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## Spring Meetings focus on IMF reform, global growth

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The world's top financial and development officials gather in Washington, D.C., on April 14–15 for meetings of the IMF's International Monetary and Financial Committee (IMFC) and the World Bank–IMF Development Committee. High on the agenda of the IMFC will be the outlook for the world economy and progress with the IMF's medium-term strategy. The Development Committee's agenda will include the latest *Global Monitoring Report*.



Ponchai Kittiwongsakul/AFP/Getty Images

## World economy forecast to grow by 4.9 percent in 2007

page 84

Global economic growth will moderate to 4.9 percent in 2007 and 2008, down from 5.4 percent in 2006, according to the IMF's *World Economic Outlook (WEO)*. Despite recent volatility in financial markets and concerns about the housing market in the United States, the *WEO* predicts that strong global growth will continue, albeit less fast. Although risks to the outlook are judged to have declined since the last *WEO*, several factors create uncertainty.



Xu Jinghui/Imagine China Photos

## Financial conditions remain strong, but risks on rise

page 86

Despite recent gyrations in world stock markets, financial market volatility across a broad range of assets has continued to be at remarkably low levels and risk spreads are narrow, both historically and relative to the same point in previous business cycles, according to the IMF's latest *Global Financial Stability Report*. However, the report, released on April 10, warns that investors may be giving insufficient weight to downside risks.



Jim West/ZUMA Press

## African countries see merits of PSI framework

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A number of African countries are considering adopting a flexible new policy framework with the IMF that enables them to secure Fund support for, and endorsement of, their economic policies without a borrowing arrangement. Four countries in Africa—Nigeria, Uganda, Cape Verde, and most recently Tanzania—have adopted the new Policy Support Instrument (PSI), which the IMF Executive Board approved in October 2005.



Matt Brown/AFP/Getty Images

# What's on

## APRIL

**14–15** 2007 Spring Meetings of the World Bank Group and the IMF, Washington, D.C., United States

**16** Special High-Level Meeting of the Economic and Social Council with the Bretton Woods Institutions, the World Trade Organization, and the United Nations Conference on Trade and Development, New York, United States

**25–26** World Economic Forum on Latin America, “The Power of a Positive Regional Agenda,” Santiago, Chile

**25–27** United Nations Economic Commission on Europe, 60th anniversary session, Geneva, Switzerland

### IMF Executive Board

For an up-to-date listing of IMF Executive Board meetings, see [www.imf.org/external/np/sec/bc/eng/index.asp](http://www.imf.org/external/np/sec/bc/eng/index.asp)

## MAY

**2–3** Bretton Woods Committee seminar, “10 Years after the Asian Financial Crises, Asia’s New Responsibilities in the International Monetary System,” Seoul, Korea

**4–7** 40th Annual Meeting of the Board of Governors of the Asian Development Bank, Kyoto, Japan

**6–8** G-8 labor and employment ministers’ meeting, “Shaping the Social Dimension of Globalization,” Dresden, Germany

**9–14** IMF High-Level Seminar on Macroeconomic Management and the Japanese Experience in Economic Development, Tokyo, Japan

**14–15** OECD Forum 2007, “Innovation, Growth, and Equity,” Paris, France

**14–23** World Health Organization, 60th World Health Assembly, Geneva, Switzerland

**16–17** Annual Meetings of the Governors of the African Development Bank Group, Shanghai, China

**18–19** G-8 ministerial meeting, Schwielowsee, Germany

**20–21** European Bank for Reconstruction and Development, Annual Meeting and Business Forum, Kazan, Russia

**30–June 15** 96th Session of the International Labor Conference, Geneva, Switzerland

## JUNE

**6–8** G-8 Summit, Heiligendamm, Germany

**18–July 21** The International Economic Forum of the Americas, “Succeeding through Uncertainty: From Risk Evaluation to Strategic Decision,” Montreal, Canada

## JULY

**6–8** Cercle des Economistes Seminar, Aix-en-Provence, France

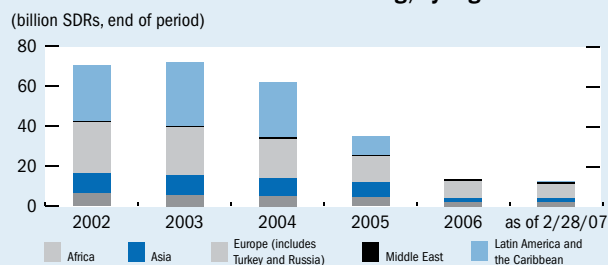
### New Perspectives on Financial Globalization IMF, Washington, D.C., April 26–27, 2007

The conference, sponsored by the IMF’s Research Department and Cornell University, aims to provide a forum to present recent theoretical and empirical research on the macroeconomic implications of financial globalization.

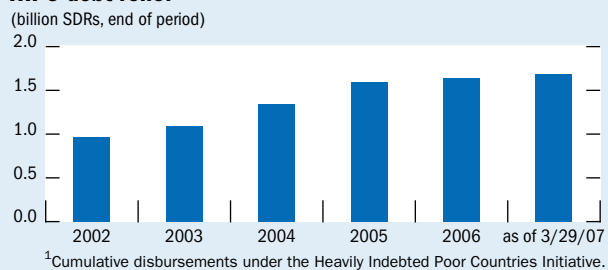
For details, see [www.imf.org/external/np/seminars/eng/2007/finglo/042607.htm](http://www.imf.org/external/np/seminars/eng/2007/finglo/042607.htm).

# IMF financial data

## Total IMF credit and loans outstanding, by region



## HIPC debt relief<sup>1</sup>

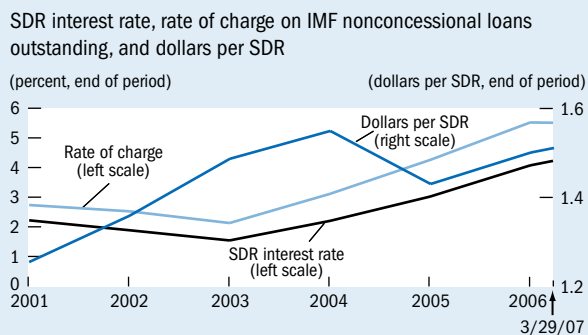


Note: Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also

## Major currencies, rates per SDR

	April 2, 2007	Year ago (April 03, 2006)
Euro	1.133	1.192
Yen	178.590	169.760
U.K. pound	0.767	0.832
U.S. dollar	1.510	1.440

## Related rates



serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

## Global economy, IMF reform top Spring Meetings agenda

The world's top financial and development officials will review the outlook for the global economy and assess progress with the IMF's medium-term strategy during the Spring Meetings of the IMF and the World Bank in Washington, D.C., on April 14–15. Managing Director Rodrigo de Rato will present a report to the IMF's International Monetary and Financial Committee (IMFC) outlining progress on a range of key issues since the IMF–World Bank Annual Meetings, held in Singapore last September.

The IMFC, chaired by U.K. Chancellor of the Exchequer Gordon Brown, will review the outlook for the global economy. Despite the recent turmoil in financial markets and concerns about the housing market in the United States, the IMF's *World Economic Outlook* predicts that strong global growth will continue, albeit at a somewhat reduced pace (see pages 84–85). De Rato is expected to brief the IMFC, the primary advisory committee of the Fund's Governors, on progress with reducing global payments imbalances through multilateral consultations. The IMFC will also hear from Pascal Lamy, Director of the World Trade Organization, on the status of world trade talks.

### Revamping operations

The IMFC endorsed de Rato's medium-term strategy for the Fund at the Spring Meetings last May. Since then, the 185-member institution has been working to revamp operations in a number of areas, including its surveillance of global, regional, and country economies; help for low-income countries; governance of the IMF; and its income position.

**Surveillance:** The IMF is modernizing its surveillance framework and strengthening its monitoring and assessment of the financial sector and capital markets (see pages 94–95). It is also discussing with members possible revisions in its approach to surveillance of exchange rates. But de Rato said in a speech prepared for delivery to the Peterson Institute for International Economics in Washington on April 9 that there were limits to what the Fund could do. "The Fund can advise, but we cannot and should not dictate to our members on the choice of their exchange rate regimes, their intervention policies, or their exchange rate levels," de Rato stated. "Indeed, in a world of globalized financial markets, there are limits to what countries can do to influence exchange rate levels. The days when a group of finance ministers could sit in a hotel room and decide currency values are over."

**Multilateral consultations:** The IMF has held meetings over the past year with key economies—China, the euro area, Japan, Saudi Arabia, and the United States—to discuss how



U.K. Chancellor of the Exchequer Gordon Brown (left), Chairman of the IMFC, and IMF Managing Director Rodrigo de Rato.

to wind down global payments imbalances gradually while maintaining world economic growth. In his April 9 speech, de Rato said the IMF aimed to solidify agreement on an approach for a gradual reduction in the imbalances. He said the work was well advanced and that he would have more to say after the IMFC discussion.

**Low-income countries:** De Rato said that the Fund would focus on what it can do best and on tasks where it can make the greatest contribution in helping low-income countries. The recently issued Malan Committee report on Fund-Bank collaboration also pointed in this direction, he stated, adding that he expected growing interest from countries in the IMF's Policy Support Instrument (see pages 92–93).

**Quotas and voice:** The IMF is pressing ahead with what is envisaged to be a two-year process of reform designed to update the representation of members and modernize the governance of the 62-year-old institution (see *IMF Survey*, February 26, 2007). After an initial round of ad hoc increases last September for four economies that were clearly underrepresented (China, Korea, Mexico, and Turkey), the IMF has now embarked on the second and more far-reaching phase of the reform process. The IMFC is expected to review progress so far, and the Fund's objective remains to come back to the IMFC with proposals on a new quota formula by the next Annual Meetings, if possible.

