration are nonsense,” Wolf emphasized. Transnational companies do not rule the world. Neither the World Trade Organization nor the IMF can force countries to do what they would very much prefer not to do. Crises do not afflict sound financial systems. Global economic integration does not render states helpless, nor has it created unprecedented poverty and inequality.

Ten commandments of globalization

“What precisely should we be trying to do?” asked Wolf. He offered what he called the “Ten Commandments of Globalization.”

- The market economy is indeed the only arrangement capable of generating sustained increases in prosperity; providing the underpinnings of stable, liberal democracies; and giving individual human beings the opportunity to seek what they desire in life.

- Individual states remain the locus of political debate and legitimacy. Supranational institutions must always remember that they derive their legitimacy and authority from the states that belong to them.

- It is in the interest of both states and their citizens to participate in international treaty-based regimes and institutions that deliver global public goods.

- Such regimes do, however, need to be specific, focused, enforceable, and limited.

- Of those regimes, the World Trade Organization, though enormously successful, has strayed too far from its primary function of promoting trade liberalization—by, for example, becoming involved in trade-related aspects of international property rights—and should be brought back firmly to its specific aim.

- There is a case for regimes covering investment and global competition, but it would be best to create such regimes among select countries and forgo universality, thus ensuring that these regimes have reasonably high standards.

- It is in the long-run interest of countries to integrate into global financial markets, but they must do so carefully, with a full and proper understanding of the risks.

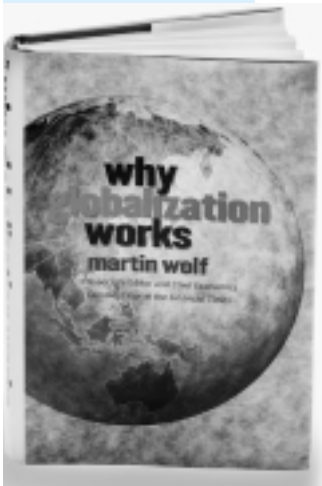
- In the absence of a global lender of last resort, it is necessary, as the IMF has been arguing, to have a specific and explicit system to coordinate and organize standstills and renegotiate sovereign debt.

- Though official development assistance is very far from a guarantee of successful development, the sums now provided are so small and the resources of some countries so inadequate that the case for increased aid is very strong. Without expanded assistance, a large part of the world will fall ever further behind.

- Finally, and this is perhaps the most difficult, countries should always—or almost always—be allowed to learn from their own mistakes. But the international community also needs the capacity, the will, and the wisdom to intervene where it is evident that states have permanently failed.

All these commandments matter, he argued, but the first two—about markets and states—are the most important. “If we wish to make our world a better place, we must look not at the failures of the market economy,” Wolf concluded, “but at the hypocrisy, greed, and stupidity—and worse—that so often mar our politics in both developing and developed countries.” ■

Christine Ebrahim-zadeh
IMF External Relations Department



Why Globalization Works, by Martin Wolf, is published by Yale University Press. Copies are available for \$30.00 each.

Reducing poverty tops agenda in talks between IMF and labor unions

About 80 leaders of labor unions and international confederations of unions, with nearly 200 million workers worldwide, joined IMF and World Bank management, staff, and Executive Directors in Washington on October 6–8 to discuss how to reduce poverty, create more jobs, enhance social inclusion, and reduce inequalities. While the unions' leaders acknowledged efforts by the Bretton Woods institutions to consult more widely with unions and civil society, they said the IMF continues to pay too little attention to employment, wages, and social protection in its economic advice to countries. The meeting, the second in a biennial series instituted in 2002, built upon a tradition of dialogue with the global labor movement begun more than a decade ago.

In opening remarks, IMF Managing Director Rodrigo de Rato welcomed the continued dialogue with labor unions, noting that in many countries organized labor is an important, and sometimes indispensable, instrument for social change. In a world characterized by ongoing and fast-moving transformation, countries must adapt, he said, and this often requires dealing with such challenges as aging populations, the need to modernize labor markets, and the liberalization of trading systems. Participation of civil society—including labor unions and employers' organizations—in these economic and social debates can strengthen the consensus on what often constitutes difficult policy choices. And strong global expansions such as the current one, de Rato observed, provide a timely opportunity to undertake reforms, since changes in behavior are easier to bring about during economic recovery.

The trade union delegation—led by Guy Ryder, General Secretary of the International Confederation of Free Trade Unions (ICFTU), and Willy Thys, General Secretary of the World Confederation of Labor, with representatives from the Global Union Federations and the OECD's Trade Union Advisory Committee—pointed out that, despite the IMF's upbeat assessment of the global economy, most developing countries will miss the United Nations Millennium Development Goals by a wide margin. If progress toward these goals is to be accelerated, the international community must take more ambitious action on debt relief and consider the various initiatives being proposed—including some form of global taxation—to raise extra funding. They took note, however, of de Rato's observation that the problem

with obtaining new resources is political, not technical.

The labor union leaders also stressed that poverty reduction depends on implementing the right policies. In their view, the Bretton Woods institutions' emphasis on



pro-growth, market-oriented economic liberalization is inadequate “because growth is not enough.” They argued that too little attention is paid to employment, wages, and social protection; growth must be accompanied by “decent” job creation and an increase in social security and justice.

The union representatives welcomed the more systematic consultations with local unions during the IMF's annual country (Article IV) consultations and other missions. But they called for greater involvement of local unions in the elaboration of poverty reduction strategies in low-income countries. IMF representatives pointed out that the decision on whom to consult is made chiefly by the governments themselves.

