IMF Survey

INTERNATIONAL MONETARY FUND

MARCH 19, 2007 VOL. 36, NO. 5

www.imf.org/imfsurvey

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Simon Johnson named IMF's chief economist

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Eugene Salazar/IMF Photo

The MIT professor was named as Economic Counsellor and Director of the Research Department by Managing Director Rodrigo de Rato. For Johnson, who replaces Raghuram Rajan, it is a homecoming of sorts. He was an Assistant Director in the Research Department from 2004 to 2006. The 44-year-old specializes in financial and economic development. De Rato cited Johnson's ability to communicate complex issues to policymakers and the general public.

IEO urges clearer IMF role in aid to Africa

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Michael Spilotro/IMF Photo

The Independent Evaluation Office has released a report assessing the IMF's role in aid to sub-Saharan Africa. It found that macroeconomic performance in 29 African countries had improved—partly because of the advice and actions of the Fund. But it also found "ambiguity and confusion" about the IMF's policies and practices in important aid-related areas and "miscommunications to external audiences," according to IEO Director, Tom Bernes.

Committee calls for better IMF–World Bank collaboration

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Steve Jaffe/IMF Photo

The final report of a high-level independent committee created to assess the working relationship between the IMF and the World Bank recommends, among other changes, a stronger culture of collaboration, led by the institutions' managements, Boards, and Governors; greater exchanges between their staffs; more effective cooperation on crisis management; and better coordination of technical assistance.

Conference assesses European financial integration

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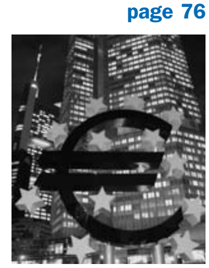


Sean Gallup/Getty Images

The IMF teamed up with the Brussels-based think tank Bruegel to hold a two-day conference in February to take stock of progress toward a more integrated European financial system. More than 100 policymakers, academics, and financial officials agreed that much has been achieved but that there are still many economic and regulatory issues to overcome, as well as the need to adapt Europe's crisis prevention, management, and resolution framework.

What's on

March

16–20 48th Annual Meeting of the Inter-American Development Bank and the 22nd Annual Meeting of the Inter-American Investment Corporation, Guatemala City, Guatemala

24–25 G-20 Deputies meeting, Pretoria, South Africa

April

2–4 3rd Secondary Education in Africa Regional Conference, Ghana Ministry of Education, Accra, Ghana

3 1st Annual Plenary of the OECD Global Forum on Development, "The Evolving Landscape of Development Finance: Towards Reform," OECD, Paris, France

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

May

2–3 Bretton Woods Committe 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

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

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*.

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

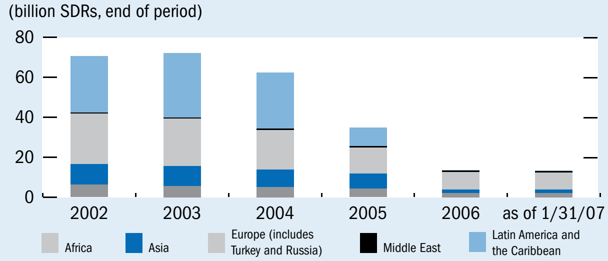
IMF Executive Board

For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp*

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



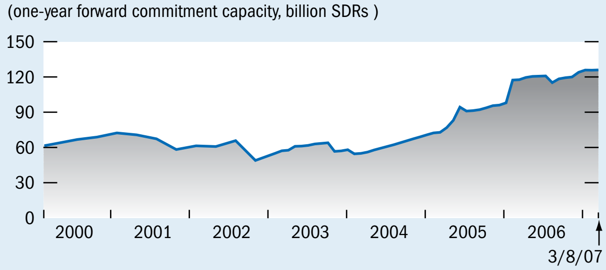
Largest outstanding loans

(billion SDRs, as of 1/31/07)

Nonconcessional		Concessional	
Turkey	6.88	Pakistan	0.93
Ukraine	0.54	Congo, Dem. Rep. of	0.55
Dominican Rep.	0.31	Bangladesh	0.32
Iraq	0.30	Georgia	0.16
Sudan	0.27	Yemen, Republic of	0.14

Available IMF resources

(one-year forward commitment capacity, billion SDRs)

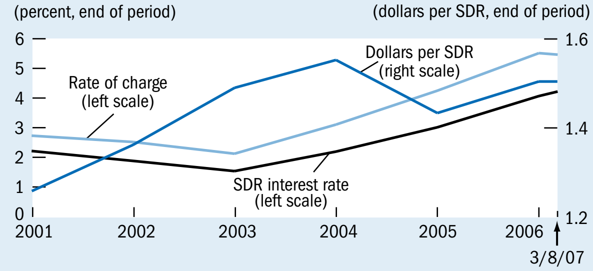


Related rates

SDR interest rate, rate of charge on IMF nonconcessional loans outstanding, and dollars per SDR

(percent, end of period)

(dollars per SDR, end of period)



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 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.

MIT professor named to head IMF Research Department

Simon Johnson, a professor at the Massachusetts Institute of Technology (MIT), was nominated by Managing Director Rodrigo de Rato to become the IMF's Economic Counsellor and Director of the Research Department. Johnson succeeds Raghuram Rajan, who resigned in January to return to the University of Chicago, and under whom Johnson worked from 2004 to 2006 as an Assistant Director for Research.

In proposing Johnson, de Rato said the Ronald A. Kurtz Professor of Entrepreneurship at MIT's Sloan School of Management possesses "the right blend of knowledge, skills, and experience necessary to successfully lead the Fund's Research Department and to excel in the role of our chief economist." Most of Johnson's work has focused on financial and economic development. He has done fieldwork in many parts of the globe—for example, Latin America, Africa, East Asia, and Eastern Europe, including the former Soviet Union. He ran a research center in Russia.

Johnson, 44, said in a telephone interview that the only job better than the one he now has at MIT is research director at the IMF. He said the reason an organization like the IMF has its own research capability rather than buying from the outside is to have the "in-house expertise" to support the Fund as it carries out its responsibilities. He called both the basic and policy-oriented research "excellent."

De Rato, in a statement, called Johnson "a recognized leader in original economic research relevant to the Fund, including the study of the causes and effects of economic crises, as well as development and poverty issues. He has a proven ability to conceptualize a strong policy-oriented agenda, with an enduring interest in global economic policy issues and a substantial level of expertise relevant to developing, emerging market, and advanced economies. . . . Also, he has the ability to communicate complex issues to policymakers and the general public."


Eugene Salazar/IMF Photo

Simon Johnson has "the right blend of knowledge, skills, and experience" to lead the IMF's Research Department, said Rodrigo de Rato.

