IMF Survey

INTERNATIONAL MONETARY FUND

OCTOBER 17, 2005 VOL. 34, NO. 19

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Narong Sangnak/EPA/Newscom

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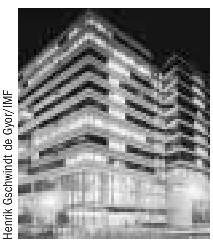
Henrik Gschwindt de Gyor/IMF



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George Esiri/Reuters

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Claudia Daut/Newscom

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What's on

October

17–18 World Economic Forum, Russia and the World, Moscow

19 IMF Book Forum, Pietra Rivoli, *Travels of a T-Shirt in the Global Economy: An Economist Examines the Markets, Power, and Politics of World Trade*, Washington, D.C.

21–23 Annual Meeting of the Parliamentary Network on the World Bank, Helsinki, Finland

24 United Nations Day

27–28 "China's and India's Changing Economic Structures: Domestic and Regional Implications," IMF, the China Society for Finance and Banking, and the Stanford Center for International Development, Beijing

27–28 European Investment Bank Forum, "Closing the Innovation Gap," Helsinki, Finland

November

3 "Monetary Institutions and Economic Development," 23rd Annual Conference, Cato Institute, Washington, D.C.

3–4 IMF Jacques Polak 6th Annual Research Conference, Washington, D.C.

4 IMF Economic Forum, "Reforming the IMF: Governance and the Executive Board," Washington, D.C.

4–5 Summit of the Americas, Mar del Plata, Argentina

8–11 IMF forums on regional economic developments—Guatemala, El Salvador, Nicaragua, and the Dominican Republic

16–18 World Summit on the Information Society, Tunis, Tunisia

18 APEC Joint Ministerial Meeting, Busan, Korea

24 IMF forum on regional economic developments for academics, nongovernmental organizations, and media, San José, Costa Rica

27–29 World Economic Forum, India Economic Summit, New Delhi

28–30 IMF seminar for parliamentarians from Algeria, Libya, Morocco, and Tunisia, Rabat, Morocco

December

4–9 International Conference on HIV/AIDS and Sexually Transmitted Infections in Africa, Abuja, Nigeria

10 Meeting of Group of Seven Finance Ministers and Central Bank Governors, London

13–18 The 6th World Trade Organization Ministerial Conference, Hong Kong SAR

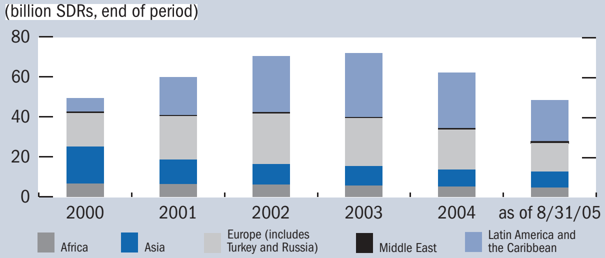
IMF Executive Board
For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp*.

At a glance

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



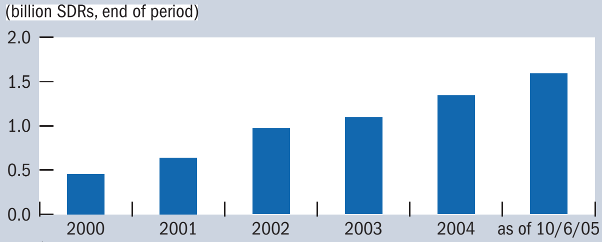
Largest outstanding loans

(billion SDRs, as of 8/31/05)

Nonconcessional		**Concessional**	
Turkey	10.99	Pakistan	1.01
Brazil	10.79	Congo, Dem. Rep. of	.53
Argentina	7.50	Zambia	.49
Indonesia	5.74	Ghana	.31
Uruguay	1.67	Tanzania	.25

HIPC debt relief[1]

(billion SDRs, end of period)

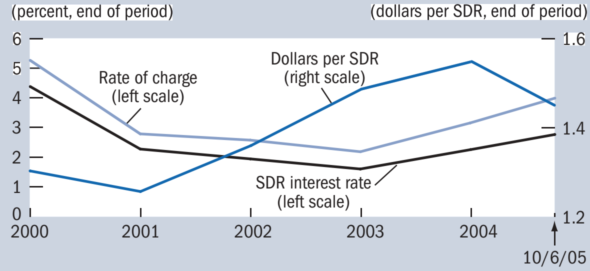


[1]Cumulative disbursements under the Heavily Indebted Poor Countries Initiative.