The IMF's recommendations to countries on labor market reform remained a point of contention for many of the union representatives. They expressed concern that the IMF calls for greater labor market flexibility regardless of a country's circumstances, and this, they said, tended to result in simple deregulation and increased social insecurity. They urged greater consultation with unions on policies to promote a less disruptive restructuring of the labor market. ■

Sofia Soromenho-Ramos
IMF External Relations Department

A summary of the proceedings, jointly agreed by the participants, will be published at a later date on the IMF's website (www.imf.org).

Clockwise from top: Andrew Kaillembo (General Secretary of ICFTU-AFRO, Nairobi), Lawrence Egulu (Public Service International), Willy Thys (General Secretary of the World Confederation of Labor), Rodrigo de Rato (IMF Managing Director), Guy Ryder (General Secretary of the ICFTU), Willy Kiekens (IMF Executive Director).

Tanzania's legislators, civil society seek greater role in reforms and poverty reduction policymaking

On October 14–15, the IMF and the Tanzanian Parliament's Committee on Finance and Economic Affairs sponsored a macroeconomic policy seminar—the first of its kind—for the country's legislators. A workshop was held for representatives from civil society and the media the following day. Both events—which took place in Bagamoyo and drew some 30 parliamentarians and 20 representatives from local think tanks, nongovernmental organizations, and the press—focused on Tanzania's widely heralded reforms under President Benjamin Mkapa to step up the pace of development and poverty reduction.



Members of the Tanzanian Parliament's Committee on Finance and Economic Affairs and participants in a macroeconomic policy seminar gather after the meeting.

There was broad agreement among participants that Tanzania's reforms, supported by the IMF and the World Bank, have helped the country make a successful transition from a state-controlled to a market-oriented economy. In recent years, Tanzania has enjoyed high economic growth (around 6 percent a year), low inflation (around 4 percent a year), robust reserves, increasing foreign capital inflows, improved government revenue collection, and sound expenditure management. This performance is in stark contrast to the previous 30 years when annual growth averaged about 2 percent (less than the rate of population increase) and annual inflation averaged more than 30 percent.

The country's strong reform efforts have attracted substantial support from the international community, including \$3 billion in debt relief under the IMF–World Bank Heavily Indebted Poor Countries (HIPC) Initiative, and aid is expected to increase significantly in FY 2005 to \$1.4 billion (equivalent to 13.3 percent of GDP). “Tanzania can serve as an example of what can be achieved with determination and effort,” said Robert Sharer, the IMF's mission chief for Tanzania.

However, much remains to be done if Tanzania is to meet the United Nations Millennium Development Goals. Participants pointed to the fact that poverty and disease are still widespread, the country continues to be dependent on donor assistance, development efforts remain constrained by a narrow export base and regional instability, and the benefits have not been evenly spread—with 90 percent of the

poor living in rural areas. Parliamentarians asked that the benefits from debt relief under the HIPC Initiative be used to improve social services and increase expenditure for the poor. Representatives for the local nongovernmental organizations and media wondered whether the poor would even benefit from macroeconomic stabilization.

Peter Ngumbullu, IMF Executive Director for the constituency including Tanzania, said that these challenges must be addressed through ambitious and consistent reforms, keyed in particular to improving the business environment and bolstering the agricultural sector. Deputy Minister of Finance Festus Limbu reiterated his government's commitment to reforms, noting that only nationally owned reforms can fully succeed.

Stepped-up dialogue

Another major concern was access to information and the need for an open dialogue. Parliamentarians said that they—as elected representatives of the people—had not been sufficiently involved in the formulation and decision-making process regarding the development of Tanzania's poverty reduction strategy, the budget, and other important economic reform issues. They emphasized their role in ensuring that the voices of the people are heard in the major policy debates, including conveying to the IMF the social implications of its policy advice. For that reason, they greatly welcomed the two-day workshop. Njelu Kasaka, Chair of the Committee on Finance and Economic Affairs of the Tanzanian Parliament, noted that recognition of legislators as “an important interlocutor of the IMF is a commendable turnaround.” Marie Shaba, with the Tanzania Media Women's Association, said that “this is really a milestone for us,” adding that “anti-IMF ideas may be there because previously there had been no interaction.” Musa Bilegeya, Tanzania Association of Nongovernmental Organizations, stressed, “let the people debate economic decisions.”

In recent years, the IMF has expanded its outreach to parliamentarians, organizing and participating in country seminars, workshops, and regional conferences. IMF spokesperson Thomas Dawson emphasized that these seminars offered an opportunity for a truly open two-way dialogue. “It allows us to listen to your concerns and to improve our understanding of the political, cultural, and social context in which economic decisions are taken,” he said. ■

Europe's productivity growth— not as bad as it seems

In 2000, the European Union (EU) announced with much fanfare a 10-year strategy to overtake the United States as the world's most competitive economy. Today—almost five years later—gloom is the prevailing mood on the likelihood of achieving this goal. A new report concludes that the Lisbon agenda—as the EU's plan for improving competitiveness is known—risks becoming “a synonym for missed opportunities and failed promises.” But Marcello Estevão of the IMF's European Department suggests that things may not be as bad as they seem. Camilla Andersen of the *IMF Survey* spoke with him.

Europe has lagged the United States in terms of economic growth since the mid-1990s, when GDP per capita growth in large European economies began to fall behind that of the United States. As a result of these trends, per capita income in the euro area (converted using purchasing power parities) was about one-third lower than in the United States in 2002, compared with about one-quarter lower in the early 1990s. A number of theories have been advanced to explain this widening of the gap. Some point to the information technology boom in the United States, which provided a major boost to productivity in the late 1990s (see top chart). Others blame Europe's low rates of labor utilization, which are caused in part by labor market rigidities that discourage people from seeking work.