Johnson, who holds both U.S. and U.K. citizenship, was a member of the U.S. Securities and Exchange Commission's Advisory Committee on Market Information and concluded in an assessment that is part of the committee's 2001 report that there is a need for continued strong regulation of the securities market. ■

Legislators get own website

The IMF has launched a new website to promote increased engagement with legislators around the world. The new site (www.imf.org/legislators) will support outreach efforts to establish and maintain an ongoing relationship between the Fund and its members' legislatures—an institutional need highlighted by a working group of Executive Directors in 2004.

Reflecting the demands of today's communications environment, the new website has been designed to provide a platform that not only supplies relevant and timely information to legislators, but also includes an interactive discussion forum that will enable them to participate in an ongoing dialogue about the IMF and its work. Ultimately, it is envisaged that the site will evolve into a fully integrated, virtual meeting place for the IMF and its network of legislators. Such an interface would provide an efficient way to increase existing efforts while also creating opportunities for more frequent and inclusive dialogue with this influential group. ■

IMF watchdog calls for more clarity, candor in IMF's Africa work

The IMF's Independent Evaluation Office (IEO) released a report on March 12 assessing the IMF's role in aid to sub-Saharan Africa (SSA). The report presented evidence from 29 SSA countries that had borrowed from the IMF through the Poverty Reduction and Growth Facility (PRGF)—the concessional lending window for low-income countries—between 1999 and 2005. It found that macroeconomic performance in these countries had improved, partly because of the advice and actions of the Fund. But it also found "ambiguity and confusion" about the IMF's policies and practices in important aid-related areas and "miscommunications to external audiences."

Thomas Dooley/IMF Photo

Bernes: Fund communications oversold what the institution committed to do—and did—on aid and poverty reduction, and undersold the institution's contribution through its support for enhanced macroeconomic stability, fiscal governance, and debt relief.

IEO Director Tom Bernes said that the "the overarching message of the evaluation is that the Fund should be clearer and more candid about what it has undertaken to do on aid and poverty reduction, and more assiduous, transparent, and accountable in implementing its undertakings." The report had unearthed considerable lack of clarity about Fund policy, both inside and outside the institution, which past communications failures had aggravated.

In a statement, IMF Managing Director Rodrigo de Rato welcomed the IEO report, noting that it is an important contribution to making the Fund's engagement with low-income countries more effective. "The report should be considered," he said, "in the context of the Fund's Medium-Term Strategy (MTS), which reiterates the Fund's commitment to low-income countries and sets the framework for more focused engagement in those countries." This strategy was formulated in 2006, after the period covered by the IEO report. He also noted that the report's "candid assessments and useful recommendations will help management and the Board clarify further the institution's mandate and policies to help sub-Saharan Africa achieve growth and reduce poverty."

Key report findings

What are the report's key findings? Bernes and lead author Joanne Salop point to three.

- First, there has been considerable ambiguity and confusion about key aspects of Fund policy and practice on aid and poverty reduction. Affected areas include the Fund's role in the mobilization of aid, the analysis of alternative aid scenarios, poverty and social impact assessments of macroeconomic policies, and pro-poor and pro-growth budget frameworks. Salop noted that "the IMF's Executive Board remains divided on some of these issues, and as a result, IMF policy is unclear."
- Second, lacking clear policies and guidance on these areas, Fund staff have tended to limit their focus to macroeconomic stability, in line with the institution's core mandate and deeply ingrained professional culture. When the Fund's policy and guidance were clear, such as on the accommodation of aid, staff implemented them—albeit without communicating the rationale to aid providers and other partners.
- Third, there has been a major disconnect between the Fund's public communications on aid and poverty reduction and its policies and practices. Fund communications oversold what the institution committed to do—and did—on aid and poverty reduction, and undersold the institution's contribution through its support for enhanced macroeconomic stability, fiscal governance, and debt relief.

On the macroeconomic front, the report acknowledged that PRGF programs catalyzed available aid—through the Fund's policy advice and support for country efforts and PRGF leveraging effects on donor resources, including for debt relief. It found that when country and donor performance improved, PRGF-supported macroeconomic programs eased and became more accommodative of aid. "The combi-

What is the IEO?

The Independent Evaluation Office (IEO) was established in 2001 to conduct objective and independent evaluations on issues relevant to the mandate of the Fund. It operates independently of IMF management and at arm's length from the IMF's Executive Board. Its reports can be found at *http://www.imf.org/ieo.*

Key recommendations

The report made several recommendations about how, in the future, the IMF could improve the coherence—actual and perceived—of its policies and actions relating to aid to SSA:

- The Executive Board should clarify IMF policies on macroeconomic performance thresholds for the spending and absorption of additional aid, the mobilization of aid, alternative scenarios, poverty and social impact analysis, and pro-poor and pro-growth budget frameworks.
- IMF management should establish transparent mechanisms for monitoring and evaluating the implementation of the clarified policy guidance, including with respect to the necessary collaboration with World Bank staff, and ensure that institutional communications are consistent with Fund policies and operations.
- Management should clarify expectations and resource availabilities for resident representatives' and mission chiefs' interactions with local donor groups and civil society. It should monitor trends in the institution's country-level operating environment, including for aid, periodically assessing the cross-country implications for Fund policies and strategies.

nation of improved country and donor performance and the associated adaptation of PRGF program design have materially improved SSA's prospects for growth and poverty reduction," it noted.

The IEO report follows publication of a separate report examining the working relationship between the IMF and the World Bank (see pages 74–76). Asked how the IEO findings related to IMF–World Bank collaboration, Bernes said: "The Fund should have been a more proactive and engaged partner with the Bank—and user and requestor of the Bank's analysis—in areas of material importance to its work. More generally, on Bank-led mandates, we believe the Fund should strive for the middle ground—neither passively waiting for analysis by the Bank nor aggressively taking over the production of that analysis—given the resource constraints the Fund faces and the agreed division of labor with the Bank."

The IMF's response

In response to the report, IMF management said that it agreed with the thrust of the IEO's specific recommendations (see box), including the call for further clarification by the Executive Board on several aid-related issues (such as the role of the Fund in aid mobilization) and the need to better align its communications with its delivery.

Abdoulaye Bio-Tchané, Director of the African Department, welcomed the report's finding that the Fund had supported countries' spending on health and education, especially out of savings from debt relief. He pointed to the fact that the IMF was the first institution to implement the Multilateral Debt Relief Initiative, which eliminated the debt owed to the IMF by 20 poor countries, with more countries poised to benefit from this relief. He said that for SSA to reach the Millennium Development Goals for health and education "its budgets must become more pro-poor and pro-growth, and it must use additional aid flows effectively."

As for Bank-Fund collaboration and the Fund's involvement with other partners, including donors, Mark Plant, Senior Advisor in the IMF's Policy Development and Review Department, observed that "the Poverty Reduction Strategy process, the move by donors from project to program support, and the emergence of new lenders have all reinforced the interdependence of our work with others. And we must develop more effective ways of engaging in the global effort to turn macroeconomic stability into sustained growth high enough to make a real dent in poverty."