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 on IMF Special Drawing Rights
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.

Regional Economic Outlooks

Promising growth prospects for Asia and Middle East

The strengthened economic performance of Asia and the Middle East over recent years is expected to continue this year and next, although high oil and petroleum prices pose major risks in both regions, according to the IMF's *Regional Economic Outlooks*. The reports, launched by senior IMF staff of the Asia and Pacific (APD) and Middle East and Central Asia (MCD) Departments, urged oil-consuming countries to pass through higher oil prices to avoid mounting fiscal costs, and oil-producing countries to invest in physical and human capital to foster long-term growth. The regional outlooks are part of the IMF's enhanced regional surveillance and complement the biannual *World Economic Outlook*.

Asia. Growth in Asia has been impressive, averaging 5.5 percent a year during 1999–2004, and is forecast at 6.1 percent this year and 5.9 percent next year, propelled by vigorous exports and strong domestic demand in China and India. Inflation is expected to remain moderate as lower food prices offset higher oil prices, and the region's current account balance is forecast to remain in surplus at around 3 percent of GDP. Presenting the report in Tokyo, APD Director David Burton stressed that the growth outlook for Japan, in particular, has improved considerably—to 2 percent, from only about 0.8 percent in the spring—as domestic demand is regaining momentum.

High petroleum prices, however, remain a particular danger because many Asian economies are manufacturing-intensive and highly oil-dependent. Some governments have shielded consumers from higher costs by passing only a portion of the increases in world prices on to domestic prices, but some are now reconsidering this practice. Indonesia, for example, recently cut fuel subsidies. IMF Chief Economist Raghuram Rajan hailed this move as "an extremely good step in the right direction" and urged other countries to adopt similar measures. In a presentation in Singapore, Rajan and APD Deputy Director Wanda Tseng said governments must explain to their people that they do not control oil prices, while providing targeted help to the poor.

Additional risks in the region come from potential weaknesses in external demand and the rise of protectionist sentiment. Central banks have generally responded to large foreign exchange inflows by accumulating foreign exchange reserves, in some cases on a large scale. A further appreciation of Asian currencies will ultimately need to be part of the resolution of global imbalances, the report said.

Middle East and Central Asia. Economic growth in the Middle East and Central Asia is projected at 5.7 percent in 2005 and 5.9 percent in 2006, after growth of 5.9 percent in 2004. While real GDP growth in the region's low-income and emerging market economies is projected to slow somewhat in 2005 before rebounding in 2006, growth in the oil-exporting countries is expected to remain strong in 2005 before easing in 2006, in line with the outlook for oil prices.

As oil prices are expected to decline only gradually, the fiscal and external positions of oil-exporting countries are likely to improve even further, largely offsetting the slight worsening in the rest of the region. Inflation has been reasonably well contained, with governments limiting the pass-through of oil prices to the retail level, but inflationary pressures are expected to strengthen in the next 18 months.

Oil-producing countries should seize this opportunity to develop the non-oil sector and generate sustainable employment prospects for their rapidly growing labor forces. "The emerging market countries can create opportunities for the private sector to invest," MCD Director Mohsin Khan said in an interview in Beirut. At the same time, significant downside risks exist, including higher-than-expected inflation, major corrections in equity and real estate markets, a reversal of oil-fueled growth, and a global economic slowdown. ■

Board approves Policy Support Instrument

Meeting shortly after the IMF–World Bank Annual Meetings, the IMF's Executive Board approved the Policy Support Instrument (PSI)—one of a series of steps designed to bolster the organization's ability to support its low-income members. The PSI is intended to help countries that may not need, or want, IMF financial support but seek assistance in supporting, monitoring, and endorsing their policies. The Board welcomed the PSI as a sound approach that will help countries "design effective economic programs and provide signals to donors, the multilateral development banks, and markets."

The Board emphasized that the PSI is conceived as, and must remain, a "voluntary, demand-driven instrument supported by strong country ownership." It made clear that the PSI should serve as a complement to, and not as a substitute for, concessional financing available under the IMF's Poverty Reduction and Growth Facility (PRGF).