In a new IMF Working Paper, Estevão takes an in-depth look at the euro area's productivity performance. He does not dismiss the productivity leap made by the United States in the late 1990s. But he argues that the euro area's low labor productivity growth is due less to slowing total factor productivity growth—something that would point to problems in adopting new technology and improving managerial efficiency—and more to a slowdown in capital investment. This phenomenon, he says, can be explained by labor market reform in many euro area economies that—combined with wage moderation—has made it advantageous for companies to hire new workers rather than invest in new technology to improve the productivity of existing workers.

Excessive pessimism is misplaced

Many European countries are seeking to increase labor market flexibility as a means to boost labor participation, which is much lower in the euro area than in the United States (see bottom chart). While labor market

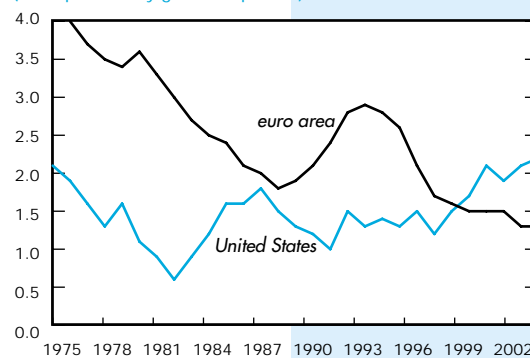
reform is something Europe needs—to deal with a dwindling labor force caused by aging and falling birth rates—this reform also has the effect of temporarily slowing labor productivity growth. “Slowing labor productivity growth in Europe can be explained by the positive shock coming from the labor market. With more people being hired, there is a decline in labor productivity growth because the capital-to-labor ratio does not grow as fast,” Estevão says.

The EU's Lisbon agenda tries to address both labor market participation and productivity growth. But according to Estevão, these two goals are contradictory to some extent. “When you increase labor market participation, you are going to have a negative effect on labor productivity growth,” he says.

So should the European Commission and national governments stop fussing about productivity? Yes and no. “It is not that productivity is not important—it is very important—but given the problems in Europe caused by low labor utilization, it makes sense to focus on increasing participation first,” Estevão says. But, he continues, policymakers need to realize that this will have a perverse effect on labor productivity over the short to medium term. In sum, “excessive pessimism about what is going on with labor productivity growth in Europe may be misplaced.” In terms of economic policy, Europe should focus on what matters most. According to Estevão, “this would entail focusing a bit less on productivity growth and a bit more on increasing labor market utilization.” ■

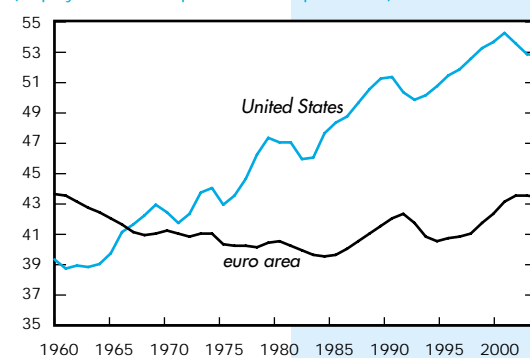
U.S. labor productivity growth is higher

(labor productivity growth in percent)



More people in the United States work

(employment rates in percent of total production)



Note: The euro area comprises Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

Data: EC-AMECO database; OECD productivity database; and IMF staff calculations

Copies of IMF Working Paper No. 04/200, “Why Is Productivity in the Euro Area So Sluggish?” are available for \$15.00 each from IMF Publication Services. See page 323 for ordering information. The full text of the paper is also available on the IMF's website (www.imf.org).

Recent publications

IMF Country Reports (\$15.00)