The IMF's Executive Board, which discussed the report on March 5, supported the report's recommendation on the need for further clarification of Fund policy on several aid-related issues, including the mobilization of aid, alternative scenarios, poverty and social impact assessments of macroeconomic policies, and pro-poor and pro-growth budget frameworks. It asked the staff to come back with specific and costed proposals.

It also welcomed the report's recommendation to establish transparent mechanisms for monitoring and evaluating the implementation of the clarified policy guidance. And it welcomed the recommendation to clarify expectations under Fund policies—and resource availabilities—for resident representatives' and mission chiefs' interactions with local donors and civil society groups. Regarding communications, the Board supported the call for greater clarity on what the Fund can and cannot do in its low-income members, but it emphasized that, given budgetary constraints, improvements would need to be implemented in a strategic manner.

Going forward

Over the next few months, the Board will be considering several staff papers that will look at some of the issues raised in the IEO report—including the role of the Fund in the poverty reduction strategy process, donor collaboration and management of aid flows, and issues relating to program design. ■

Strengthening IMF surveillance

IMF improves tools for exchange rate analysis

Yen carry trade. U.S.-China trade relations. Hedging strategies. Subprime mortgage lending. What do these issues have in common? They all influence exchange rates in today's complex world of open borders and freely moving capital. When the IMF was created more than 60 years ago, it was given the mandate to promote exchange rate stability. But, back then, exchange rates were fixed and backed by gold. Today, many countries have adopted flexible exchange rates, letting the markets determine the price of their currencies. Other countries operate various forms of pegged regimes and intervene by buying or selling currency to target a particular exchange rate.

The IMF gives its member countries advice on how to manage their exchange rates through a policy dialogue known as surveillance. In recent years, there have been many calls for the Fund to get tough on countries that are perceived to be manipulating their currencies to gain an unfair trading advantage. But giving countries firm guidance on how to manage their exchange rates is far from straightforward.

The multilateral exchange rate assessments provide a useful reality check for the bilateral assessments.

First, there is no widely agreed upon economic theory to analyze many exchange rate issues. Second, the IMF's charter—known as the Articles of Agreement—gives countries wide latitude in choosing their preferred exchange rate regime. And, beyond the power of persuasion—and invoking a rarely used option known as "supplemental consultations"—there is little the IMF can do to effect change in countries' policies.

As part of his medium-term strategy for modernizing the IMF, Managing Director Rodrigo de Rato asked his staff to approach this dilemma on two fronts: first, by coming up with a proposal to modernize the IMF's surveillance mandate—known as the 1977 decision—as a way of clarifying the institution's role in advising countries, not just on exchange rates, but on other aspects of economic policy as well. And second, by seeking to improve the IMF's analytical tool kit for examining exchange rates.

The IMF carries out exchange rate analysis on two levels—the bilateral and the multilateral (see diagram, page 73)—that feed into each other. The multilateral exchange rate assessments provide a useful reality check for the bilateral assessments. This is because bilateral assessments of exchange rates need to add up—if one country's currency is deemed overvalued, some other country's currency has to be deemed undervalued—and the only way to ensure this is by imposing a multilateral consistency constraint.

As an important step toward strengthening the IMF's analytical framework for exchange rate analysis, the IMF's Research Department published a paper in October 2006 outlining a new methodology for assessing the consistency of exchange rates with medium-term fundamentals, within a multilaterally consistent setup. The approach is known within the IMF as "CGER"—short for the Consultative Group on Exchange Rate Issues—because of its origins as an interdepartmental exercise. The CGER's original mandate was to focus on industrial countries. But with the growing weight of emerging market countries in the global economy, there was a clear need to integrate the key emerging market countries into the CGER exercise. This necessitated a revision of the methodology, given the very different economic conditions in advanced and emerging market countries. Three complementary approaches now underpin the CGER's approach to assessing the consistency of exchange rates with medium-term fundamentals. They are

- ***the macroeconomic balance approach***, which calculates the difference between the current account balance projected over the medium term at prevailing exchange rates and an estimated equilibrium current account balance;
- ***the reduced-form equilibrium real exchange rate approach***, which estimates an equilibrium real exchange rate for each country as a function of medium-term fundamentals, such as the net foreign asset position of the country, productivity growth in the tradables and nontradables sectors, and the terms of trade; and
- ***the external sustainability approach***, which calculates the difference between the actual current account balance and the balance that would stabilize the net foreign asset position of the country at some benchmark level.

The complementarity among these three approaches helps to establish whether the underlying results are robust. The three methods focus on different aspects: flow quantities, stock quantities, and relative prices. So when they point in a similar direction, they provide a powerful signal that economically relevant aspects of exchange rate misalignment are being captured. This, in turn, should lead to more balanced judgments about how currencies may need to adjust as present global imbalances are unwound.

Looking at currency misalignment

Deputy Director Jonathan Ostry of the IMF's Research Department, in an interview with Jeff Hayden of the IMF's External Relations Department, explains what lies behind the changes in exchange rate analysis and how the new methodology will strengthen the Fund's ability to make sound judgments on exchange rate issues.

IMF Survey: Could you summarize key changes in how you approach exchange rate analysis at the multilateral level?

Ostry: In the early days of the CGER [Consultative Group on Exchange Rate Issues], we relied on two approaches to assess the consistency of exchange rates with medium-term economic fundamentals. First, a macrobalance approach, in which a norm for the current account is estimated and then compared with the projection of the IMF's *World Economic Outlook* five years out. The difference between the norm and the projected current account determines the extent of misalignment. A second approach involved comparing the exchange rate to a historical trend or average value to get a direct estimate of misalignment.

When we decided to integrate emerging market countries into the CGER exercise, we had to go back to the drawing board to some extent. We needed an approach that could accommodate the different economic structures in advanced and emerging market countries and that was robust.

We did three things. First, the macrobalance approach was updated to include a richer set of economic fundamentals—this step was essential, given the very different countries in the sample. Second, we now assess the medium-term trend in exchange rates on the basis of a set of fundamentals rather than, as before, on the basis of a simple historical average or time trend. And third, we added the so-called external sustainability approach, which looks at the relationship between a country's current account, or flow, position, and net international investment, or stock, position. The three approaches look at misalignment from different angles. This is why, when they point in a similar direction, we're pretty confident that we've captured economically relevant aspects of the problem.

IMF Survey: How will the new methodology help strengthen the Fund's advice on exchange rates?

Ostry: Country desks are ultimately responsible for exchange rate assessments in the IMF's country reports. This is as it should be—after all, the desks can take into account the full range of country-specific factors that a large multilateral exercise like the CGER cannot always do. At the same time, country desks will be interested in the CGER results, which impose

Steve Jaffe/IMF Photo

Ostry: "Multilateral exchange rate analysis serves as a useful cross-check for country-specific exchange rate assessments."

multilateral consistency and can act as a useful cross-check to their analysis. This is all the more so now that the exercise covers so much more of the world economy.