**IMF income:** Andrew Crockett, head of a committee that looked at alternative ways of financing the IMF, has been invited to brief officials about the committee's proposals, which were presented at the end of January. The proposals include investing a portion of the IMF's quota resources to generate a regular income flow and limited sales of gold (of about one-eighth of the Fund's total gold holdings) to establish an income-generating endowment (see *IMF Survey*, February 12, 2007). ■

## Global economy on track for continued strong growth, says IMF

**G**lobal economic growth will moderate to 4.9 percent in 2007 and 2008, from 5.4 percent in 2006—a strong performance despite the recent volatility in world financial markets and difficulties in some parts of the U.S. housing market, according to the IMF's *World Economic Outlook (WEO)*. Although economists judged that the risks to the forecast are lower now than they were six months ago when the last *WEO* was issued, those risks remain tilted to the downside. The *WEO* said five are worth noting:

- There could be a sharper slowdown in the United States if the housing market continues to deteriorate.
- Oil prices could spike given limited spare production capacity and continuing geopolitical uncertainties.
- Inflationary pressures could be rekindled as output gaps continue to close,

particularly if there were another spike in oil prices.

- Continued volatility in financial markets could lead investors to move further away from risky assets.
- Global imbalances could unwind in a disorderly fashion. Although the probability of this occurring is low, the costs would be high.

Finally, from a longer-term perspective, several trends—including the aging of populations, rising political resistance to increasing globalization, and the environmental consequences of rapid growth—could undermine the buoyant productivity that has underpinned recent strong global growth.

### Outlook for the large economies

Among the major advanced economies, the *WEO* predicts that the slowdown in year-on-year growth in 2007 will be most pronounced in the United States. The U.S. economy should gather some momentum again during the course of the year as the drag from the housing sector moderates in the second half of 2007, although a return to growth in line with potential is not expected until mid-2008. The U.S. Federal Reserve has kept interest rates on hold since June 2006, seeking to balance risks from a cooling economy and continuing concerns about inflation.

Growth is projected to ease in the euro area this year, following the best growth performance there in years in 2006. This projected slowdown reflects the gradual withdrawal of monetary accommodation and further fiscal consolidation, as well as the unwinding of certain onetime factors, such as the acceleration of consumption in Germany ahead of the preannounced increase in the value-added tax, which boosted growth in 2006.

In Japan, inflation readings remain uncomfortably close to zero, and the central bank has raised its policy interest rate only very gradually since exiting its zero interest rate policy in July 2006. But the IMF expects the expansion there to continue at about the same pace as last year, with the economy growing at 2.3 percent in 2007.

Emerging market economies and developing countries are expected to continue to grow strongly, although at

a less torrid pace than in 2006. China's growth is expected to moderate to about 10 percent in 2007, from 10.7 percent in 2006. India's economy is also expected to slow, as economic policies are tightened to counter overheating. The IMF also expects commodity-rich countries in Africa, the Commonwealth of Independent States, the Middle East, and Latin

America to continue to prosper, with growth in Africa accelerating to 6.3 percent in 2007.

### How big are the risks?

The IMF sees about a one in five chance of global growth falling below 4 percent in 2008. The housing market downturn in the United States represents one of the most significant risks to the *WEO* forecast. Over the past few months, there have been some tentative signs of stabilization, at least on the demand side, with existing home sales and mortgage applications steady, and even improving. But the housing correction is far from over. Housing starts and permits are still heading downward, whereas inventories of unsold homes remain close to their highest levels in 15 years. The subprime mortgage market, which constitutes about 12 percent of the total

### World economy to continue expanding

Even though the U.S. economy is slowing, other players in the global economy will continue to grow at a healthy pace, according to the *WEO*.

	2006	2007	2008
World output	5.4	4.9	4.9
United States	3.3	2.2	2.8
Euro area	2.6	2.3	2.3
Germany	2.7	1.8	1.9
Japan	2.2	2.3	1.9
Africa	5.6	6.3	5.8
China	10.7	10.0	9.5
India	9.2	8.4	7.8

Source: IMF, *World Economic Outlook*, April 2007.

mortgage market, is under duress, with sharp increases in delinquency and default rates.

The key question is whether the problems in the subprime market will affect the U.S. economy more broadly. Although house prices have continued to slow on a national level, with outright price declines in many metropolitan areas, household finances still look solid.

Therefore, the *WEO* does not predict major spillovers from the current difficulties in the housing sector, provided that employment and income growth remain resilient. That said, there is still a risk that a sharper-than-expected slowing in house prices could lead to a more prolonged slowdown, particularly if consumption were affected through the impact on wealth and employment.

Inflation pressures in the advanced economies have generally eased, but concerns remain. In the United States, core inflation is still somewhat higher than the Federal Reserve's implicit comfort zone, and a gradual slowing of productivity growth is adding to cost pressures. In the euro area, price and wage increases remain subdued, but unemployment has fallen to cyclical lows, capacity utilization is high, and inflation pressures could emerge if labor markets continue to tighten. Output gaps are also closing in emerging markets, which means that the dampening effect of global competition on wages and prices in the advanced economies could start to moderate. Finally, inflation could increase as a result of spikes in commodity prices, not least in the price of oil.

There are also threats to financial stability. Although the recent turbulence in financial markets appears to be contained, it serves as a healthy reminder of underlying financial risks. Recent years have been unusual for markets, with relatively low real interest rates and very low

volatility despite monetary tightening by major central banks. The concern is that the drive for yield may have led to greater risk taking in less-well-understood markets and instruments. This strategy has been successful in buoyant markets, but price setbacks, rising volatility, and loan losses could lead investors to pull back from overextended positions. Such an unwinding could have

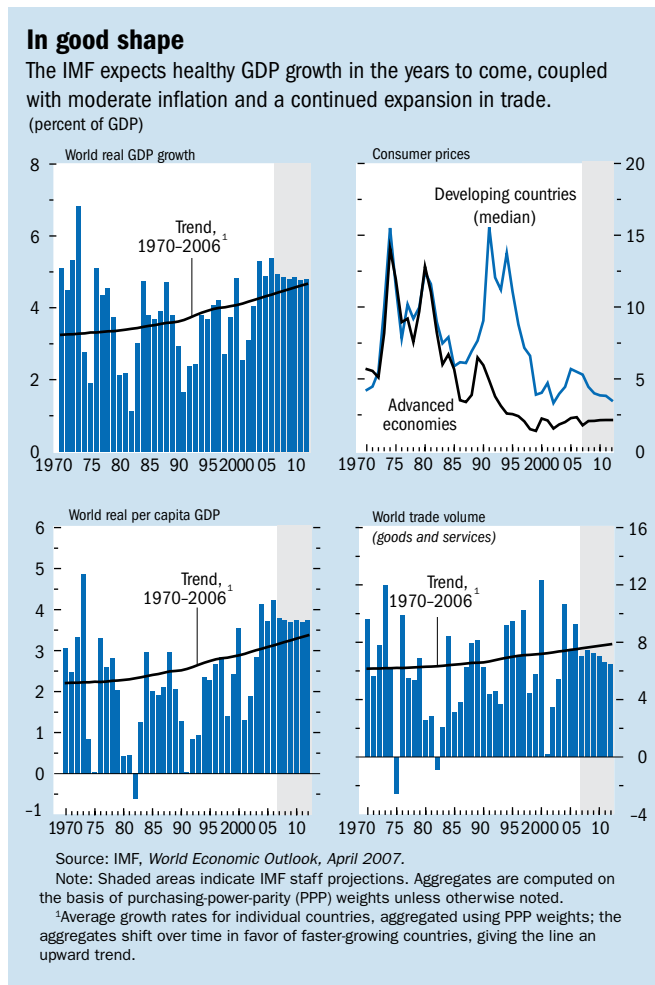
serious macroeconomic consequences.

Finally, there are risks stemming from global economic imbalances. Over the past six months, there has been some welcome movement toward containing global imbalances, which has reduced, although far from eliminated, the risk of a disorderly unwinding. There has been a further reduction in the real effective value of the dollar and some increased flexibility for the currencies of countries in Asia with large current account surpluses. There has also been a decline in the price of oil, and a somewhat more balanced pattern of global demand is emerging.

### The bottom line

The sum of all these developments has not substantially changed the outlook for the global economy. But it would be a mistake to become

complacent, the *WEO* warns. Policymakers need to remain vigilant to short-term macroeconomic risks while taking advantage of the continuing strong performance of the global economy to press ahead with more ambitious efforts to tackle deep-seated structural challenges. ■



See pages 88 and 89 for more coverage of the *World Economic Outlook*. Copies of the *World Economic Outlook*, April 2007, are available for \$57.00 (\$54.00 academic rate) each from IMF Publication Services. See page 100 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## Global Financial Stability Report

# Financial, credit market conditions strong, but risks are rising

Global economic conditions are underpinning a positive financial environment, but underlying risks and conditions have shifted somewhat since the September 2006 *Global Financial Stability Report (GFSR)* and have the potential to weaken financial stability (see Chart 1). Indeed, despite recent gyrations in world stock markets, financial market volatility across a broad range of assets remains at remarkably low levels and risk spreads remain tight, both historically and relatively to previous business cycles, according to the IMF's latest *GFSR*.

However, investors may be giving insufficient weight to downside risks, perhaps assuming that the current low risk premiums have become a semipermanent feature of the financial landscape. "A market correction, potentially triggered by a 'volatility shock,' could be amplified by leveraged positions and uncertainties about concentrations of risk exposures stemming from the rapid growth in innovative, complex products, some of which have rather illiquid secondary markets. For these reasons, we have raised our assessment of market risks," according to the first chapter of the report.