Directors underscored their intention to turn quickly to a proposed "shocks window" within the PRGF. An on-track PSI could provide the basis for rapid access to PRGF resources in the event of a shock.

Critics say IMF must change or risk becoming ineffective

The subject of IMF reform is a hardy perennial. The recently concluded Annual Meetings of the IMF and the World Bank saw the Fund's membership endorse the thrust of IMF Managing Director Rodrigo de Rato's proposed medium-term strategy for the institution. But that has not precluded others from voicing their own views. At an oversubscribed conference held on the eve of the Annual Meetings, the Institute for International Economics (IIE) assembled an impressive array of experts—many of them former IMF staff—to discuss what the IMF needs to do to stay relevant in the 21st century.

The conference's ambitious agenda covered almost all aspects of the IMF's governance and work, most notably the distribution of voting power among member countries, exchange rate surveillance, the IMF's role in capital account liberalization, and lending. A common thread running through many of the presentations was that the IMF's influence has waned in recent years. IIE Director Fred Bergsten argued, for instance, that "the IMF has become weak and ineffective." Yet there was also praise for de Rato's strategy. U.S. Under-Secretary of State Timothy Adams, while offering critical advice in other areas, referred to de Rato's strategy paper as a "good first step" and urged everybody to pay close attention to what it had to say.

"The perception that the IMF is asleep at the wheel on its most fundamental responsibility—exchange rate surveillance—is very unhealthy for the institution and the international monetary system."

—Timothy Adams

Redistributing voting power

With about 17 percent of the total voting power, the United States is the IMF's largest shareholder. On the issue of voice and representation, Adams made clear that while the United States favors a rebalancing of quota shares to fix the underrepresentation of countries such as Korea, Mexico, and Turkey, which have recently experienced rapid growth, it would not accept any change in its own share. It would also oppose any proposal for a quota increase (seen by many as a prerequisite for progress on the issue) given that the IMF's liquidity ratio stands at an all-time high. Adams called instead for "a voluntary rebalancing of quotas, within the existing total, from 'overweight' countries to the most 'underweight' emerging markets." And to improve representation on the IMF's Executive Board, he called on Europe to consolidate its chairs; at present, the representation of the 25 European Union (EU) member states is spread out over 10 chairs.

A scheme for how to do just that came from a somewhat unlikely corner. Lorenzo Bini Smaghi—a member of the European Central Bank's Executive Board and a former official at the Italian Ministry of Finance—argued that voting power should be measured in a way that takes into account a country's ability to form coalitions with other countries, rather than just in terms of a country's own voting share. Until now, Bini Smaghi said, Europeans have not been very effective in using their many chairs and total voting share of 32 percent to form effective majorities. But if the 25 EU countries combined to form one chair speaking with one voice, they would see their effective voting power increase dramatically—even if their combined voting power was somewhat reduced. A euro area seat (composed of the 12 countries that have so far adopted the euro) would also leave Europe better off than the present situation, Bini Smaghi said.

Getting tough on exchange rates

On surveillance, Adams urged the IMF to be much tougher on exchange rates. "The perception that the IMF is asleep at the wheel on its most fundamental responsibility—exchange rate surveillance—is very unhealthy for the institution and the international monetary system," he said. Morris Goldstein, a former Deputy Director of the IMF's Research Department and now an IIE Senior Fellow, concurred. China's recent currency reform had done little to change its de facto behavior, he said, and simply calling for greater flexibility was not enough. Instead, the IMF should consider making more use of "supplemental consultations," a seldom-invoked option under the IMF's policies on surveillance, and elevate the status of exchange rate analysis.

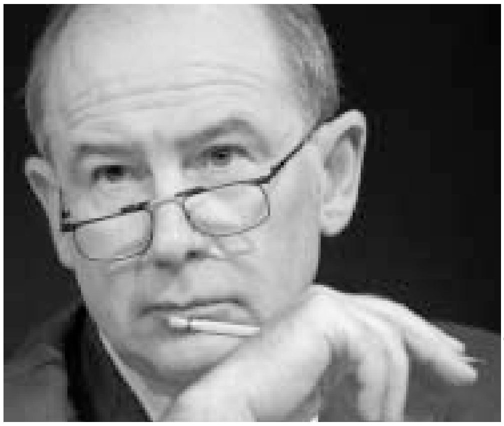
De Rato, however, poured cold water over calls for the IMF to take on a more aggressive role as an exchange rate enforcer. "If we want China to adopt more exchange rate flexibility, then we need to be sensitive to the Chinese authorities' concerns, too. I am a strong advocate of transparency, but if you're in a room with a friend, you don't need to talk through a megaphone." He added that "quiet diplomacy" has produced good results, and not just in the area of exchange rates.