- 04/211: Pakistan: Eighth Review Under the Three-Year Arrangement Under the PRGF and Request for Waivers and Modification of Performance Criteria
- 04/212: Botswana: Selected Issues and Statistical Appendix
- 04/213: Germany: ROSC—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism
- 04/214: Zambia: 2003 Article IV Consultation and Ex Post Assessment of Performance Under IMF-Supported Programs
- 04/215: Pakistan: Financial System Stability Assessment, including ROSCs on Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation
- 04/216: Haiti: Staff-Monitored Program
- 04/217: Republic of Poland: 2004 Article IV Consultation
- 04/218: Republic of Poland: Selected Issues
- 04/219: Republic of Poland: ROSC on Fiscal Transparency Module—Update
- 04/220: Romania: Selected Issues and Statistical Appendix
- 04/221: Romania: 2004 Article IV Consultation and Request for Stand-By Arrangement
- 04/222: Zambia: Request for Three-Year Arrangement Under the PRGF
- 04/223: Democratic Republic of the Congo: Interim PRSP Preparation Status Report
- 04/224: Democratic Republic of the Congo: Joint Staff Assessment of the Interim PRSP Preparation Status Report
- 04/225: Botswana: 2003 Article IV Consultation
- 04/226: Peru: Request for Stand-By Arrangement
- 04/227: Turkey: Seventh Review Under the Stand-By Arrangement, and Requests for Waiver of Applicability and Nonobservance of Performance Criteria, Rephasing of Purchases, and Extension of Arrangement
- 04/228: United States: Selected Issues
- 04/229: Botswana: ROSC on Data Module—Response by the Authorities—Update
- 04/230: United States: 2004 Article IV Consultation
- 04/231: Republic of Congo: Selected Issues and Statistical Appendix
- 04/232: Republic of Congo: 2004 Article IV Consultation and New Staff-Monitored Program
- 04/233: Union of the Comoros: Selected Issues and Statistical Appendix
- 04/234: Euro Area Policies: Staff Report
- 04/235: Euro Area Policies: Selected Issues
- 04/236: Austria: 2004 Article IV Consultation
- 04/237: Austria: Selected Issues
- 04/238: Austria: Financial System Stability Assessment, including ROSCs on Banking Supervision, Securities Regulation, Insurance Regulation, and Anti-Money Laundering and Combating the Financing of Terrorism
- 04/239: Nigeria: 2004 Article IV Consultation
- 04/240: Denmark: 2004 Article IV Consultation
- 04/241: Denmark: Selected Issues
- 04/242: Nigeria: Selected Issues and Statistical Appendix
- 04/243: Democratic Republic of the Congo: Fourth Review Under the Three-Year Arrangement Under the PRGF, Requests for Waiver of Performance Criteria and Additional Interim Assistance Under the Enhanced Initiative for HIPC
- 04/244: Sweden: 2004 Article IV Consultation
- 04/245: Sweden: Selected Issues
- 04/246: Bhutan: PRSP
- 04/247: Japan: Selected Issues
- 04/248: Republic of Tajikistan: Third Review of the Three-Year Arrangement Under the PRGF, and Request for Waiver of Performance Criterion
- 04/249: Japan: 2004 Article IV Consultation
- 04/250: Mexico: Selected Issues
- 04/251: Republic of Croatia: Selected Issues and Statistical Appendix
- 04/252: Republic of Croatia: ROSC on Banking Supervision, Payment Systems, and Securities Regulation—Update
- 04/253: Republic of Croatia: 2004 Article IV Consultation and Request for Stand-By Arrangement
- 04/254: Mexico: 2003 Article IV Consultation
- 04/255: Solomon Islands: Selected Issues and Statistical Appendix
- 04/256: San Marino: Selected Issues and Statistical Appendix
- 04/257: San Marino: 2004 Article IV Consultation
- 04/258: Solomon Islands: 2004 Article IV Consultation
- 04/259: Union of the Comoros: 2004 Article IV Consultation
- 04/260: Republic of Latvia: 2004 Article IV Consultation
- 04/261: Republic of Latvia: Selected Issues
- 04/262: Japan: ROSC on Fiscal Transparency Module—Update
- 04/263: Jamaica: 2004 Article IV Consultation
- 04/264: Czech Republic: ROSC on Fiscal Transparency Module—Update
- 04/265: Czech Republic: Selected Issues
- 04/266: Czech Republic: 2004 Article IV Consultation
- 04/267: Bulgaria: Request for Stand-By Arrangement
- 04/268: Republic of Kazakhstan: Financial System Stability Assessment—Update Including ROSCs on Banking Supervision and Anti-Money Laundering and Combating the Financing of Terrorism
- 04/269: Chile: Financial System Stability Assessment, including ROSCs on Monetary and Financial Policy Transparency, Banking Supervision, and Securities Regulation

- 04/270: Rwanda: Second and Third Reviews Under the Three-Year Arrangement Under the PRGF, Request for Waiver of Performance Criteria, and Request for Additional Interim Assistance Under the Enhanced HIPC Initiative
- 04/271: Kingdom of the Netherlands—Netherlands Antilles: Assessment of the Supervision and Regulation of the Financial Sector Volume I—Review of Financial Sector Regulation and Supervision
- 04/272: Kingdom of the Netherlands—Netherlands Antilles: Assessment of the Supervision and Regulation of the Financial Sector Volume II—Detailed Assessment of Observance of Standards and Codes
- 04/273: Rwanda: PRSP Progress Report
- 04/274: Rwanda: Joint Staff Assessment of the PRSP Progress Report
- 04/275: Niger: 2004 Article IV Consultation, Sixth Review Under the Three-Year Arrangement Under the PRGF, and Request for Waiver of Performance Criterion, and Ex Post Assessment of Performance Under IMF-Supported Programs
- IMF Working Papers (\$15.00)**
- 04/147: “Structural Factors Affecting Exchange Rate Volatility: A Cross-Section Study,” Jorge I. Canales Kriljenko and Karl F. Habermeier
- 04/148: “Country Insurance,” Tito Cordella and Eduardo Levy Yeyati
- 04/149: “Bank Consolidation and Performance: The Argentine Experience,” Ritu Basu, Pablo Druck, David Marston, and Raul Susmel
- 04/150: “Identifying Threshold Effects in Credit Risk Stress Testing,” Giancarlo Gasha and Armando Morales
- 04/151: “Analysis of Recent Growth in Low-Income CIS Countries,” Elena Loukoianova and Anna Unigovskaya
- 04/152: “What Are the Potential Economic Benefits of Enlarging the Gulf Cooperation Council?” Saade Chami, Selim Elekdag, and Ivan Tchakarov
- 04/153: “Quantitative Assessment of the Financial Sector: An Integrated Approach,” DeLisle Worrell
- 04/154: “Measuring the Trade Effects of EMU,” Hamid Faruqee
- 04/155: “The IMF and Russia in the 1990s,” John Odling-Smee
- 04/156: “Fiscal Policy and Debt Sustainability: Cardoso’s Brazil, 1995–2002,” Fabio Giambiagi and Marcio Ronci
- 04/157: “Front-Loaded or Back-Loaded Fiscal Adjustments: What Works in Emerging Market Economies?” Emanuele Baldacci, Benedict J. Clements, Sanjeev Gupta, and Carlos Mulas-Granados
- 04/158: “Dimensions of Land Inequality and Economic Development,” Lennart Erickson and Dietrich Vollrath
- 04/159: “Russia and the WTO: The ‘Gravity’ of Outsider Status,” Bogdan Lissovlik and Yaroslav Lissovlik
- 04/160: “External Debt Sustainability in HIPC Completion Point Countries,” Yan Sun
- 04/161: “Grants Versus Loans,” Tito Cordella and Hulya Ulku
- 04/162: “Credible Commitment to Optimal Escape from a Liquidity Trap: The Role of the Balance Sheet of an Independent Central Bank,” Olivier D. Jeanne and Lars E.O. Svensson
- 04/163: “Can Public Discussion Enhance Program Ownership?” Peter Isard and Allan Drazen
- 04/164: “Monetary Policy Rules and the U.S. Business Cycle: Evidence and Implications,” Pau Rabanal
- 04/165: “Will You Buy My Peg? The Credibility of a Fixed Exchange Rate Regime as a Determinant of Bilateral Trade,” Bernhard Fritz-Krockow and Emilia M. Jurzyk
- 04/166: “Monetary and Exchange Rate Policies in Colombia: Progress and Challenges,” Sergio Clavijo
- 04/167: “Foreign Currency Deposits and International Liquidity Shortages in Pakistan,” Abbas Mirakhor and Iqbal Zaidi
- 04/168: “The Challenge of Fiscal Adjustment in a Democracy: The Case of India,” Catriona M. Purfield and Ricardo Hausmann
- 04/169: “The Impact of Preference Erosion on Middle-Income Developing Countries,” Katerina Alexandraki and Hans P. Lankes
- 04/170: “Financing Uganda’s Poverty Reduction Strategy: Is Aid Causing More Pain Than Gain?” Mwanza Nkusu
- 04/171: “Understanding India’s Services Revolution,” James P. Gordon and Poonam Gupta
- 04/172: “The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea,” Dong He
- Policy Discussion Papers**
- 04/4: “Pension Reform, Investment Restrictions, and Capital Markets,” Jorge E. Roldos
- 04/5: “Banking Reform in the Lower Mekong Countries,” Olaf Unteroberdoerster
- Other**
- IMF Research Bulletin*, Volume 5, Nos. 2 and 3
- IMF Staff Papers*, Volume 51, No. 2
- MacroLinks: A Program About the Interrelations Among Macroeconomic Accounts Produced by the IMF Institute (English, French, Spanish)
- FATF = Financial Action Task Force
 HIPC = Heavily Indebted Poor Countries
 PRGF = Poverty Reduction and Growth Facility
 PRSP = Poverty Reduction Strategy Paper
 ROSC = Report on the Observance of Standards and Codes