None of the risks by themselves significantly threatens global financial stability. However, investors may not have

adequately factored in the possibility that a volatility shock may be amplified, given the increased linkages across products and markets.

The report identifies four key areas of heightened short-term risk:

- **The U.S. subprime mortgage market:** The subprime segment of the U.S. housing market is showing signs of credit quality deterioration; although the fallout has so far been limited and diffused, it has the potential to deepen and spread to other markets—possibly to structured mortgage credit products held by a variety of global investors (see box).



This foreclosure sign in Detroit, Michigan, is an indication of deteriorating credit quality in the U.S. subprime housing market.

Jim West/ZUMA Press

- **Leveraged buyouts:** Low interest rates and healthy corporate balance sheets have spurred an increase in private equity buyouts. This has led to a substantial rise in leverage for bought-out firms, potentially making them more vulnerable to economic shocks. "The situation bears careful attention especially if a large high-profile

deal runs into difficulty, as this could trigger a wider reappraisal of the risks involved," the report says.

- **Capital flows to emerging markets:** Capital inflows to some emerging markets have risen rapidly, reflecting in part improved economic fundamentals, but they are also prompted by the search for yield as a result of low real interest rates in most mature markets. In general, strong private capital inflows reflect a reallocation of capital to more productive investments and are to be welcomed. However, the shift to private sector debt flows—especially bank-based flows into emerging Europe and portfolio flows into other regions, including sub-Saharan Africa—shows that foreign investors are taking more risk.

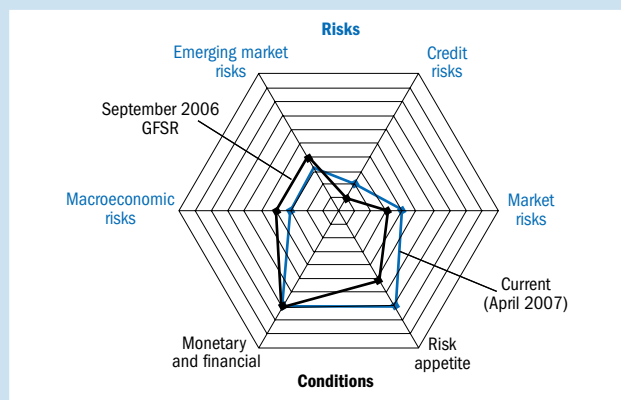
- **Global imbalances:** Although the downside risk from a possible disorderly unwinding of global payments imbalances has receded, it remains a concern. The larger role fixed-income inflows have played in financing the U.S. current account deficit indicates that inflows may have become more sensitive to changes in world interest rate differentials.

The report sees the growth of carry trades as another sign that market participants do not view the cyclical factors contributing to the low-volatility environment—abundant low-cost liquidity, low leverage in the corporate sector, and high-risk appetite—as likely to reverse in the near term. Investors in the carry trade sell a certain currency with a

Chart 1

### Rising market and credit risks

Investors are willing to increase their exposure to riskier assets because they are searching for higher returns.



Source: IMF staff estimates.

Note: Closer to center signifies less risk or tighter conditions.

## Risks from the U.S. subprime mortgage market

Although there are some signs that the U.S. housing market is stabilizing, risks of further deterioration cannot be ruled out, the report states. Overall, the U.S. mortgage market has remained resilient, but the subprime segment has deteriorated more rapidly than had been expected at this point in a housing downturn (see Chart 2). The fallout has so far been limited to subprime originators and lenders, but could still affect other market participants.

U.S. residential mortgage-related securities represent one of the largest pools of fixed-income securities in the world, totaling about \$5.8 trillion as of January 2007. Non-U.S. holdings of these securities, estimated at \$850 billion as of mid-2006, represent a significant portion of foreign holdings of U.S. securities.

The report argues that although credit risk is concentrated among subprime borrowers—those with impaired or limited credit histories—there is a risk that other, higher-quality mortgage collateral may be subject to some of the underwriting weaknesses observed in the subprime sector. That would hurt profitability at banks that invest in, originate, securitize, and structure mortgages; other credit markets that were fueled by rising house prices may also be at risk. The report cites anecdotal evidence suggesting that overseas investors and hedge funds also have significant exposure to the riskier portions of the collateralized debt obligation market exposed to subprime risks.

relatively low interest rate and use the proceeds to purchase a different currency or security yielding a higher rate—which poses risks if either exchange rates or anticipated interest rates change rapidly.

The report argues that competitive pressures and risk models may be helping to perpetuate risk taking. From an individual institution's view, risk taking is a rational response to the current environment but, collectively, could raise systemic risks by causing a buildup of investment positions in certain markets that could result in a disorderly correction if conditions changed.

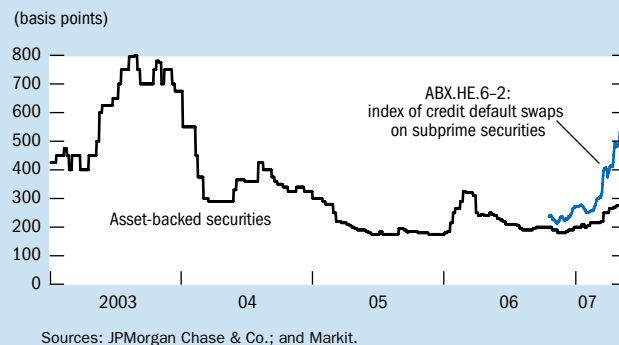
### Rising credit risks

Overall, corporate profits appear robust, balance sheets are strong, credit spreads have declined further, and default rates remain low. However, corporate debt in private markets is rising from low levels as a result of the boom in leveraged buyout (LBO) activity. The size of target companies in the current wave of LBOs is much larger than those in the 1980s and late 1990s, and the use of loans is expanding more than that of high-yield bonds. So far, target firms are mostly those

Chart 2

### Widening spreads on subprime securities

The deterioration in the credit quality of subprime mortgages has meant wider spreads on the securities collateralized by them.



with strong cash flows and low debt. But some LBO-acquired firms have become heavily indebted and may thus be more fragile if there is an economic downturn. At the same time, there appears to be less due diligence and a general weakening of loan covenants in more recent deals. In view of these developments and those in the U.S. housing market, the IMF's overall assessment is that *credit risks* have increased since last September, although from a low level.

### Bigger risk appetite

Emerging market countries generally continue to follow sound macroeconomic policies, external positions are generally strong, and robust growth has improved fiscal positions in many countries, the report says. Despite recent declines, commodity prices remain high. Where sovereign issuance in international capital markets has declined, private corporate issuance has filled the void. The favorable external environment and accompanying rise in *risk appetite*—reflected in the rapid rise in capital flows to some emerging market countries—pose challenges for those authorities and could threaten financial and economic stability, especially if capital flow were reversed. In some countries, the generally strong external position of the government may mask potentially growing vulnerabilities for corporations and banks. The report urges policymakers to manage stability risks by making sure that investors adequately understand and appreciate the risks they are taking. ■

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Copies of the *Global Financial Stability Report: Market Developments and Issues*, are available for \$57.00 (\$54.00 academic rate) each from IMF Publication Services. See page 100 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## Labor globalization: bane or boon?

Over the past two decades, labor has become increasingly globalized; that is, countries have access to an increasingly large global supply of labor through immigration, offshoring of the production of intermediaries, and imports of final products. Chapter 5 of the IMF's April 2007 *World Economic Outlook (WEO)* estimates that the integration of China, India, and the former Eastern bloc into the world economy, together with population growth, has quadrupled the size of the effective global labor force since 1980. By 2050, it could more than double again.

Labor globalization has benefited advanced economies: it has expanded export opportunities considerably and, by lowering input costs and improving production efficiencies, has boosted productivity and output. As a result, labor compensation has risen in all advanced countries since 1980. For instance, calculations suggest that the decline in traded goods prices over the past 25 years has generated a 6 percent increase, on average, in both output and real labor compensation.

Research published in the *WEO* suggests that labor globalization, technological change, and labor market policies have all affected the share of income accruing to labor (the labor share) over the past two decades (see chart). The first two have reduced the proportion of income going to labor, with technological advances having the larger effect. This share has declined by about 7 percentage points, on average, since the

early 1980s in advanced countries, with the European countries, Japan, and unskilled sectors of the economy experiencing the largest declines. In contrast, countries that have reduced the tax wedge, thereby lowering the cost of labor to business, and ensured that unemployment benefits do not deter workers from seeking employment have generally experienced a smaller decline in labor share.

Technological change has hit the labor share in unskilled sectors particularly hard; growth in real labor compensation has been sluggish in those sectors. In the United States, unskilled employment has held steady, but the earnings gap between skilled and unskilled workers has widened by 25 percent. In Europe, real compensation per worker in both skilled and unskilled sectors grew at roughly the same rate, but employment in unskilled sectors lost ground to employment in skilled sectors.

**The issue:** Is globalization forcing down labor income in advanced economies?

**The bottom line:** Although the global labor force has swelled over the past two decades, it has contributed to rising labor compensation in advanced economies.

**Is there a downside?** Yes. Globalization is one of several factors that have reduced the share of income accruing to labor in advanced economies.