I see the CGER as helping IMF country teams engage with policymakers on issues surrounding exchange rate misalignment. Inevitably, IMF economists will need to discuss with country authorities the sources of possible currency misalignment: Does it reflect unsustainable policies? Distort incentives for private sector behavior? Anticipate messy adjustment over the medium term? Or, is it more benign, being merely part of a short-run adjustment path that the private sector already anticipates?

Finally, I should emphasize that the new version of CGER by no means marks the beginning of bilateral exchange rate assessments by the Fund for emerging market countries—this has always been an important component of our work for the entire membership. But the broad country coverage of the exercise—and the enhanced benefits in terms of multilateral consistency—means that the CGER can play a more useful role than in the past in informing judgments about exchange rate misalignment in both advanced and emerging market countries. It may also be a helpful tool for guiding thinking about the role exchange rate adjustment might play as global imbalances are unwound, a topic that the forthcoming *World Economic Outlook* will be looking at in some detail.

IMF Survey: What lessons have you learned so far?

Ostry: As our paper makes clear, we're under no illusion that the estimates of exchange rate misalignment resulting from the CGER approaches are very precise. The uncertainty relates to a number of factors, including the potential instability of underlying macroeconomic links, differences in these links across countries, measurement problems, and the imperfect fit of the models themselves. Some of these problems may be even more severe in emerging market countries, where structural change may be playing a greater role and where limitations in terms of data availability and the length of data samples are more acute.

But this should not divert from the fact that the three methods do, in practice, tend to yield similar results in many cases. When we presented the paper late last year to the IMF's Executive Board, the consensus seemed to be that this methodology is state of the art—it's the best we can do at this point.

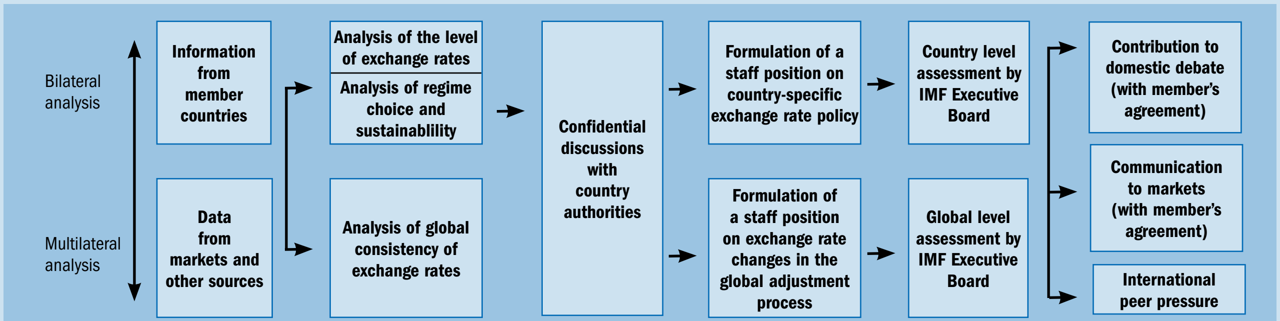
***IMF Survey*:** What are the next steps in applying this approach?

Ostry: We plan to let this process run a little while and then take stock. We hope to see references to the CGER assessments in IMF country reports. My sense is that many country desks do make use of the assessments. But whether they refer explicitly to the CGER seems to vary: some do, some don't.

We also hope to improve understanding among government officials and policymakers about what we're doing, and so have undertaken outreach efforts that target this community. These efforts have two-way benefits: the authorities learn about the framework and how it is used, and we get to learn from policymakers—as well as from market participants, academics, and others included in the outreach events—about areas for improvement. ■

More information on the IMF's approach to exchange rate analysis can be found at *www.imf.org*.

The IMF's framework for exchange rate analysis



Source: Adapted from an issues paper by the IMF's Independent Evaluation Office entitled, "The IMF's Advice on Exchange Rate Policy."

Foreign exchange markets are notoriously fickle, so how do IMF economists estimate whether or not a country's exchange rate policy is appropriate and sustainable? As a *first step,* they assess the policy at the country level, including both the choice of exchange rate regime—for instance, whether the currency is fixed or floats against other currencies—and whether the level of the exchange rate is appropriate. They also incorporate the IMF's multilateral analysis of exchange rates (described on pp. 71–72) to ensure consistency between the bilateral and multilateral levels.

As a *second step*, IMF economists discuss their findings with the country's authorities (including, among others, the finance minister and central bank governor). The content of these discussions is then shared with IMF management.

As a third step, once staff and management have made up their minds, they provide their assessment—which usually comes in the form of a country report that contains detailed analysis of all of the country's economic policies—to the IMF's 24-member Executive Board. The Board then issues its own assessment (which is the IMF's official view).

As a *fourth step*, the IMF makes the country report public (while this requires the permission of the member country, the vast majority of the IMF's 185 member countries agree to do so). As part of this process, the Board's statement is normally published on the IMF's website as a "public information notice." In consultation with the countries concerned, the staff can also choose to provide input into the policy debate by publishing articles or holding press conferences. All these actions may in some cases influence the currency markets. Because of this, IMF staff must carefully balance how they communicate their advice on exchange rates.

As a *fifth step*, IMF economists evaluate whether their advice has been effective. Did it lead the country in question to change the way in which it manages its exchange rate—if such was the advice? These assessments feed into the next surveillance cycle and may also trigger more direct measures, such as technical assistance. ■

Belize: returning the economy to a sustainable footing

On February 20, 2007, the Belize government concluded a debt exchange operation with its foreign commercial creditors. The exchange was part of an effort to restore balance of payments and debt sustainability and to create a macroeconomic environment conducive to strong growth and social progress. Throughout this process, the IMF worked closely with the Belize authorities.

After a period of relatively modest growth, the government embarked in the late 1990s on aggressive policies to stimulate economic activity. The result was large fiscal and current account deficits, financed primarily by foreign borrowing by the government. As debt service costs rose, access to voluntary financing fell and commercial borrowing costs soared.

Starting in the late 1990s, the IMF cautioned that macroeconomic policies were overly expansionary and inconsistent with fiscal and debt sustainability and could ultimately threaten the country's currency peg. It suggested curbing domestic demand by reining in public sector spending and moderating credit expansion. The IMF also advised the government to develop a coherent strategy to help align the country's high debt service with its medium-term capacity to pay.

A homegrown program

After initial hesitation, the authorities started to implement a stabilization program in the 2005/06 budget that began in April 2005. They developed a homegrown program to generate the political support necessary to implement difficult measures. Although the authorities did not request a formal IMF program, they consulted closely with IMF staff in designing and implementing stabilization policies.

Belize raised taxes, cut expenditures, and tightened monetary conditions, helping to reduce the central government deficit from 8½ percent of GDP in FY2004/05 to 3 percent in FY2005/06 (see chart). It also hired a financial advisor to develop and help implement a debt management strategy.