Publications are available from IMF Publication Services, Box X2004, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey’s* annual *IMF in Focus, Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF’s website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF’s website.

What has Asia learned about surging capital flows?

Between early 2003 and mid-2004, many emerging markets in Asia experienced a strong revival in private capital inflows. Although these inflows slowed significantly in the second quarter of 2004, their resurgence reminded observers and policymakers of two “facts of life” for emerging market economies: sharp increases in capital inflows are to be expected, and they may entail difficult trade-offs between internal and external policy objectives. A recent conference paper by Charles Adams, Andrea Richter Hume, Romuald Semblat, and Alessandro Zanello reviews recent experience and draws several lessons for policymakers.

One-sided intervention has produced a dramatic increase in the official reserves of Asian emerging economies.

In 2003, about two-thirds of all private capital flows to emerging markets went to Asia—about \$100 billion in net terms. China attracted the bulk of flows to the region, mostly in the form of foreign direct investment (FDI). India was another major recipient, though in its case portfolio investment flows predominated. Indonesia, Korea, Malaysia, and Thailand also experienced a sharp increase in portfolio investment.

Why is Asia so attractive? Improving macroeconomic fundamentals in much of the region created a powerful magnet for foreign savings. Expectations of currency appreciation were another important pull factor, especially in China and India. Furthermore, low interest rates in the major industrial countries, easing geopolitical tensions, and a gradual strengthening of the global recovery spurred a quest for higher returns among investors, who ventured into riskier assets in emerging markets. The exceptions were Indonesia and the Philippines, where somewhat weaker macroeconomic conditions and heightened uncertainties muted private capital inflows.

Déjà vu all over again?

Yet some observers took the seemingly good news with a grain of salt, highlighting similarities between the recent capital inflow episode and the run-up to the Asian crisis, and voicing concerns that regional vulnerabilities might re-emerge. Why such nervousness? The underlying concern is that while capital inflows can benefit recipient economies by supplementing domestic savings, they can also lead to a real exchange rate appreciation, weakened external positions, and—ultimately—a capital flow reversal and an exchange rate crisis.

A closer inspection of the earlier capital inflow episode, however, puts these concerns in perspective.

In the early 1990s, private capital flows to all emerging markets expanded rapidly following the resolution of the international debt crisis. As in the recent episode, Asia was a major beneficiary of the pickup in capital flows, attracting some 40 percent of the \$1 trillion global surge through 1996. Capital inflows were driven by low interest rates in advanced economies, relatively fixed exchange rates in the host countries, and structural changes in international financial markets—notably, liberalization of capital account transactions as well as financial innovations that underpinned greater capital mobility. The inflows eventually proved destabilizing, primarily because they exacerbated balance sheet weaknesses in the corporate and financial sectors through mismatches in the currency and maturity structure of debt. They also fueled inflationary pressures that had been gathering strength on the heels of a prolonged expansion.

Faced with a surge of capital inflows, policymakers have a variety of tools at their disposal, notably countercyclical macroeconomic measures (such as nominal exchange rate appreciation and fiscal tightening), administrative steps limiting capital inflows and/or encouraging outflows, and ad hoc prudential policies. Although most Asian countries adopted these measures to some degree, they were not adequate to deal with the tensions between internal and external balance that surging inflows had brought about by the mid-1990s. When capital flows reversed sharply in 1997 (in a rush-for-the-door as Thailand's banking crisis ballooned into a regionwide collapse of confidence), the consequences were devastating for the regional economy.