### Challenges for policymakers

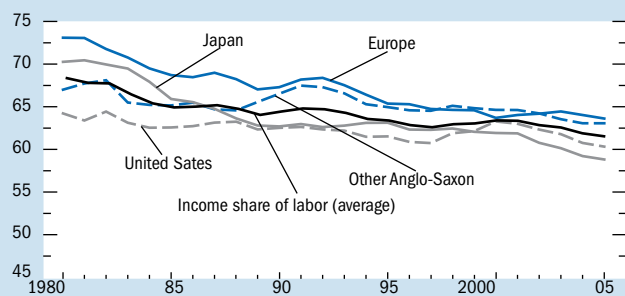
Policymakers in advanced economies must seek to harness the benefits that the growing pool of global labor and technological progress are creating. This means continuing to liberalize trade while ensuring that domestic economies are flexible enough to adjust and respond to the pressures of ongoing changes. They must also be aware of adjustment costs and implement policies that support individuals adversely affected. Policies should meet three broad objectives:

- **Improve the functioning of labor markets.** Policies that reduce labor costs to business (specifically, that lower the tax wedge) and make it easier for workers to move from declining to expanding areas of the economy will help the adjustment. In some countries, making health care less dependent on continued employment and increasing the portability of pension benefits would also help.
- **Increase access to education and training.** Workers in skilled sectors have been better able to adapt to changing conditions caused by the revolution in information and communications technology than workers in unskilled sectors.
- **Ensure adequate safety nets.** Adequate income support should be available to cushion, but not obstruct, the process of change. ■

Florence Jaumotte and Irina Tytell  
IMF Research Department

### Declining slice of a growing pie

Although labor compensation in advanced economies has risen, the proportion of income accruing to labor is falling as a percentage of GDP (percent of GDP)



Source: IMF, *World Economic Outlook*, April 2007



## In search of greater global balance

Some analysts argue that large global imbalances—the U.S. trade deficit and the surpluses of some advanced economies, emerging markets, and oil exporters—can be sustained for a relatively long time because they reflect secular changes in the global economy, such as the integration into world markets of countries with large and underutilized labor forces and the relatively less rapid aging of the U.S. population. According to this view, the narrowing of the imbalances will depend on a rebalancing of the saving and investment behaviors of the United States and the surplus economies, with exchange rate realignment playing a minor role.

Others argue that because of the incomplete global integration of markets for goods and services and the rigidities that impede the reallocation of resources to tradable sectors, a narrowing of global imbalances will require a rebalancing of demand between the United States and surplus economies *plus* considerable movement in real exchange rates to avoid a prolonged U.S. recession.

### History sheds some light

Chapter 3 of the IMF's April 2007 *World Economic Outlook (WEO)* looks at a broad range of countries over the past 40 years to identify

episodes of large external imbalances. It then looks at the length of the episodes and the roles real exchange rates and changes in growth differentials played in the adjustment of the imbalances.

The *WEO* analysis shows that movements of real exchange rates helped smooth the rebalancing of demand involved in the narrowing of external imbalances. GDP growth declined

less in advanced countries undergoing a large and sustained reversal of external deficits when their currency depreciation was relatively large (see chart). Domestic policies were also important for external adjustment. In particular, increases in saving rates and strong fiscal consolidation in deficit countries helped sustain investment and growth rates. For both advanced and emerging market countries, large and sustained reversals of external surpluses tended to entail real currency appreciations. Moreover, when countries' surpluses narrowed, domestic demand

generally picked up and monetary and fiscal policies were more expansionary.

**The issue:** Large external imbalances are considered potentially risky, but how can they be reduced?

**The bottom line:** Cross-country experiences suggest that a market-led realignment of real exchange rates, in conjunction with a balancing of demand across countries, can smooth the unwinding of external imbalances.

**The debate:** There's no consensus about how long such imbalances can be sustained or the channels through which adjustment takes place.

### U.S. trade balance

The *WEO* analysis suggests that U.S. trade volumes may be more responsive to changes in the real value of the U.S. dollar than is often assumed. Standard trade models tend to underestimate this response because they do not account for the large differences in response across sectors or for the extent to which imports include intermediate products that are produced domestically. Furthermore, long-run U.S. trade price elasticity has increased over time, reflecting greater competition among firms in an increasingly globalized economy. Taking these factors into account, the *WEO* finds that a real depreciation of the U.S. dollar of 5–10 percent, rather than the usually quoted 10–20 percent, could reduce the U.S. trade deficit by 1 percent of GDP. The current U.S. trade deficit represents about 6½ percent of GDP.

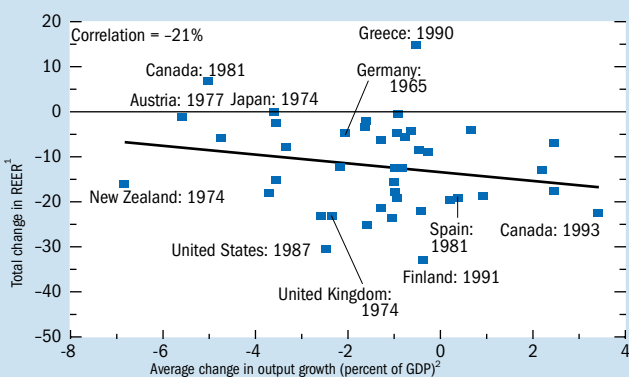
In sum, the adjustment of global imbalances will probably entail a combination of exchange rate movements and a rebalancing of domestic demand—rising rates of absorption in surplus countries and lower demand growth in the United States. Fiscal consolidation designed to ensure that the U.S. economy is well placed to face the cost of population aging would also help. ■

Roberto Cardarelli and Alessandro Rebucci

IMF Research Department

### Depreciation helps

During deficit reversals, GDP growth in advanced economies declined less when their currency depreciation was large.



Sources: IMF staff calculations.

<sup>1</sup>Maximum change in real effective exchange rate within the period surrounding the reversal (-T...T). A decrease represents a real depreciation of a country's currency relative to its trading partners.

<sup>2</sup>Average real GDP growth after the reversal (1...T) less average real GDP growth before the reversal (-T...-1).

## The IMF and Africa

### How effective budgeting supports poverty reduction

**G**reater progress toward meeting global poverty goals in Africa by 2015 will require further increases in government spending on critical public services. This will often mean higher spending on public sector wages to pay the nurses, doctors, and others who are essential to providing these services. But if programs supported by the IMF restrict spending with tight deficit targets—and sometimes wage bill ceilings that limit hiring and wage increases—can progress still be made toward poverty reduction?

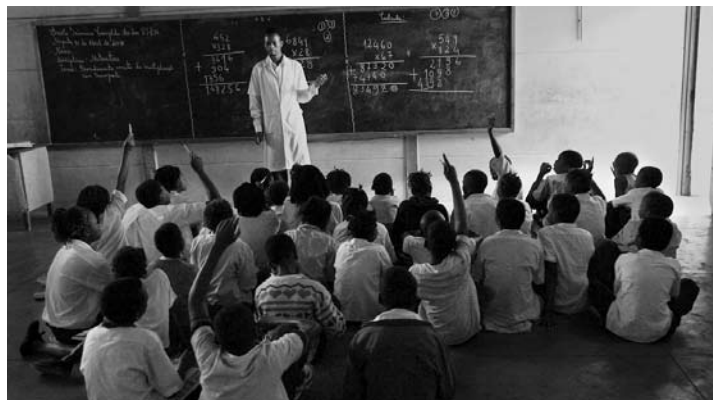
Given the scarcity of resources, the answer lies in effective budgeting. There is not enough foreign exchange to pay for critical imports; aid, although sometimes large as a share of recipient-country GDP, generally remains much below needs, and below recent commitments of donor countries; and tax revenue is small relative to GDP. In addition, there are not enough skilled people to teach, cure diseases, manage spending programs, or even run private businesses.

In this difficult environment, the main responsibility of the IMF is to promote stronger macroeconomic fundamentals: notably low inflation, stable exchange rates, debt sustainability, good public financial management, and strong financial systems. These fundamentals are the prerequisite for sustained growth and poverty reduction. They help support the vibrant private sector that creates employment and raises incomes, and they provide the tax base for higher domestic revenues that can create a sustainable basis for more education and better health care.

The IMF is also adapting its policies and operations to help its member countries make difficult choices in ways that best promote growth and poverty reduction. Let's look at how this is occurring in sub-Saharan Africa.

#### Using aid effectively

Although Africa lags behind most other regions, progress has been made in recent years toward the achievement of the Millennium Development Goals (MDGs). With strong macroeconomic policies—often facilitated by IMF policy advice, program support, and technical assistance, and aided by financial resources from debt relief—growth over the past three years has been in the 5–6 percent range, inflation has been in the single digits, private capital inflows have been increasing, and pro-poor public spending is up. To get closer to achieving the MDGs, however, African countries need faster growth.



The IMF is helping countries expand spending for education and health care. Pictured is a math class in Maputo, Mozambique.

One way the IMF is adapting is by making stronger efforts to help countries find ways to increase their capacity to absorb aid prudently and effectively. To this end, it supports programs that allow such resources to be spent. Indeed, Fund-supported programs in Africa have been designed to allow grants to finance larger deficits when basic macroeconomic stability has been established. The Fund also helps countries manage the aid volatility that can make good public expenditure management so difficult, including by helping countries accumulate adequate reserves as a buffer against shocks.

More generally, the IMF is helping to ensure that countries have the fiscal space they need in their budgeting to expand priority social spending and public investment programs.

- **Raising revenues.** Tax revenues are one of the most stable and sustainable sources of financing for government spending. By providing advice and technical assistance, the IMF helps countries raise revenues efficiently and durably. The average program supported by the IMF's Poverty Reduction and Growth Facility (PRGF) in sub-Saharan Africa envisages a 2 percent increase of revenues as a share of GDP over the course of four years. The actual outturn was slightly better than this, with the average revenue share at 20 percent of GDP by the end of the program.