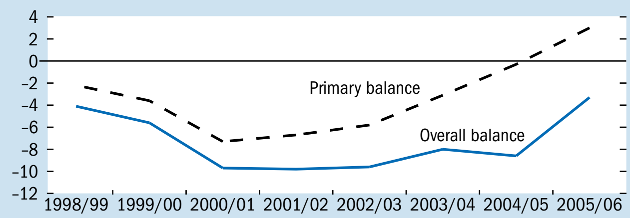
At the conclusion of the Article IV consultations last October, the IMF's Executive Board welcomed the progress, but noted that large fiscal and balance of payments financing gaps were still likely to emerge in 2007 and beyond. The Board noted that further adjustments, together with a cooperative agreement with commercial creditors to restructure Belize's external debt, would be critical to regaining balance of payments and debt sustainability.

The government announced in August 2006 its intention to reach an agreement with external commercial creditors to put Belize's external debt on a sustainable footing. In addition, the Inter-American Development Bank, the Caribbean Development Bank, and bilateral lenders offered new financing to help support the country's return to macroeconomic viability.

Reducing the fiscal deficit

Belize raised taxes and cut spending to sharply reduce its overall deficit and move into surplus on its primary balance.[1]

(percent of GDP)



Source: Belize authorities and IMF staff estimates.
[1]Overall balance less interest payments.

In mid-October, the authorities presented creditors with three debt restructuring scenarios and, after six weeks of intensive consultations, launched a formal debt exchange offer. The offer envisaged converting eligible debt instruments into new bonds that would start amortizing in 2019 in 20 equal, semiannual installments with final maturity in 2029. The bonds would carry a lower coupon of 4¼ percent for the first three years, 6 percent for the next two years, and 8½ percent thereafter.

The debt exchange settled on February 20 with a participation rate of more than 98 percent. Reflecting the country's improved debt service outlook as a result of the debt exchange, both Moody's and Standard and Poor's upgraded Belize sovereign debt ratings, to "Caa1" and "B," respectively.

The outlook

The high participation in the debt exchange and the more favorable conditions of the new bonds will substantially close the fiscal and external financing gaps projected for the coming years. Belize should use this breathing space to address remaining macroeconomic vulnerabilities. This will require that it maintain prudent fiscal and monetary policies to achieve a steady reduction in the still-high debt burden and build up a more comfortable cushion of international reserves. ■

Gamal El-Masry
IMF Western Hemisphere Department

A summary of the Executive Board discussion and the staff report for the 2006 Article IV consultation with Belize can be found at *http://www.imf.org/external/country/BLZ/index.htm*.

Malan report

IMF and World Bank can do a better job of working together

A high-level independent committee established to recommend how the IMF and the World Bank could improve their working relationship issued its final report on February 27, stressing that closer collaboration is critical for the effective and efficient delivery of services to the institutions' member countries—especially given an ever-shifting global economic landscape and emerging pressures from global warming, energy security, and population aging. It also urges the IMF to continue to clarify its role in low-income countries, including financing activities.

The External Review Committee on Bank–Fund Collaboration was formed in March 2006 by IMF Managing Director Rodrigo de Rato and World Bank President Paul Wolfowitz to assess the working relationship between the 61-year-old sister agencies. The six-member committee, headed by Pedro Malan, Chairman of Unibanco and a former Minister of Finance of Brazil (see Box 1), offered a range of recommendations that call for action by the heads of the two institutions and, in some cases, by their governing bodies.

De Rato and Wolfowitz credited the report with providing a solid foundation on which to build. Noting that the issue would be discussed at this year's spring and annual meetings, de Rato said that he and Wolfowitz would work toward "proposals to implement a better framework for collaboration."

Malan, speaking to the press, said he disagreed with the view, voiced by some critics, that the institutions had lost relevance. "We have confidence in their ability to continue to rise to the challenges posed by an ever-changing world environment, and we are deeply convinced of the importance of further improvements in Bank-Fund collaboration."

Working with each other

The report emphasizes that the costs of insufficient collaboration between the Fund and the Bank are significant and include poor and conflicting advice, wasted resources, and unmet needs. Close collaboration is vital, it argues, because the two institutions' mandates are inherently linked (see Box 2). Macroeconomic stability (a Fund concern) will not be sustained unless linked to supply-side measures and improved quality of public spending (a Bank concern). Similarly, global monetary stability (a Fund concern) will have a direct bearing on overall development prospects (a Bank concern).

Some shortcomings in the relationship are the lack of autonomy of Fund country, or resident, representatives; the blurring of the distinction between the Fund's short-term balance of payments lending and the Bank's longer-term development lending; the absence of a robust dialogue between the institutions; the lack of clarity in the roles of the Bank and the Fund in providing technical assistance, in particular, on financial sector activities; and their failure to coordinate missions and information requests from countries.

But the committee also points to examples of good collaboration and to significant improvements. Among the examples are the Financial Sector Assessment Program, the Heavily Indebted Poor Countries Initiative, debt sustainability analysis and framework, and Reports on Standards and Codes.

Working with poor countries

The report finds that the IMF has moved beyond its core responsibilities in low-income countries and into activities that increase its overlap with the work of the Bank. And it recommends that the Fund start withdrawing from long-term

Box 1

Who's who on the committee

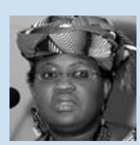
Pedro Malan (chair)
Chairman of the Board of Unibanco and former Finance Minister of Brazil.

Caio Koch-Weser
Vice Chairman of Deutsche Bank, former German Deputy Finance Minister, and former World Bank Managing Director.

Sri Mulyani Indrawati
Indonesia's Minister of Finance and a former IMF Executive Director.

Michael Callaghan
Executive Director of the Australian Treasury's Revenue Group and a former IMF Executive Director.

William McDonough
Vice Chairman of Merrill Lynch and a former president of the Federal Reserve Bank of New York.



Ngozi Okonjo-Iweala
Nigeria's former Foreign and Finance Minister, and former Vice President of the World Bank Group.

financing operations in low-income countries. "But we suggested a clarification of the Fund's [role]—not a retrenchment, not a reduction in the level of support for low-income countries, but working closely with the World Bank" in these countries, Malan emphasized.

The IMF's primary instrument for lending to these countries is the Poverty Reduction and Growth Facility (PRGF), under which loans carry a concessional rate of interest and a longer repayment period than do loans under the IMF's nonconcessional lending facilities. The report notes that loans and new commitments of assistance under the PRGF have fallen sharply in recent years, which should allow the Fund to refocus its efforts and resources in areas where it has the greater comparative advantage—that is, macroeconomic stabilization; monetary, fiscal, and exchange rate policies; institutional arrangements and related structural measures; and financial system issues.

The IMF should therefore reconsider the appropriateness of successive PRGF arrangements, which take on the character of development financing. On that point, de Rato told the press, "we agree that we should be careful in focusing on our mandate, and it is not our mandate to provide development financing." He underscored that the Fund, as part of its medium-term strategy, is already working to better focus its role in low-income countries, an effort the report calls "highly appropriate." He pointed to the Policy Support Instrument, a nonfinancial instrument for low-income countries, through which the IMF signals that countries are making necessary adjustments, as an example of this better focus.