A tale of two capital inflow episodes

At first glance, the recent surge of capital flows shares similarities with the run-up to the Asian crisis. In both cases, the inflows were very large, found their roots in similar global conditions, and elicited broadly similar policy responses. On closer examination, however, there are significant differences.

First, most economies in the region (with the possible exception of China) were not on the verge of overheating when capital inflows revived, as was the case in the mid-1990s. Economic growth in the region, while healthy, has been primarily export-led, and domestic demand pressures have been moderate. Also, local asset price bubbles (in equity or housing markets) have generally been absent.

Second, the scale of capital inflows this time around has been significantly smaller in relation to GDP. On average, capital inflows represented about 4 percent of GDP in 2003, whereas in 1996, the share was nearer to 10 percent (see top chart). The composition was also more favorable, with a lot less short-term external borrowing and significantly more FDI and portfolio equity investment in 2003.

Finally, resilience to a reversal in capital flows has been strengthened. External vulnerability (as measured by external debt-to-GDP ratios and reserve cover in terms of short-term liabilities) is now much lower throughout the region. Current accounts are in surplus in most countries, implying that despite the sizable inflows, the region is still a net capital exporter. And exchange rate systems in the majority of emerging Asia's economies are—de jure and de facto—somewhat more flexible, thus providing a natural buffer for adjusting to any external pressures that might emerge. With regard to domestic vulnerabilities arising from high leverage ratios in the corporate sector and weak balance sheets in banks, most economies in emerging Asia are also in much stronger positions than before.

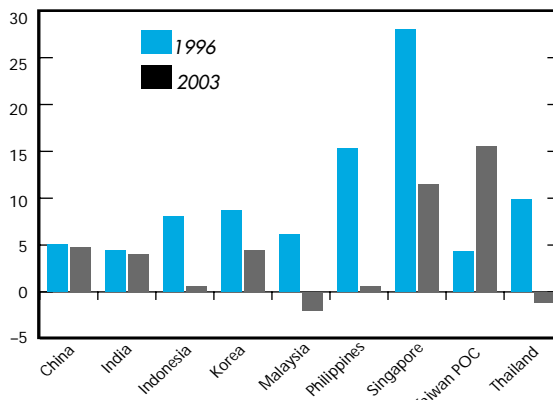
A familiar trade-off

Despite these differences, however, the recent capital inflows episode presented policymakers with the same challenges that they faced during the previous episode. And policy responses were not unlike those in the run-up to the Asian crisis. Burgeoning capital inflows exerted pressure on regional currencies to appreciate. And central banks, seeking to avoid a loss of competitiveness that could undermine economic performance, chose to intervene in foreign exchange markets by purchasing foreign currencies. This one-sided intervention has produced a dramatic increase in the official reserves of Asian emerging economies. Indeed, reserves rose (see bottom chart) by some \$450 billion between the beginning of 2003 and mid-2004.

And intervention, in turn, created its own problems. To limit the inflationary impact of an expanding domestic money supply, monetary authorities have drained liquidity through the issuance of central bank paper or the sale of government securities. Allowing pressure for an eventual exchange rate appreciation to build, however, this policy may have validated investor perceptions of a one-way currency bet, further encouraging capital inflows. Administrative measures to facilitate outflows may similarly have added to the attractiveness of investing in the region. This vicious circle shows the difficulties involved in trying to use monetary policy to simultaneously address both domestic (inflation) and external (exchange rate) policy objectives.

Capital inflows in 2003 were smaller

(percent of GDP)



Data: IMF and national authorities

What next?

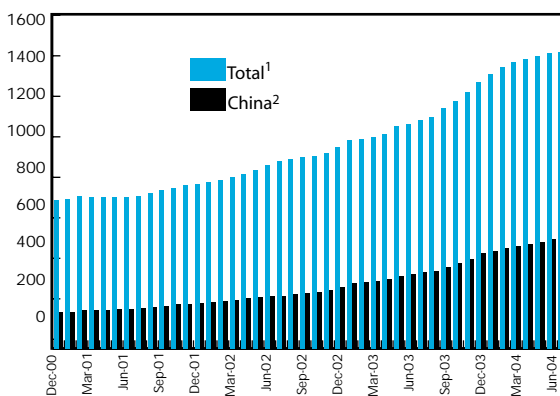
As it happened, the recent capital inflow episode fizzled out before the tension between achieving domestic and external policy objectives became unsustainable. A reversal (and in some cases, a slowdown) in portfolio and other investment flows was sparked by several factors, including an upward adjustment in U.S. interest rate expectations and rising concerns about a “hard landing” in China.

However, as expectations of a rapid rise in U.S. interest rates have moderated, global investment funds are once again casting an eye on Asia's emerging markets, and some countries are already experiencing a revival in capital inflows.

Should capital inflows to emerging Asia pick up in earnest again, policymakers in the region are likely to face a greater challenge than before in meeting internal and external objectives simultaneously. Headline inflation has been rising across the region and is now

Intervention led to soaring reserves

(billion U.S. dollars)



¹China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand.

²Excludes the effects of the end-2003 recapitalization of two large commercial banks in China with foreign reserves of the People's Bank of China (\$45 billion).

Data: IMF, CEIC, and national authorities

As expectations of a rapid rise in U.S. interest rates have moderated, global investment funds are once again casting an eye on Asia's emerging markets.

A move toward flexible exchange rate systems will be needed across the region to mitigate the inflationary impact of renewed capital inflows.

averaging about 4 percent a year, some 2 percentage points higher than a year ago. Although supply-side shocks related to high oil and commodity prices mean that core inflation remains low in most countries, in some of them inflation expectations are ratcheting up, raising the fear of more entrenched cost pressures. Against this backdrop, any foreign exchange market intervention by the central bank would need to be heavily sterilized, lest the nascent price spiral gain momentum. The scope for further sterilized intervention may be reaching its limits, however, because of a shrinking availability of official securities or because of the prospect of rising domestic interest rates (where official securities are imperfect substitutes for the domestic assets that foreign investors want).