- **Using grants and concessional loans.** Foreign borrowing can provide extra resources. But if the associated investments do not pay off, debt servicing difficulties down the road can become an obstacle to growth. Countries thus need to make use of grants and concessional debt as much as possible to keep this risk as low as possible. The IMF and the World Bank have established an enhanced debt sustainability framework designed to help countries put in place debt management strategies to avoid a renewed buildup of unsustainable debt.

• **Avoiding a debt trap.** Borrowing from domestic sources can be a way to raise some additional revenue, but it can soak up resources that the financial system might otherwise lend to the private sector. Moreover, interest rates on such borrowing are often very high, so that even a relatively small amount of such debt leads to a large fraction of public expenditure going toward domestic debt service. For example, interest on domestic debt in Zambia reached 2.9 percent of GDP in 2004 but is expected to come down to about 1.1 percent of GDP in 2007, freeing substantial additional resources for poverty-reducing spending. The Fund helps countries strike a balance here.

On the spending side, the IMF encourages the orientation of budgets to pro-poor spending. Such spending—typically defined in a country’s Poverty Reduction Strategy Paper (PRSP) to include primary education, basic health care, and country-specific priorities such as rural roads, agriculture, water, and HIV/AIDS programs—is reported by the IMF and is generally rising in PRGF countries. For example, in sub-Saharan Africa it rose a full percentage point in 2006 to 11 percent of GDP. In some cases, it may be useful to have a floor on the level in a Fund-supported program, so that in the event of shocks, such as a shortfall in expected aid, critical spending is protected from cuts. IMF-supported programs have thus in some recent cases, as in Uganda and Rwanda, included such floors.

### Restricting wage bill ceilings

A recent report by the IMF’s Independent Evaluation Office raised concerns about key aspects of IMF policy and practice on aid to Africa, including the use of wage bill ceilings in Fund-supported programs (see *IMF Survey*, March 19, 2007). This comes at a time when the Fund is examining the scope for removing wage bill ceilings from many of its programs in Africa. In some instances, however, these ceilings will be retained when the authorities feel strongly that they are needed to help contain serious wage bill pressures.

Because this issue has been the subject of substantial controversy over the past few years, it may be worthwhile looking at the rationale for wage bill ceilings—sometimes used in support of civil service reforms—along with the justification for working to limit their use.

Why might wage bill ceilings be useful? In many countries, the public sector wage bill has been a source of macroeconomic imbalances as a result of unplanned, excess spending and poor expenditure control. If the budget process works, there should be no need for wage bill ceilings; wage and employment increases would be in the budget and thus properly planned for and financed. When wage policy is not coordinated with sectoral priorities and the availability of money to pay for them, however, the ceiling can be a useful second line of defense. Wage bill ceilings are intended, in these circumstances, to help

implement a budget that spends all available resources—and no more—and that provides for books as well as teachers and medicines as well as nurses.

Wage bill ceilings have not restricted the use of donor funds. The ceilings are set in the context of the annual budget cycle and can be revised during program reviews to incorporate new information on expected aid flows and desired staffing and wage levels. For example, the quantitative benchmark on wage bill ceilings in the program for Senegal allowed a 20 percent rise in the number of civil servants during 2003–05, in line with levels projected in the government’s PRSP. Moreover, in many cases, there are “carve-outs” to accommodate additional hiring or wage increases when higher-than-expected donor funds become available. For example, Zambia’s ceiling incorporated the hiring of additional health and education staff, while Malawi’s ceiling adjusts automatically for donor-funded health expenditure.

Partly for these reasons, an independent survey of health practitioners in low-income countries found few constraints attributed to IMF conditionality. Asked for the most important reasons why funds remain unspent, only 1 percent of those practitioners surveyed by the Center for Global Development and the International AIDS Economics Network of health economics practitioners cited IMF or World Bank restrictions. The critical constraints reported in that survey included a lack of political will (29 percent of respondents), poor national coordination (28 percent), shortcomings in the health care delivery system (14 percent), and national absorptive capacity constraints (8 percent). The last two categories presumably partly reflect the shortage of skilled health workers and managers.

Even so, wage bill ceilings are not the best way to eliminate related macroeconomic imbalances because they do not solve the underlying problems that need to be addressed through civil service reforms and improvements in payroll management. In addition, they are often not binding but cause problems of their own instead. For example, they can create incentives to increase nonwage compensation, reducing the transparency of overall wage-related spending.

Therefore, ceilings should be selectively used in support of sound structural reforms of public sector employment and wage policy. When the budget process works well enough, the ceilings should be dropped, as recently happened in the IMF-supported program in Mozambique. ■

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For further information on wage bill ceilings and Kenya, see [http://www-int.imf.org/depts/exr/exrsite/resources/resources\\_KenyaHealth.pdf](http://www-int.imf.org/depts/exr/exrsite/resources/resources_KenyaHealth.pdf); for Mozambique, see <http://www.imf.org/external/np/vc/2006/020706.htm>; and for Ghana, Zambia, Uganda, Kenya, and Malawi, see [http://www-int.imf.org/depts/exr/exrsite/resources/resources\\_BritishMedicalAssociation%20.pdf](http://www-int.imf.org/depts/exr/exrsite/resources/resources_BritishMedicalAssociation%20.pdf).

## IMF's Policy Support Instrument promotes close policy dialogue

A number of African countries are considering adopting a flexible new policy framework with the IMF that enables them to secure Fund support for, and endorsement of, their economic policies without a borrowing arrangement. Since the new Policy Support Instrument (PSI) was established by the IMF's Executive Board in October 2005, four countries in Africa—Nigeria, Uganda, Cape Verde, and most recently Tanzania—have adopted it.

The PSI was created to provide a support framework for low-income countries that no longer need IMF financial assistance but want Fund endorsement of their economic policies. The PSI, which is voluntary and demand driven, is well suited to countries graduating from Poverty Reduction and Growth Facility (PRGF) arrangements. These countries—the so-called “mature stabilizers”—have made significant progress toward macroeconomic stability and debt sustainability, are well advanced in structural reforms, and have built up adequate international reserves. Nevertheless, they may still want Fund advice and support as they continue to strengthen their growth prospects, together with their macroeconomic policy frameworks, institutions, and governance structures. An on-track PSI may also provide the basis for rapid access to the IMF's quick-disbursing Exogenous Shocks Facility in case emergency assistance is required.

### Underpinning stability

The PSI encourages countries to deepen and broaden their ownership of the policy agenda. As much as possible, policy strategies and objectives draw on domestically produced documents, including budget documentation and Poverty Reduction Strategy Papers. Nigeria's PSI, for example, is based on the National Economic Empowerment and Development Strategy, the country's homegrown poverty reduction strategy. The authorities chose to present their policies to the Fund in their own policy statement rather than in the format of a conventional letter of intent. Uganda's initial PSI and its new three-year PSI incorporate macroeconomic targets based on its existing medium-term expenditure framework and reflect the priorities and strategies set out in the country's Poverty Eradication and Alleviation Plan.

Similarly, the PSIs for Cape Verde and Tanzania have been developed in coordination with these countries' overall development and poverty reduction strategies. In support of domestic ownership, PSI countries typically pursue a range of

measures to strengthen local skills and capacities. For example, measures to increase capacities in such areas as public sector financial management, delivery of public services, and resource mobilization are prominent in the current PSIs.

### Tailored strategies

Under their PSIs, countries have the flexibility to specify policy objectives and design reform strategies that are tailored to their economic conditions. In general, policies aim to consolidate macroeconomic stability and push ahead with structural reforms, addressing, in particular, critical bottlenecks to private sector-led growth and poverty alleviation. The reform agenda often includes measures to improve public sector management, strengthen the financial sector, and move forward in other areas consistent with the IMF's medium-term strategy. Under some of the current PSI-supported programs, countries can borrow on less concessional terms for high-quality projects, broadening their financing options and helping them move away from aid dependency. Within each program, however, there is substantial flexibility as to the specific areas of emphasis:

- Uganda began with a 16-month PSI centered on preserving its long record of macroeconomic stability. The country then decided on a new three-year PSI that would both sustain this macroeconomic progress and give particular attention to financial market development—both longer-term financing for businesses and access to financial services in rural areas—together with energy security and transportation infrastructure as the keys to future prosperity. Uganda's PSI also makes special provisions for nonconcessional financing for hydroelectric dam construction, which is a critical part of solving the country's electricity crisis.
- The PSI for Cape Verde aims to support the country's strong economic performance and prospects—as reflected, for example, in high and rising inflows of foreign direct investment. Particular attention is given to reducing macroeconomic risks and providing a safety margin against exogenous shocks, including through the reduction in public debt and further buildup of official foreign reserves.
- In Nigeria, the PSI recognizes the large infrastructure gap that is a major obstacle to private sector development while emphasizing the need for continued efforts to safeguard the country's oil wealth and macroeconomic stability.
- The recently approved PSI for Tanzania seeks to support sustained growth and poverty reduction by enhancing

**The PSI encourages countries to deepen and broaden their ownership of the policy agenda.**



On a recent mission, the IMF's Nils Maehle (front row, right) discusses macro-economic issues with officials in Cape Verde.

public resource mobilization and the efficiency of spending, increasing the financial sector's contribution to growth and the effectiveness of monetary policy, and improving the business climate.

#### Signal to donors

The PSI also provides an important signal—to bilateral donors, multilateral development banks, and financial markets, among

others—that a country's economic policies have been discussed with and endorsed by the IMF. Successful performance under the PSI has allowed Nigeria to implement an agreement with its Paris Club creditors, leading to a substantial reduction of its external debt. Such signals were also viewed as particularly important in Cape Verde, which continues to face significant needs for external assistance to support infrastructure development and other efforts to increase growth and reduce poverty. The signaling role of the PSI is reinforced by the regular, six-monthly review cycle of PSI-supported programs, coupled with the expectation that the country's staff report and other program documents will be published following each review.