Yu Yongding, Director-General of the Institute of World Economics and Politics in Beijing, noted that while China is ready to cooperate with the Group of Seven (G7) industrial countries, "it will not yield to any pressure exercised collectively by the G7 or individually by its member countries."

About that capital account

With regard to the IMF's role in capital account liberalization, Harvard Business School's Rawi Abdelal favored the status quo. There was absolutely no reason to push for an expansion of the Fund's mandate to cover the capital account, he said. Rather, the IMF should continue giving the kind of cautious advice it has been giving its member countries over the past few years—offering counsel on how to sequence capital account liberalization with other policies when countries wish to take that route, and on how best to impose nondistortive capital controls for those countries that remain wary of opening their borders to capital flows.

De Rato, referring to past criticism of the IMF's stance on this issue, said that while "it was tempting to withdraw and let the advocates and enemies of capital account liberalization just fight it out," the IMF could not do that. Instead, it would seek to further deepen its knowledge in this area so it could continue advising countries on how to properly sequence reforms.


Eugene Salazar/IMF

De Rato: "If we want China to adopt more exchange rate flexibility, then we need to be sensitive to the Chinese authorities' concerns."

To be or not to be the lender of last resort

The IMF's role in providing large-scale lending to emerging market countries—and in particular its role as a lender of last resort—was vigorously defended by William R. Cline, a Senior Fellow at IIE and the Center for Global Development. While he acknowledged that the IMF runs the risk of being caught in a "lender's trap"—rolling over loans indefinitely to avoid default by the borrowing country—he dismissed the risks of moral hazard and saw little validity in arguments that large-scale lending to such countries as Argentina, Brazil, Korea, and Turkey preempted other countries' access to scarce IMF resources. While Argentina's default had taught the IMF many valuable lessons—perhaps most importantly that it needed to pay more attention to the political setting into which it was lending—that experience alone was not a reason for the IMF to withdraw from its unique role as lender of last resort.

Chris Salmon, Head of the Bank of England's international finance division, disagreed, insisting that "there has been excessive optimism about the potential for large Fund programs to resolve crises and in particular to catalyze private capital flows." He argued for strengthening the IMF's framework for exceptional access to make it more difficult for the Fund to engage in large-scale lending.

Michael Mussa, former IMF Economic Counsellor and Research Department Director and now an IIE Senior Fellow, sided with Cline. He also cautioned against placing too much emphasis on the rules governing lending access. Citing advice of a German general, Mussa said that any plan of battle loses validity as soon as the battle begins. However, he made a point of distinguishing between the IMF as a lender of *last* resort and the IMF as a lender of *final* resort. Whereas lenders of last resort are expected to lend freely but at a penalty rate, the IMF "does not, and was never intended to, pump large amounts of general liquidity into global financial markets to help avert a worldwide financial crisis," Mussa said.

The final panel of the day ended on much the same note as the conference had begun—with Barry Eichengreen of the University of California, Berkeley, arguing that the IMF is "a rudderless institution in a sea of liquidity." Some countries, especially in Asia, were taking action to become independent of the IMF by self-insuring—building up large foreign exchange reserves so that they would not need the IMF in the event of a crisis.

Mohammad El-Erian, Managing Director and Senior Member of U.S.-based PIMCO's portfolio and investment strategy groups, agreed that the IMF is ineffective. He worried, in particular, that the IMF's lending facilities might be inadequate in dealing with "the next crisis." Such a crisis, he warned, would likely be different from those experienced even in the recent past, given changes currently taking place in financial markets. ■

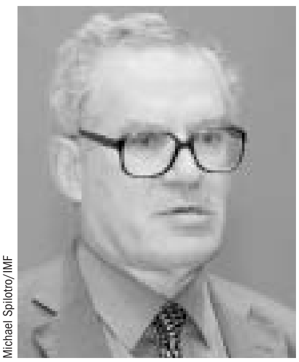
Camilla Andersen
IMF Survey

Conference papers and speeches are available on the IIE website at *http://www.iie.com/prog_imf_reform.cfm*. IIE Senior Fellow Ted Truman's background paper, also on this website, gives an excellent overview of all the issues. IMF Managing Director Rodrigo de Rato's IIE speech and the Fund's Medium-Term Strategy are available on the IMF website at *www.imf.org*.