This suggests that a move toward more flexible exchange rate systems will be needed across the region

to mitigate the inflationary impact of renewed capital inflows. More flexible exchange rate systems would be beneficial from both a domestic and a global perspective. It would allow monetary policy to be better geared toward domestic stabilization, reduce susceptibility to external shocks, and contribute to resolving the global current account imbalances that continue to threaten the world's economic recovery. ■

Andrea Richter Hume and Alessandro Zanello
IMF Asia and Pacific Department

This article is based on a paper prepared by Charles Adams, Andrea Richter Hume, Romuald Semblat, and Alessandro Zanello for a high-level seminar on capital flows co-sponsored by the Bank of Thailand and the IMF. Copies of the paper are available on request from the authors.

Available on the web (www.imf.org)

Press Releases

- 04/218: IMF Executive Board Completes First Review Under Nepal's Three-Year PRGF Arrangement and Approves \$10.6 Million Disbursement, October 20
- 04/219: IMF and World Bank Support \$836 Million in Debt Service Relief for Madagascar, October 21
- 04/220: Joint Statement by the General Secretary of the World Council of Churches, President of the World Bank, and Deputy Managing Director of the IMF, October 22
- 04/221: Andrew Crockett Named Chair of Per Jacobsson Foundation, October 22
- 04/222: IMF Managing Director Rodrigo de Rato Underscores Strengthening Economic Cooperation Among the Gulf Cooperation Council Countries, October 23
- 04/223: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of His Visit to Saudi Arabia, October 23–24, 2004, October 24
- 04/224: Inauguration of the Middle East Technical Assistance Center (METAC), October 25
- 04/225: IMF Staff Concludes Second Round of Discussions on a New Stand-By Arrangement for Turkey, October 26
- 04/226: IMF Revises Guide to the General Data Dissemination System, October 26
- 04/227: Statement by IMF Managing Director Rodrigo de Rato at the Conclusion of a Visit to the Arab Republic of Egypt, October 26
- 04/228: IMF Mission Statement on Discussions in Serbia and Montenegro, October 27
- 04/229: Statement of the IMF Mission to the Dominican Republic, October 29
- 04/230: Press Statement of the IMF Mission in Paraguay, October 29
- 04/231: Director of the IMF's African Department Visits Cameroon, November 1

- 04/232: Press Statement by IMF Staff Mission to Algeria, November 2
- 04/233: Statement by IMF Deputy Managing Director, Mr. Takatoshi Kato, Upon the Conclusion of His Visit to Angola, November 2
- 04/234: IMF Managing Director de Rato Names Sean Hagan as General Counsel and Director of the Legal Department, November 3

Public Information Notice

- 04/120: IMF Concludes 2004 Article IV Consultation with Germany, November 2

Speeches

- "Emerging Asia: Outlook, Challenges, and India's Growing Role," David Burton, Director, IMF Asia and Pacific Department, Reserve Bank of India, New Delhi, October 21
- Rodrigo de Rato, IMF Managing Director, World Trade Organization's General Council Meeting on Coherence, Geneva, October 22
- Agustín Carstens, IMF Deputy Managing Director, World Council of Churches–World Bank–IMF High-Level Encounter, Geneva, October 22
- Rodrigo de Rato, IMF Managing Director, Meeting of the Ministers of Finance and Governors of the Cooperation Council of the Arab States of the Gulf, Jeddah, Saudi Arabia, October 23
- Rodrigo de Rato, IMF Managing Director, Middle East Technical Assistance Center, Beirut, October 25

Transcripts

- "Rules-Based Fiscal Policy in Emerging Markets," IMF Book Forum, October 6

PRGF = Poverty Reduction and Growth Facility

Interview with Manmohan Singh

Dealing in distress?

Understanding the market for distressed debt

Capitalism without default would be like religion without sin. Countries and corporations have erred a lot in recent years, judging by the huge supply of defaulted or distressed assets. Surprisingly, there is also a healthy demand for these assets. Is this demand an attempt to feed off the distress of countries and corporations or does it offer them a chance of redemption? Manmohan Singh, an economist in the IMF's International Capital Markets Department, talks to Prakash Loungani of the IMF Survey about how the market for distressed assets works.

IMF SURVEY: What is a distressed asset?

SINGH: It means that the asset holder or lender is not getting the income stream he was supposed to get. Either the corporation or the country has defaulted outright or some payment is being made, but below the agreed rate—that's called a subperforming asset.

IMF SURVEY: It seems odd that there's a healthy market in distressed assets.

SINGH: Not really. Think of what happens when, let's say, people don't pay a hospital bill. After a few reminders, the hospital may turn it over to a collection agency. The hospital doesn't have the time or resources or the professional expertise to figure out why you haven't paid. But the collection agency specializes in this task. Or think of the market for junk cars. Some people buy junk cars and specialize in repairing them and selling them for a higher price than the often ridiculously low price for which they bought them. So where you and I may see a wreck, these specialists might see some recovery value.

IMF SURVEY: OK, so let's think of it as a market. Who are the sellers in the market for distressed assets?

SINGH: Often the sellers are pension funds and insurance companies. They are required by law to classify an asset as nonperforming when the original terms are not being honored by the borrower. Moreover, these companies then have to allocate some extra capital to shield themselves against the possible losses from such nonperforming assets. That makes it expensive to hold on to distressed assets. So they tend to sell them off. And that's the time when sometimes these assets are sold below their intrinsic value because it's being done under regulatory pressure. Sometimes the holders of these assets do not have the

expertise to assess their quality. So the fact that payments have been missed is enough to make them want to sell, particularly if they see that others in the market are also selling.