In summary, the PSI offers low-income countries a flexible tool for articulating their policy priorities with the support of a continuing, close dialogue with the Fund and for signaling their policy commitments to the international community. Experience under the PSI to date has been positive, both among the countries and among their development partners. These favorable responses may well continue in the period ahead, with countries that graduate from PRGF arrangements finding that the PSI provides an appealing framework for focusing on the broader outcomes sought from their policy agendas and for exploring alternative approaches to reaching these goals. ■

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## African banks need more lending nerve, says author

**B**anks in Africa have money, but “they don't lend very much. The biggest challenge is getting banks to lend more. It's not a question of liquidity. They have the money. . . . There's a lack of banking nerve,” according to Patrick Honohan, who, with his World Bank colleague Thorsten Beck, is the author of a new World Bank book on African finance.

At a panel discussion at the World Bank on March 13 to discuss *Making Finance Work for Africa*, Honohan—Senior Advisor, Finance and Private Sector Development—said that there has been some progress in the past decade in deepening financial systems in sub-Saharan African countries. Private credit, bank deposits, and liquid liabilities have all turned up since 1996. And there has been some pickup in stock markets, too. Still, the financial systems in most sub-Saharan African countries are dominated by banks, and African banking systems are small, absolutely and relatively. They are also reluctant to lend to the private sector, and what little private lending they do is expensive.

Banking spreads are high, far higher than in most of the rest of the world, Honohan said in his presentation, perhaps

because of what banks perceive as the riskiness of lending. Those banks lend only about 30 percent of their resources to the private sector. In most other regions, banks lend 60 percent or more of their resources to the private sector (in Latin America and high-income countries, banks lend 70 percent).

As a result, financial systems in sub-Saharan Africa are the most frequently cited barrier to growth, according to a survey of enterprises. Honohan and Beck, a Senior Financial Economist, Development Research, suggested a number of reforms to increase *finance for growth*, including making banks more comfortable with lending by working on information and legal infrastructures (including property rights), getting rid of unnecessary regulations, and finding other sources of finance, such as pension and social security funds.

In addition to making improvements to enhance economic growth, Honohan and Beck cite developments, such as the Internet and cell phone technology, that can overcome isolation and costly teller services to give households and small businesses better access to banking services—what they call *finance for all*. ■

## Modernizing surveillance

# IMF is reshaping its framework for economic monitoring

The IMF is modernizing its framework for monitoring and advising its 185 member countries on their economic and financial policies, a core activity that it calls surveillance. The goal of surveillance is to promote healthy national economies and a stable international financial system. In his medium-term strategy for reforming the IMF, Managing Director Rodrigo de Rato emphasized the critical role surveillance plays in helping the IMF adapt to the challenges posed by globalization.

To serve this purpose effectively, surveillance must meet several criteria: it should be focused, candid, transparent, evenhanded, and accountable, and it should take into account cross-country spillovers—an area where the IMF is uniquely placed to give advice because of its near-universal membership. Consistent with this strategy, the IMF has launched a number of initiatives to improve the implementation of surveillance. Some of these initiatives seek to improve the institution’s analytical tools; others relate to procedures (see Box 1). Another set of more abstract—but very important—reforms aims at reviewing and, if necessary, modernizing the framework for surveillance. These reforms are the focus of this article.

Box 1

### Improving surveillance implementation: a snapshot

Innovations to improve the implementation of surveillance are under way, complementing the work on updating the legal framework. Some of this work is still at the experimental stage. Multilateral consultations are a new vehicle that allows the IMF to take up issues of shared concern with several member countries at the same time, with a view to promoting collaborative solutions. The first consultation of this type focuses on how to resolve global payments imbalances while maintaining global growth.

Another initiative involves sharpening the focus of the IMF’s dialogue with member countries to concentrate on the most important issues, such as through streamlined consultations with selected countries. The IMF is also strengthening the global and regional perspective of surveillance and is enhancing its exchange rate analysis and its financial and capital markets analysis. As part of this process, it recently refined its methodology for medium-term real exchange rate assessments and extended coverage to include additional economies. Finally, new tools are being developed to better integrate financial sector and capital markets analysis into macroeconomic assessments.



A man in Copenhagen, Denmark, changes foreign exchange figures.

Surveillance serves several important functions. Through the surveillance process, the IMF offers the international community an impartial, expert assessment of the economic and financial policies of each member country (see Box 2). Surveillance relies on candid dialogue, with the IMF acting as a trusted advisor to member countries. It also provides the machinery for international economic cooperation by serving as a forum for its members to engage in discussions of macroeconomic developments at both the country and global levels, including on how one country’s actions may affect other countries. Such cooperation is especially crucial in today’s globalized economy, in which the economic and financial policies of one country may affect the economic well-being of many other countries. Surveillance contributes to well-informed policy debates and well-functioning markets through the release of information to the public and the markets.

### A bit of history

Surveillance as it is practiced today came into being in the late 1970s. In 1977, the Executive Board crafted a policy statement to provide guidance to both members and the IMF itself on how to implement the new Article IV of the IMF’s Articles of Agreement, introduced after the breakdown of the Bretton Woods system of fixed exchange rates. This policy statement is known as the “1977 Decision on Surveillance over Exchange Rate Policies.” It is the IMF’s main policy statement on surveillance.

Since 1977, the practice of IMF surveillance has evolved in response to a changing economic and financial landscape.

Perhaps the most striking adjustment to the surveillance framework was necessitated by the enormous expansion of international financial and capital markets and the subsequent increase in cross-border flows of private capital. This expansion led the IMF to zero in on financial sector surveillance and to pay much greater attention to global spillover effects, notably through exchange rates. The IMF also started to pay more attention to structural policies to relaunch growth in the wake of the oil price shocks in the 1970s, the developing country debt crisis in the 1980s, and the emergence of transition economies in the 1990s. Institutional issues—such as central bank independence and financial sector oversight—were also included in the surveillance portfolio after research showed that weak institutions, along with poor macroeconomic policies, could slow growth. Finally, since the emerging market crises of the late 1990s, the IMF also seeks to assess the extent to which countries may be vulnerable to crises.

In sum, the IMF has continuously refined its analytical tools in response to changes in the global economy. Best practice today is different from what was considered best practice even five years ago. And now the IMF is weighing whether it also needs to modernize the legal framework for surveillance.

### **Modernizing the surveillance framework**

A review of the guiding principles of surveillance—adopted 30 years ago—is important because it will help improve governance by making the IMF and its work on surveillance both more transparent and more accountable. It is also an opportunity for IMF members to make sure that they agree on the role and mandate of surveillance in the 21st century and to set out clear expectations that will help improve the quality and evenhandedness of surveillance. The IMF's 24-member Executive Board launched a review of the 1977 decision in 2006. It has already found important areas of broad agreement and is building common ground in other areas where agreement has yet to be reached.

Although the review process is unfolding, certain things are clear. First, if the decision is to be revised, there will be no new obligations for member countries, and dialogue and persuasion will remain the key pillars of surveillance. Second, the need for due regard to countries' specific circumstances and for evenhandedness in the treatment of members will continue to be emphasized. And, third, the framework will remain flexible to allow surveillance to continue to evolve in response to changes in the global economy.

The IMF has also been examining its methods for assessing the effectiveness of its monitoring and advice and for setting

Box 2

### **Article IV consultations— what they are and what they do**

On a regular basis—usually every year—IMF economists visit each of the institution's 185 member countries to gather information and hold discussions on economic developments, prospects, and policies with government and central bank officials. As part of this process, the IMF team usually also meets with business executives, labor representatives, members of parliament, and civil society organizations.

When the IMF mission has wrapped up its visit, which includes leaving a preliminary statement with the country's authorities, it returns to headquarters and prepares a staff report, which is then submitted to the IMF's Executive Board for discussion. This report contains background information, a summary of the discussion with the authorities (including their views), and an overall appraisal by the staff team. As part of this process, the Executive Director representing the country is given the opportunity to convey the authorities' views to the rest of the IMF's Executive Board.

Each of the 185 IMF members is represented at the Board meeting by one of the 24 Executive Directors, who may submit written statements in advance of the meeting as well as participate in the discussion during the meeting itself. The Board's views are summarized at the end of the meeting in what is known as a "summing up." This statement formally concludes the Article IV consultation and is transmitted to the country's authorities. With the authorities' consent, both the staff report and a "public information notice," which includes the summary of the Executive Board's assessment, are then published on the IMF's website.

priorities. The goal is to make sure that the institution uses robust methodologies when it assesses whether surveillance is achieving its objectives and helping member countries improve their economic performance. Clear objectives are critical so that benchmarks can be set against which to assess effectiveness. In this context, one specific tool under consideration is a high-profile statement of time-bound surveillance priorities—a so-called surveillance remit. Such a statement would help guide the implementation of surveillance and would make it easier to assess the effectiveness of the IMF's advice. ■

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## Booming India at risk of overheating

India's economy continues to perform impressively. Growth has accelerated and, with the right types of reforms, India can effectively leverage its favorable demographic profile into continued strong performance, resulting in higher living standards and declining poverty. But the immediate challenge is dealing with overheating in the face of accelerating inflation, booming credit, and soaring asset prices.

India's GDP growth has averaged 8.5 percent for four years running, making it one of the world's fastest-growing economies. Well known for its strength in the services industry, India is now also gaining ground in manufacturing. Compared with much of East Asia—where reducing export dependence is a policy issue—India's domestic demand is buoyant. One benefit of this diversified growth is India's ability to weather the adverse effects of volatile international oil prices and slowing U.S. growth.