Wolfowitz noted that cooperation between the Bank and the Fund had improved since tensions over the handling of the Asian financial crisis of the late 1990s. "It would be a mistake if the IMF stopped working in poor countries," he said. "These institutions are going to have a very important role in many different ways in the future, and our ability to adapt to changing circumstances will depend on our ability to work together."

Box 2

The IMF and the World Bank—what's the difference?

Established in 1945, the IMF focused initially on reestablishing confidence in international cooperation and the international financial system, and the World Bank on reconstructing war-ravaged Europe.

The IMF, with a staff of about 2,700, promotes international monetary cooperation and provides member countries with policy advice, temporary loans, and technical assistance so they can establish and maintain financial stability and external viability, and build and maintain strong economies.

The World Bank, with a staff of about 10,000 around the world, promotes long-term economic development and poverty reduction by providing its members with technical and financial support.

Ways to improve collaboration

The committee's remaining recommendations, which address the "culture" of collaboration, staff exchanges, cooperation on crisis management, collaboration on fiscal issues and on financial sector issues, technical cooperation, procedural changes, and the monitoring of progress on collaboration, call for the following:

A stronger culture of collaboration. The Governors, Boards, and managements of the two institutions must set the example and lead the effort. To achieve this, the report suggests

- a *special joint meeting* of the International Monetary and Financial Committee (which advises the IMF Board of Governors) and the joint Development Committee to consider the report and reinforce why and how the two institutions must collaborate.
- the establishment of a *standing Bank-Fund Board working group* to actively promote and monitor collaboration.
- a stronger *ongoing, informal dialogue* between management and senior staff in the two institutions.
- a *longer-term strategic assessment of the Bank's operations*, based on existing Bank documents.

Greater staff exchange. Interchanges between the staffs of the Fund and the Bank should be encouraged, and any impediments in terms of different remuneration and retirement arrangements resolved.

A new understanding on collaboration. A high-level framework that lays out how the institutions should work together and the responsibilities of management in promoting good collaboration should be established. Improved collaboration entails both a better demarcation of responsibilities and a stronger emphasis on working together.

Cooperation on crisis management. The Bank and the Fund must ensure that they have learned from the past and can work together more effectively in responding to future crises. In particular, any new or expanded financing facilities and liquidity instruments designed to help countries face shocks should complement rather than duplicate each other.

Collaboration on fiscal issues. The two institutions need to harmonize their recommendations rather than formally divide their responsibilities. Short-term stability and long-term growth should be viewed as complementary, not competing, objectives.

Collaboration on financial sector issues. The delineation of responsibilities should be based on the institutions' comparative expertise. The Fund should take the lead when there are significant domestic or global stability issues, and the Bank, when financial sector development issues are paramount.

Continued on page 76

European Union: keeping up with financial integration

The IMF and the Brussels-based think tank Bruegel took stock of progress toward a more integrated European financial system and explored policy options to accelerate financial integration at a joint two-day conference in February that included more than 100 policymakers, academics, financial professionals, and key IMF officials.

Participants in the Brussels conference, "Putting Europe's Money to Work: Financial Integration, Financial Development and Growth in the European Union," agreed that financial integration was important for Europe's growth performance. They had a generally positive assessment of what financial integration policies had already achieved: the European Union's Financial Services Action Plan has put in place the basic elements of an integrated EU market, its implementation is well advanced, and its benefits will build significantly over time. Europe's financial markets have been transformed and are successfully competing with those elsewhere in the world, with London at the forefront.

Nonetheless, there was also a consensus that more work lies ahead. Among the main themes that emerged from the discussion was the need to adapt Europe's crisis prevention, management, and resolution framework to its integrating market and the changing risks that integration entails. The discussion focused in particular on the question of how countries should share the fiscal burden of cross-border bank insolvencies (that is, the cost to taxpayers of dealing with a failing bank that operates in several countries) and how addressing this burden-sharing question relates to other reforms of the financial stability framework. Several participants noted, however, that they thought that the current political climate was not conducive to addressing these problems at their roots, because there is no appetite for the far-reaching reforms that would be required. Much discussion also focused on whether and how much Europe's financial sector is responsible for the low number of garage-to-multinational-in-one-generation companies, those that start penniless, with little more than an idea, and evolve into large firms, such as Apple Computer in the United States.

Participating in the February 21–22 conference, which was split into off-the-record and public sessions, were the IMF's First Deputy Managing Director, John Lipsky; Jaime Caruana, Director of its Monetary and Capital Markets Department; and Michael Deppler, Director of the European Department.

In his keynote speech, European Commissioner for Economic and Financial Affairs Joaquín Almunia observed that national authorities were not keeping up with developments on the ground. In particular, he said, reform of the supervisory framework was lagging: financial institutions operate increasingly across borders, but the incentive structures of supervisory authorities remain oriented toward the national level. Almunia called for an open discussion of the costs and benefits of financial integration and argued that cost estimates were often exaggerated by vested interests, who feel threatened by the greater efficiency and competition an integrated market would bring. He also called for a debate on the risks related to hedge funds.

Malan report urges greater collaboration between IMF and World Bank

Continued from page 75

Technical cooperation. The Bank and the Fund need to better coordinate their delivery of all forms of technical assistance.

Procedural changes. Both institutions should alter procedures to promote more effective collaboration. For example, the Bank should be more flexible in mobilizing resources so that it can respond faster to countries' requests for technical assistance; the Fund must be able to provide the Bank with comprehensive macroeconomic assessments of all countries, not just those with a Fund program. Members, for their part, should readily agree to the sharing of information between institutions.

Monitoring of progress on collaboration. The managements of the Bank and the Fund should periodically report to their Boards and Governors on progress and issues in implementing the understanding on collaboration.

Next steps

De Rato agreed that staff exchanges were an excellent way to improve collaboration and said he intends to promote them, as well as to focus more on strengthening cooperation on crisis management. He said that the Fund expects to "improve integration and harmonization of work on fiscal issues, as well as collaboration on financial sector issues." He also welcomed the recommendation that the managements of the two institutions monitor their progress on collaboration. ■

Participants on the policy panel on financial stability were in general agreement that there is a need for further centralization of supervision, although none advocated a single supervisor at this point. They also agreed that the burden-sharing question was important. Nonetheless, there were differing views on solutions. Baron Alexandre Lamfalussy, the former president of the European Monetary Institute (the predecessor of the European Central Bank (ECB)), argued that the current environment is a dangerous cocktail of moral hazard (resulting, in part, from successful past episodes of crisis prevention), ample liquidity, and financial innovation. In this demanding environment, European institutions that manage and prevent crises are, "to put it mildly, sub-optimal," and reform is proceeding too slowly, he said.

Sean Gallup/Getty Images

Eurotower in Frankfurt, Germany.