IMF SURVEY: Who are the buyers of these assets?

SINGH: There are many different types of buyers, but one important class is "high net worth individuals"—also known as "very rich people." It is tempting to portray them as vultures feeding off other people's distress, and indeed there are times when some of them do behave that way. But remember that these buyers also provide a floor for the price of the distressed asset; their demand keeps the price from sinking to zero. Distressed-debt traders have played this role in recent years in Ukraine, Moldova, Brazil, and Uruguay, as well as in some of the Asian crisis countries.

IMF SURVEY: Aren't these individuals subject to the same regulations as the pension funds or insurance companies?

SINGH: No, because they are risking their own money, not other people's. In fact, that's how the market started. In the aftermath of the debt crisis of the 1980s, there was a lot of distressed sovereign debt floating around but U.S. banks were constrained by regulations on how much of it they could hold. So some high net worth individuals purchased this debt on the cheap.

The behavior of pension funds and mutual funds is also constrained because they often have to generate returns that track some broad market index. But

The returns to investors in emerging market distressed debt cases have been over 50 percent a year and sometimes as high as 300 percent a year.

—Manmohan Singh

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
October 25	2.06	2.06	3.17
November 1	2.09	2.09	3.22

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?2004).

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

Data: IMF Finance Department



Laura Wallace
Editor-in-Chief
Sheila Meehan
Managing Editor

Christine Ebrahim-zadeh
Production Manager

Camilla Andersen
Jacqueline Irving
Assistant Editors

Niccole Braynen-Kimani
Maureen Burke
Lijun Li
Editorial Assistants

Julio Prego
Graphic Artist

Graham Hacche
Senior Advisor
Prakash Loungani
Associate Editor

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 22 times a year, plus *IMF in Focus*. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Text from the *IMF Survey* may be reprinted, with due credit given, but photographs and illustrations cannot be reproduced in any form. Address editorial correspondence to Current Publications Division, Room IS7-1100, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to imfsurvey@imf.org. The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged \$79.00 annually. Apply for subscriptions to Publication Services, Box X2004, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

November 8, 2004
328

investors in distressed assets are not bound by these rules. They have patience. They have deep pockets. And you need both because often these cases can be tied up in litigation for years.

IMF SURVEY: So do investors in distressed assets end up making any money?

SINGH: In the market for distressed *sovereign* debt they often do, particularly if they resort to litigation. While the number of cases is admittedly small, I've found that the returns to investors in emerging market distressed debt cases have been over 50 percent a year and sometimes as high as 300 percent a year. Remember that investors buy some of this debt at only 5 or 10 percent of the face value of the asset. Then they use the courts to press for full recovery of the asset value. So the returns can be very high.

IMF SURVEY: Does this explain why we sometimes see the prices of sovereign bonds rise on the announcement of a default?

SINGH: A default does immediately attract these kinds of investors, and their demand can sometimes drive up the price. Often these investors increase their leverage with the country by picking up what are called "orphan bonds," illiquid bonds that have few other investors. Cheapest-to-deliver bonds that are associated with credit default swaps also rise in value following a credit event, as was seen in the case of Argentina and Uruguay.

IMF SURVEY: You've also studied the market for distressed *corporate* assets. How is that different from the market for distressed *sovereign* assets?

SINGH: With the sovereign you have less leverage. One of your options is to go through the courts and assert your creditor rights or simply negotiate for better terms. But it is a protracted process with many lawsuits taking as many as 10 years to settle. So even though it can be very rewarding if successful, not everybody will have the patience and the deep pockets to follow that route. Another option is to press the country to work with the IMF and hope better economic policies at the national level will bring about recovery in asset values and the country's ability to pay.

With corporations there are many more strategies that can be followed, particularly many more options for successful restructuring that can yield value for everyone—the distressed corporation, the investor, and the country too.

IMF SURVEY: What's a good example of such a turnaround?

SINGH: Perhaps the most cited is the acquisition in March 2000 of Long-Term Credit Bank of Japan by a New York-based private-equity firm called Ripplewood Holdings. They really cleaned up the bank's balance sheets, upgraded its information and technology systems, and devised a new retail strategy. Today the bank, which is now called Shinsei Bank, is considered one of the best in Japan and has seen its share price rise from the depths of four years ago. And Ripplewood has exited the scene with handsome profits.

IMF SURVEY: What are the implications of such cases for Japan and the rest of Asia?

SINGH: I think such cases can fight the perception that all distressed-debt investors are just vultures. More investors, foreign and local, will start to take an interest in this market if they feel there will be less prejudice against them. But there is a more important demonstration effect of these cases. Often countries tend to just move the nonperforming loans of their corporations to an asset management company—which is sort of a hospital for sick loans—and just let them sit there instead of trying to

restructure them. What Japan's recent experience, and that of Korea after the Asian crisis, shows is that genuine restructuring creates value. Policymakers in China and other countries in Asia facing a nonperforming loan problem understand that they would do well to heed that message. ■



Singh: "What Japan's recent experience, and that of Korea after the Asian crisis, shows is that genuine restructuring creates value."

Copies of IMF Working Paper No. 04/86, "Japan's Distressed-Debt Market," by Kazunari Ohashi and Manmohan Singh, IMF Working Paper No. 03/161, "Recovery Rates from Distressed Debt," and No. 03/242, "Are Credit Default Swap Spreads High in Emerging Markets," by Manmohan Singh are available for \$15.00 each from IMF Publication Services. See page 323 for ordering information. The full text of the three papers is also available on the IMF's website (www.imf.org).