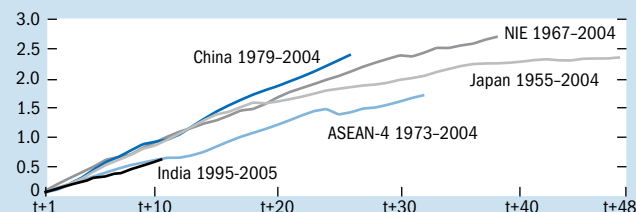
India appears to be at the beginning of a growth takeoff that was sparked initially by structural reforms begun in the mid-1990s (see chart). Over time, this takeoff will substantially raise living standards: according to the IMF's estimate of trend growth, real per capita income will double every 13 years. India can achieve even faster growth by leveraging its rapidly increasing working-age population, which is expected to grow by 140 million over the next 10 years. But success will require striking the right balance to achieve sustainable growth through an effective mix of macroeconomic policies, along with sustained reforms and job creation. A combination of these four main policy measures is critical:

- Managing price and financial stability by limiting the near-term risk of overheating in demand and by further strengthening financial regulation.

### Taking off

GDP growth has remained around 8 percent since 2002, and prospects for sustained growth look promising.

Growth in output (log, index at period t)



Sources: IMF, *World Economic Outlook*, April 2007, and IMF staff estimates. NIE = Newly Industrializing economies. ASEAN-4 = Indonesia, Malaysia, Singapore, Thailand.

### India at a glance

**Capital:** New Delhi

**Area:** 2,973,190 sq. km.

**Population:** 1.11 billion (2005/06)

**Life expectancy:** 64.71 years

**GDP per capita:** \$716 (2005/06)

**Main exports:** Software and information technology services, textiles, jewelry, agriculture, engineering goods, and chemicals

- Achieving fiscal sustainability while financing development by reducing high debt and making budgetary room to fund social and infrastructure spending.
- Broadening and deepening the financial sector to expand the channels for saving, investment, and risk management.
- Promoting more job-intensive, inclusive growth through further structural reforms to create an environment in which growth more fully benefits the least advantaged segments of the population.

### Ease up on the monetary accelerator

Overheating is an increasing risk. Inflation is climbing, with the wholesale price index posting an annual rise of more than 6 percent recently, compared with about 4 percent a year ago (see table). Inflation-adjusted interest rates are low, whereas money, credit, and asset prices are booming—all signs of overheating.

Mindful of overheating risks, the Reserve Bank of India just last week tightened policy further, so the hike in the main lending rate should be 175 basis points instead of 150, and the boost in the cash reserve ratio is now 150 basis points instead of 100. To enhance the soundness of the banking system, the RBI has strengthened prudential regulations and issued guidelines for banks to conduct stress tests. By continuing to tighten monetary policy and prudential standards, the RBI can limit risks of an inflation overshoot and ensure that banks recognize any deterioration in asset quality early on.

### Reduce debt to finance development

India's fiscal accounts are in their best shape in 10 years. The general government deficit is on track to fall to about 6 percent of GDP in the 2006–07 fiscal year (ending March), compared with a high of just over 10 percent in 2001–02.



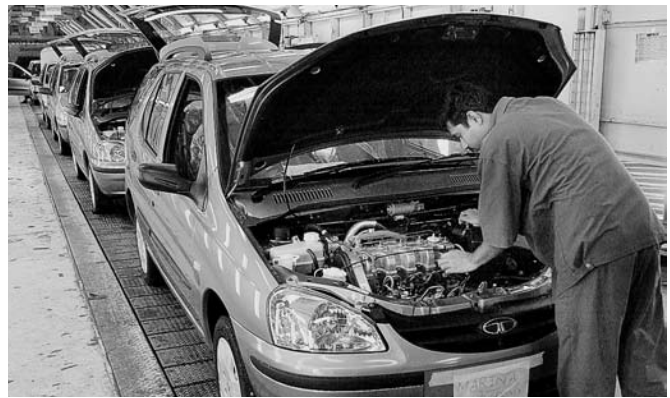
Strong economic growth has helped, particularly by boosting tax revenue. But credit also goes to India's two-pillar framework for fiscal reform. The first pillar, the Fiscal Responsibility and Budget Management Act, sets targets for the central government's deficits; the second pillar, the Twelfth Finance Commission, offers states debt relief and other incentives to adopt fiscal responsibility laws, which most states have done.

Finishing the task of putting India's fiscal accounts in order will require more work. Public debt remains high at 80 percent of GDP, and space needs to be created for priority social spending. Shrinking the deficit would also allow the government to move faster in its drive to open up the capital account. The menu of possible fiscal steps is long: trimming exemptions; introducing a national goods and services tax; eliminating nonessential subsidies and better targeting food, oil, and fertilizer subsidies; and tightening caps on states' borrowing. In the near term, fiscal restraint can also help contain overheating pressures, complementing a tighter monetary policy stance.

#### Develop broader and deeper capital markets

As in many Asian countries, better-developed financial markets in India would facilitate growth by making financial intermediation more efficient and giving market participants more tools to manage risks. A broader and deeper financial sector would also help India achieve two key policy goals: financing its sizable infrastructure needs and opening up its capital account.

The main goal is to develop the basic pillars for vibrant financial markets. Benchmarks such as the money market and government securities market need to be made more liquid, for example, by consolidating benchmark issues and broadening the scope for short selling and foreign investor participation. Steps to develop the embryonic corporate bond market could include streamlining bond issuance and



A worker conducts a final inspection of new cars at a leading automotive manufacturer in Pune, India.

broadening the investor base, especially through pension system reform.

#### Promote job growth and bolster the infrastructure

Job creation has been disappointing. Formal sector employment has gone largely unchanged since the early 1990s. Nearly 60 percent of the labor force continues to work in agriculture—a major reason that more than 800 million Indians live on less than \$2 a day. Aware of these challenges, the government is focusing on removing bottlenecks to growth, such as inadequate infrastructure. For example, the government is turning to public-private partnerships to help meet its enormous infrastructure needs, estimated at more than \$300 billion over the medium term. The India Infrastructure Finance Company has been established to provide finance and refinance facilities for long-term commercial infrastructure projects.

The hope is that through these types of measures, as well as through complementary reforms in such areas as education, India can unlock its underlying potential and leverage its favorable demographics to generate sustained, strong growth and rising living standards for all its citizens. ■

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#### Inflation risks

Although government debt has fallen, inflation is on the rise again.

	2004/05	Prov. 2005/06	Est. 2006/07
		(percent change)	
Real GDP	7.5	9.0	8.9
Wholesale prices	6.5	4.4	6.4 <sup>1</sup>
		(percent of GDP)	
General government debt	85.7	81.9	79.3
Current account balance (billion dollars)	-2.5	-9.1	-22.7
External debt	17.7	15.7	18.1
		(million dollars)	
Gross reserves	141.5	151.6	198.6

Sources: Indian authorities and IMF staff estimates and projections.

<sup>1</sup>As of week ended March 24, 2007.

#### IMF's Website for Legislators

For all the latest information on IMF seminars, policy, and operations, as well as insights into what legislators are saying about the IMF.

[www.imf.org/legislators](http://www.imf.org/legislators)

An online information resource and discussion platform for legislators

## EU accession should help sustain Bulgaria's growth

Marking a milestone in Bulgaria's long recovery from crisis a decade ago, the IMF Executive Board on March 16 completed the fourth and final review under a precautionary Stand-By Arrangement approved in 2004. One of the newest inductees to the European Union (EU), Bulgaria is on a firm footing to tackle the challenges of membership. It can also expect to reap the benefits, but this will require sustained prudent macroeconomic policies to ensure financial stability and structural reforms to maintain growth.

### What a difference a decade makes

A decade ago, the future looked bleak to Bulgarians. Failure to reform state-owned enterprises (SOEs) and to break their dangerous symbiosis with state and private banks was the root cause of the financial and economic collapse in 1996–97. Bank financing of SOE losses, including indirectly by the Bulgarian National Bank, fueled rampant inflation and undermined people's trust in the banking system. Despite strong fiscal efforts to restore stability, by 1997 inflation had surpassed 1,000 percent, GDP was collapsing (output fell by a cumulative 17 percent during 1996–97), and more than 18 percent of job seekers were unemployed.

By 2006, the Bulgarian economic landscape had changed dramatically under IMF-supported programs. Real incomes have been growing strongly, unemployment has been halved, and inflation has been slashed to single digits. To be sure, the currently benign international economic environment and recent optimism over EU accession have both helped. Much of the improvement can be traced, however, to strong macroeconomic policies and structural reforms needed to support the currency board arrangement that pegged the *lev* first to the deutsche mark and then, at the equivalent rate, to the euro.

### Performance under the recent program

A host of indicators point to broadly satisfactory economic performance. Real GDP expanded on average by 5.8 percent during 2004–06, boosted by buoyant private domestic demand. The unemployment rate fell to well below 10 percent in December 2006, while inflation, although higher than expected under the program and higher than the authorities' medium-term target, remained broadly moderate.

Firm policy implementation played a key role. Bulgaria's fiscal policy has been one of the most cautious among countries that are not rich in primary commodities. Successive budget surpluses, exceeding 3½ percent of GDP in 2006, have helped cut gross public debt in half to 25 percent of GDP and facilitated the buildup of a fiscal reserve in support of the currency board. This reserve amounted to about 10 percent of GDP at end-2006. Although

### Bulgaria at a glance

**Capital:** Sofia

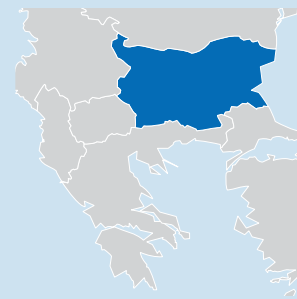
**Area, including water areas:** 110,900 sq. km.