Caruana pointed out that the EU has the opportunity and the policy tools to take a leading role in designing a regional financial stability framework and that the current favorable conditions provide a window of opportunity for doing so. A new framework would require more centralization and the inclusion of an EU dimension in supervisors' hitherto national mandates. Although he agreed that the burden-sharing question was important, he saw it as being set apart by its political nature and solvable only in the context of broader reforms. The main scope for progress, he said, was in the areas of deposit insurance and crisis prevention and management.

Andrea Moneta of Unicredit pointed out that organizing a financial institution's activities across borders rapidly becomes very complex, pushing forward the need for more identical supervisory arrangements across countries. He said it is important to keep in mind that large financial groups in the EU typically also have large activities outside the EU and off their balance sheets. In this context, Moneta saw the Basel II approach of relying on banks' own risk management as sensible and thought that it would not be desirable for banks to be able to shop around for their supervisor of choice.

Sir Nigel Wicks, Chairman of Euroclear, observed that financial business in the EU was running ahead of the supervisory framework and the political situation. He saw the uncertainties related to crisis management and resolution (and to taxpayer responsibility for losses) as key issues. Nonetheless, financial markets were doing too well for a comprehensive, "big bang" reform, which would also raise fears of heavy-handed regulation. Panel members agreed that reform efforts should focus in the first instance on the largest EU financial institutions, but held different views on the potential role of the ECB in prudential supervision. Lamfalussy and Caruana made a case for central bank involvement. Lamfalussy pointed out that central banks, as lenders of last resort, bear responsibility for ensuring financial stability. Wicks responded, however, that ECB involvement in supervision might fit uncomfortably with its status as a highly independent supranational institution.

The policy panel on financial integration and economic growth touched on a variety of issues. Former European Commissioner and Bruegel President Mario Monti argued that a major struggle was ongoing between those who envision an integrated financial market in the EU and those businesses that resist it. Lipsky called on Europe to focus on integrating its capital markets to allow banks and markets to develop symbiotically and said that this would require action by governments. Harvard Professor Philippe Aghion pointed out that firms that are intensely oriented toward research and development (R&D) need more equity capital than other firms and that such equity capital is more readily available in the United States than in Europe, where venture capital and capital markets in general are less developed. A well-developed market for corporate control is also essential, because it would ensure the exit of underperforming firms and managers. Countercyclical macroeconomic policies could also support R&D.

Sofinnova Chairman Jean-Bernard Schmidt complained that innovation in Europe was being impeded by the difficult market for initial public offerings and said that the underlying problem is that financial markets focus too much on the short run. Several people in the audience disagreed, saying that more venture capital is available than ever and long-term investors need a mix of long- and short-term investment options. Lipsky added that the growth of hedge funds was less dramatic than often portrayed, and private equity could be expected to contribute to the rebalancing of asset prices by bidding up the stock prices of undervalued companies. ■

Wim Fonteyne
IMF European Department

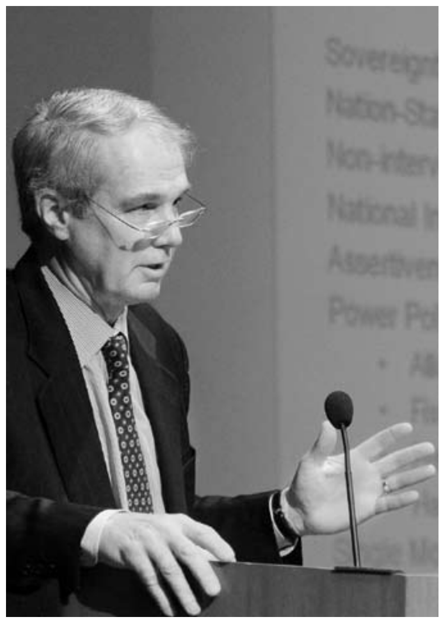
Taking a hard look at how the world cooperates

Most of today's international institutions were created after the Second World War. Although their mandate to promote global cooperation remains as important as ever, their governance structures still reflect the world of 1945. Colin Bradford and Johannes Linn, both of the Brookings Institution, have just finished editing a new book entitled *Global Governance Reform—Breaking the Stalemate*. They shared their thoughts on how to reform decision making at the global level at a March 6 book forum organized by the IMF.

In his opening remarks, Linn said that globalization is proceeding at a rapid pace, resulting in the meteoric rise of emerging market countries such as China and India. At the same time, new challenges—including global warming, pandemic bird flu, the potential for severe financial crises, and the rising threat of terrorism—have emerged. These changes have left the world's international organizations struggling both for legitimacy and for practical ways to address the new problems.

Most of the world's international organizations are part of the United Nations "family." There is the United Nations itself and its Security Council, the World Health Organization, the International Monetary Fund, and the World Bank. What all these institutions have in common is that the United States and Europe hold dominant positions—and the United States often wields veto power over much of international decision making. To efficiently and inclusively take on new tasks, these international institutions, in Linn's view, are therefore in urgent need of reform.

Linn explained that he and Bradford had initially approached the issue of global governance reform from the perspective of summit reform—how to move beyond the current G-7 group of industrial countries to create a summit diplomacy that is both effective and representative. But they soon realized that "you couldn't discuss summit reform without going into the trenches of the individual institutions." As a result, their book looks at reform proposals for the IMF, the World Bank, the World Health Organization, and the United Nations before tackling the issue of summit reform. Interestingly, however, their work "in the trenches" made them even more convinced that the key to organizational change at the international level is to reform the way world leaders arrive at common decisions.



Michael Spilotro/IMF Photo

According to Colin Bradford, a grand bargain between the United States and Europe may be necessary to break the stalemate on global governance reform.

A grand bargain

The IMF's official historian, James Boughton, himself a contributor to the book and the moderator of the book forum discussion, noted that the debate on the IMF has become more focused in recent years. Calls to close down the Fund have largely died down, as have proposals to merge the IMF with the World Bank, a move Boughton likened to folding the Federal Reserve into the U.S. Treasury. Professor Alan Meltzer's suggestion to have the Fund concentrate solely on crisis lending also seems less relevant today, as does former IMF Economic Counsellor Kenneth Rogoff's proposal that the Fund get out of the lending business altogether.

Bradford said the IMF was off to a good start with Managing Director Rodrigo de Rato's ambitious reform agenda known as the medium-term strategy. He noted the "somewhat surprising development that one of the most conservative institutions in the galaxy of international institutions—namely, the IMF—seems to be proceeding first and at a faster pace" than the other international organizations. But much more needs to be done. To make the Fund more effective and representative, and building on suggestions put forward by politicians and other scholars, Bradford said the IMF should

- revise its quota formula to include criteria that focus on GDP adjusted for purchasing power parity, financial flows, and population;
- reduce the number of chairs on the IMF Executive Board from 24 to 20 or fewer. This should be done by consolidating Europe's representation—which is currently spread out over eight chairs—into one or two chairs to make room for more chairs representing emerging market and developing countries; and
- base the selection of the IMF's Managing Director solely on merit without regard to nationality. The IMF's Managing

Director has always been a European, and the President of the World Bank has always been an American. There is broad consensus that this tradition should be abolished and that the leaders of the two institutions should be chosen from a global pool of applicants.

Although none of these proposals are new, Bradford and Linn suggested that pushing them forward will require a grand bargain between the United States and Europe. Because Europe will be asked to give up de jure influence by accepting a substantial reduction in its voting power in the IMF and the right to name the institution's Managing Director, the United States should reciprocate by giving up its veto right over decisions requiring an 85 percent majority, as well as its right to choose the head of the World Bank. As Bradford put it, "these steps are necessary to convince world public opinion—politicians in other countries, peoples in other countries—that the institutions are serious about breaking the control that Western industrial countries have had over them for the past 50 years."

From G-7 to G-20

According to Bradford, "breaking the stalemate of global governance reform and institutional reform depends first and foremost on summit reform." Deciding what should be on the agenda of the international organizations—and deciding how they make decisions in the future—ultimately comes down to political choice. The G-7 currently functions as the world's de facto steering committee. But even though it recently began inviting some emerging market countries to participate as observers in its meetings, this group lacks the legitimacy it would take to tackle the global problems of the 21st century.

To remedy this, Bradford and Linn propose vesting new power in the G-20, an informal group that includes emerging market countries like India, China, South Africa, and Brazil, as well as some of the G-7 members, including the United States, Germany, and Japan. The G-20 has taken on an increasingly prominent role in recent years, including with respect to promoting reform of the IMF. Its diverse membership represents 90 percent of the world economy and about two-thirds of the world's population, making it a more legitimate decision-making body than the G-7, they said.

Boughton agreed that having the G-20 assume the mantle of the G-7 would be an important step forward. But he warned that the G-20 would, over time, become formalized, as has happened to all the other "Gs" before it. And, with a more formal setup comes a stiffness that stifles debate and creative problem solving, two things that are acutely needed in the world right now. ■

A look inside the book

Global Governance Reform contains essays on the IMF, the World Bank, the United Nations, summit reform, global health governance, and global environmental governance. Below are a few selected quotes.

"The current benign economic and financial environment will not last and will be seen to have been a temporary lull in Fund lending activity, as has often been the case in the past. The IMF will continue to have an important role to play as a lender in the inevitable future crises."

—**Jack Boorman**, *former head of the IMF's Policy Development and Review Department*

"The IMF has not yet developed a reputation as a breeding ground for financial talent that is as strong as its reputation for macroeconomic experience. The Fund is now working to overcome its late start in this area, which is one of the key challenges identified in the strategic review."

—**James Boughton**, *official IMF historian*

"It is surprising how far the World Bank has strayed, in spirit at least, from its original conception. Today the Bank has 'borrowers' (the developing countries) and 'nonborrowers' (the advanced countries). The Bank's mission is now framed explicitly as reducing global poverty—not as supporting and encouraging global prosperity and security through trade and investment in an open, liberal economy."

—**Nancy Birdsall**, *President of the Center for Global Development*

"Accompanying the sweeping changes in the public health landscape—even the name has changed, from international health to global health—has been the entry of new players and institutions, each rushing to fill a perceived gap or weakness in the global health architecture. As a result, the design of global health governance, as it exists today, is the product of chaotic, opportunistic growth."

—**Ronald Waldman**, *Professor, Columbia University*

"While it conceives itself as the apex of global consultation and decision making, the G-8 [the G-7 plus Russia] is a forum of the eight industrialized countries that were the dominant powers of the mid-20th century. By excluding the major emerging powers of the 21st century, it has become increasingly ineffective, unrepresentative, and illegitimate."

—**Johannes Linn and Colin Bradford**, *Brookings Institution*

Colin I. Bradford Jr. and Johannes F. Linn
Global Governance Reform—Breaking the Stalemate
Brookings Institution Press, 2007, 143 pp., $22.95

Global imbalances a continued threat, de Rato says

Although there have been some signs that global imbalances may be stabilizing, they "are likely to remain large for the foreseeable future," a low-risk but potentially high-cost and disruptive threat to the world's economy if they were reduced suddenly, IMF Managing Director Rodrigo de Rato said in a speech to the Harvard Business School Alumni Dinner in Washington on February 26.

He also raised concerns about the threats to global financial markets by the practice of the so-called yen carry trade in which investors borrow in yen to take advantage of low Japanese interest rates and buy securities in countries like Brazil, New Zealand, or Turkey, where rates are higher. The risks to the global system, he said, could occur if there were a sharp narrowing of the interest rate differential—caused, for example, by a sharp appreciation in the yen or a depreciation in the high-yielding currencies or both.

Eugene Salazar/IMF Photo

De Rato: "Some political leaders and many citizens seem overly complacent about the risks of protectionism."

Equity markets

Only a day after the Managing Director's speech, markets provided a timely reminder of the potential risks. A sudden fall in stock prices in China sent global equities markets into a sharp decline, and jittery investors scurried for less risky investments across the board. Many of those who had borrowed yen to invest in emerging market currencies acted to unwind their position, buying the Japanese currency to pay off loans. The result was an appreciation in the yen and a decline in the value of target currencies, such as the Brazilian real, the Mexican peso, and the Australian and New Zealand dollars.

The global imbalances, which have become a growing concern, are reflected in a large and stubborn deficit in the U.S. current account and persistent surpluses in Asian emerging market countries, especially China, as well as in oil-exporting countries and Japan. The Fund has held meetings with key economies—China, the euro area, Japan, Saudi Arabia, and the United States—to discuss how to wind down those imbalances gradually while maintaining world economic growth. Global imbalances and the multilateral consultations will be a topic of discussion at IMF–World Bank spring meetings next month in Washington, D.C.

On the positive side, de Rato said in his Harvard Business School speech, the U.S. federal deficit, a major factor in its current account shortfall, has narrowed and there has been "some progress on greater exchange rate flexibility in China and on structural reforms in the euro area and Japan." Moreover, Saudi Arabia and other oil exporters are following through on plans to increase investment.

Ripple effects of global imbalances

But "less welcome" developments, which de Rato called the "ripple effects of the continuing global imbalances," include signs of strains in currency markets, especially affecting the euro and the yen, that "could trigger a sudden shock to financial markets," and growing protectionist sentiment around the world that "could result in a slow strangulation of global growth." He said he is worried that "some political leaders and many citizens seem overly complacent about the risks of protectionsim. . . . We know that the prosperity of the past 60 years has been founded on increased trade. But we are also aware that many people doubt the benefits of trade."

He also said most of the depreciation in the dollar that has helped reduce the U.S. current account deficit has been against the euro and the pound sterling. "What would be better is for China to make more use of the flexibility it gave itself over a year ago to allow an appreciation of the remnibi against the dollar." That would give China the ability to use monetary policy to curb investment and growth and would permit other Asian countries to allow their currencies to appreciate without losing competitiveness. ■

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