**Population:** 7,667,022 (July 2006 est.)

**Life expectancy:** 72.3 years

**GDP per capita:** \$9,793 (2006 est.)

**Main export products:** clothing, footwear, iron and steel, machinery and equipment, fuels



revenue was buoyed by strong economic activity, spending restraint also played a role. A strengthening of prudential regulation and banking supervision over the years helped rebuild confidence in the banking sector. Mirroring developments elsewhere in the region, bank credit grew rapidly, reaching a rate of 50 percent in 2004. This development reflected the openness of the capital account and financial sector liberalization, as well as the fact that very few people had access to credit during the communist years. While credit growth has slowed recently, in part because of temporary credit restraints, it remains strong.

Structural reform was also supportive. The authorities began to increase the flexibility of the labor market by eliminating the portability of mandatory seniority bonuses and cutting the social security contribution rate. In addition, the public sector was streamlined, and some sectors, such as health and education, were modernized. The government maintained ceilings on increases of the aggregate wage bills of the largest loss-making SOEs while furthering privatization. More progress could have been made to improve the business environment, however, including through more vigorous anticorruption efforts (as stressed by the European Commission in successive monitoring reports) and by completing the modernization of the business licensing and registration system, a long overdue reform under the program.

Against the backdrop of a high degree of trade and capital account openness, accession-driven optimism, and rapid credit expansion, the current account deficit of the balance of payments almost tripled between 2004 and 2006, reaching close to 16 percent of GDP. Although the current account has been consistently financed by huge net inflows of foreign direct investment, external private debt has also risen sharply and by more

than the decline in public debt. By end-2006, overall external debt had risen by 20 percentage points of GDP since 2003, to over 80 percent of GDP, making Bulgaria much more vulnerable to external shocks.

In sum, Bulgaria's progress has helped to establish an enabling environment for success in the EU. The outlook for 2007 is favorable, with growth likely to hover around 6 percent, and inflation falling gradually to about 4 percent by year's end (see table). But with underlying vulnerabilities mounting (even if many indicators currently give some comfort), the government would do well to stick with the prudent macroeconomic policies that have served the country well in the past.

### Challenges in the EU

Bulgaria's accession to the EU is a landmark in the country's international reintegration. Accession indeed holds the promise of helping to sustain growth. First, properly prioritized and targeted project spending can help improve performance over the medium term through improvements and additions to the country's infrastructure. Second, full integration into the common EU trading area should boost trade and competition and thereby increase productivity. Third, a reduction in Bulgaria's perceived risk will encourage private investment and help renew and raise the capital stock. Of a more short-term nature, net financial flows from the EU to Bulgaria—such as structural funds for project financing, funds related to the Common Agricultural Policy, and compensatory payments—will provide a domestic stimulus.

Accession is not a panacea, however. Satisfactory economic performance will continue to depend on sound macroeconomic policies and sustained structural reform. The broad-based support for the macroeconomic framework present since 1997 has improved the dialogue among social partners, facilitating structural reform. Still, avoiding reform fatigue will require strong political will and patience, given the necessarily long phase of catch-up.

#### Solid performance

Bulgaria is reaping the benefits of prudent macroeconomic policies, but challenges remain.

	2003	2004	2005	Est. 2006	Proj. 2007
Inflation (consumer price index, y-o-y, end of period)	5.6	4.0	6.5	6.5	4.2
Real GDP (percent change)	4.5	5.7	5.5	6.2	6.0
Government budget balance (percent of GDP)	-0.4	1.8	2.3	3.6	2.3
Current account balance (percent of GDP)	-5.5	-5.8	-11.3	-15.9	-15.8
External debt (percent of GDP)	60.2	64.2	70.5	81.2	81.0
Net FDI (percent of current account balance)	187.3	136.2	127.4	106.3	77.2
Loans overdue more than 90 days (percent of total loans)	3.2	2.0	2.2	2.2	... <sup>1</sup>
Foreign currency loans (percent of private sector loans)	42.8	47.5	47.3	45.3	... <sup>1</sup>

Source: Bulgarian authorities and IMF staff estimates and projections.

<sup>1</sup>Not applicable.

A prudent fiscal policy stance remains the central pillar of the macroeconomic framework. As the Bulgarian authorities are committed to exiting the currency board arrangement by eventually adopting the euro—a process that requires successful participation in the European Exchange Rate Mechanism II for a minimum of two years—there can be no independent monetary policy. Given the buoyancy of private domestic demand, it will be important for the government not to add further stimulus. Buffeted in part by the effects of EU-related financial flows to Bulgaria, the budget surplus in 2007 is set to decline to about 2.3 percent of GDP. The fiscal impulse, however, is lower than implied because part of the drop of the surplus is due to Bulgaria's contribution to the EU budget, with little impact on domestic demand. At the same time, additional nonbudgetary accession-related funds will add some stimulus on their own account. Fiscal prudence is therefore crucial, especially in view of the projected rapid decline of Bulgaria's population and the looming fiscal impact of aging.

Bringing down the rate of inflation promises to be a difficult challenge. The price level in Bulgaria is currently less than half the euro-zone average. Given that prices are expected to converge toward the level in the EU in tandem with a convergence in real income, Bulgaria's inflation rate is likely to remain higher than in the euro zone for some time. This argues even more strongly in favor of fiscal prudence and for concerted efforts to improve productivity growth.

Indeed, with the population projected to decline, productivity growth will be one of the main engines for boosting incomes. Herein lies a huge challenge for Bulgaria. Raising productivity will require efforts on many fronts, including obvious ones such as improving the quality of education and investing in research and development. Reforming product and labor markets holds perhaps even more promise. Obstacles to product market entry protect existing firms from competition, blunting their incentives to innovate and adopt new technologies. Increasing the flexibility of labor markets is an obvious complement to product market reform, since rigidities that prevent the shedding of redundant labor and slow the mobility of workers to higher-valued activities are harmful to growth. Further labor market reforms are also needed to raise Bulgaria's comparatively low employment rate. Finally, continuing to attract investors requires broad and forceful efforts to improve the business climate, including through reduced corruption. Bulgaria's low ranking on relevant World Bank and European Bank for Reconstruction and Development indicators provides ample evidence of the urgency of reforming governance and improving the investment climate. ■

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## Parliamentarians spotlight challenges facing Africa

More than 200 parliamentarians from some 100 countries gathered in Cape Town at the annual conference of the Parliamentary Network on the World Bank (PNoWB) on March 15–17 to talk about their role in promoting development and helping their countries make progress toward the Millennium Development Goals (MDGs). A key topic was Africa—and on this parliamentarians had a lively exchange with IMF Managing Director Rodrigo de Rato, World Bank President Paul Wolfowitz, African Development Bank (AfDB) President Donald Kaberuka, and South African Finance Minister Trevor Manuel. This was the first time that the PNoWB annual conference was held outside Europe.

By bringing together the heads of international financial institutions and the Group of 20 (South Africa currently holds the chair of the G-20) in the Cape Town gathering, PNoWB cast a spotlight on the continent—and on the respective roles of multilateral organizations, donors, governments, and parliamentarians in helping boost growth in Africa and improve the lives of its people.

### What needs to be done?

De Rato said that current growth rates in Africa—although high by historic standards—are not sufficient to have a decisive effect on poverty and help Africa attain the MDG of halving poverty by 2015. Countries need to accelerate growth—through more trade, more private sector development, more effective use of public resources, and a deepening of financial sectors—de Rato noted. Parliamentarians have a key role to play in these areas, he said, because “there is no substitute for homegrown policies and homegrown decisions.”

Delivering the keynote address, Manuel said African governments need to continue to manage public resources effectively to enable spending for development purposes. Manuel also stressed that “global governance—the roles and accountability of our multilateral institutions—must play a key role in achieving the economic and social outcomes associated with sustained economic growth and good policies.”

### Scaling up aid

Wolfowitz noted that Africa had not seen the promised increase in aid since most of the aid in recent years had gone to debt relief and to three countries:



IMF Managing Director greets Gwendoline Lindiwe Mahlangu-Nkabinde, the Deputy Speaker of South Africa's National Assembly.

Iraq, Afghanistan, and Nigeria. Both Wolfowitz and Kaberuka stressed the importance of developing Africa's infrastructure—but a key problem, according to Wolfowitz, was that donors were giving aid to special-purpose projects (for health and education), and infrastructure development was being inadequately funded. Abdoulaye Bio-Tchané, Director of the IMF's African Department, speaking at a panel on aid effectiveness, noted that making aid more effective will require teamwork between donors and recipients, with recipient countries driving the agenda on the use of aid.

### Role of parliamentarians

And what role can parliamentarians play in this process? Kimmo Kiljunen, a member of Finland's parliament and the new cochair of PNoWB, noted that gatherings such as this were important for promoting accountability of multilateral institutions. In that spirit, the conference included a question-and-answer session with the heads of the IMF, the World Bank, and the AfDB. Manuel called on parliamentarians “to probe and inquire” and to hold multilaterals accountable. “It is only in this way that the societies you represent as parliamentarians will benefit fully from multilateral institutions that truly work in harmony with you to achieve our common human goals,” Manuel said. ■

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For more information on the conference, visit [www.pnowb.org](http://www.pnowb.org); for the IMF and parliamentarians, [www.imf.org/legislators](http://www.imf.org/legislators).



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