Fortifying financial systems against crises

Despite growing global payments imbalances, high credit growth, and recurring concerns about possible asset price bubbles, the world's financial systems have displayed remarkable stability in recent years. What can be done to preserve this stability and help avoid further crises? In early September, a high-level conference at the IMF examined the challenges facing central banks and supervisors and debated measures that could help strengthen crisis prevention efforts.

Assessing the risk of financial crisis is an inherently difficult task, Roger Ferguson Jr. (Vice Chair, U.S. Federal Reserve) observed in his opening address. A policy challenge is how to cope with this uncertainty. The approach adopted by the Federal Reserve, he said, is to seek to limit the impact of any crisis that might occur rather than be overly preoccupied with predicting and preventing it. Finding the right balance between the roles of regulation and market discipline in crisis prevention is also a major challenge. Excessively tight regulation can stifle market discipline, which, he cautioned, may not be conducive to financial stability.


Michael Spilotro/IMF

Charles Goodhart

Malcolm Knight (General Manager, Bank for International Settlements) saw the challenges of growing global imbalances and unprecedentedly low real interest rates being further compounded by rapid changes in finance. The intensifying search for yield, together with increasingly sophisticated financial systems, allows market participants to tap a wider variety of funding sources, but this, in turn, has contributed to rapid credit growth and rising asset prices. In earlier cyclical upturns, he added, monetary tightening would have helped dampen credit growth, but in the current cycle, central banks have delayed tightening because of continued low inflation. Paradoxically, the success of monetary policy in containing inflation expectations may be contributing to credit growth and rising asset prices.


Michael Spilotro/IMF

José Roldán

Dealing with booms and bubbles

Complicating the policymakers' task is a limited understanding of the link between credit growth and financial crises. Charles Goodhart (Professor, London School of Economics) said that his recent research suggests that credit growth is more likely to trigger a crisis when accompanied by rising asset prices.

In many emerging market countries, rapid credit growth can increase the likelihood of crises by straining banks' capacity to assess credit risk. José Roldán (Director of Banking Regulation, Bank of Spain) took the view that rapid credit growth is often associated with an underpricing of risk. Spain uses prudential policy to compensate for this underpricing by requiring banks to build up provisions in cyclical upturns that can be drawn down when risks materialize in downturns.

Surveillance must also look out for asset price bubbles, Claudio Borio (Head of Research, Bank for International Settlements) cautioned, since bubbles can trigger financial crises. They can exacerbate the business cycle, which may justify a monetary policy response. But how can a bubble be identified? John Lipsky (Vice Chair, J.P. Morgan Securities) argued that bubbles are frequently hard to distinguish from sharp increases in asset prices that result from improving fundamentals. Lars Nyberg (Deputy Governor, Swedish Riksbank) cited just this difficulty in the case of Swedish housing prices. An alternative, proposed by Dino Kos (Executive Vice President, New York Federal Reserve), is to have policy focus on strengthening risk management, which reduces the risk to financial stability should asset prices fall sharply.

Defining financial stability responsibilities

Innovation and the growth of financial conglomerates have put pressure on the traditional roles of central banks and supervisors, argued Richard Herring (Professor, The Wharton School). With sector-by-sector supervision providing considerable scope for regulatory arbitrage, some countries have opted for integrated supervision. But if responsibility for banking supervision is transferred from the central bank, supervisors may pay insufficient attention to financial stability. Also, as providers of emergency liquidity, central banks typically require access to supervisory data. Herring concluded that various models can work well as long as there are robust mechanisms for coordination between central banks and supervisors.

Coordination between a central bank and an integrated supervisor can be achieved using a memorandum of understanding. Sir Callum McCarthy (Chair, U.K. Financial Services

Authority) outlined how the United Kingdom uses such a memorandum to define the respective responsibilities of the Bank of England, the Financial Services Authority, and the Treasury regarding the exchange of information and crisis management. Tomás Baliño (Deputy Director, IMF Monetary and Financial Systems Department) outlined how the joint IMF–World Bank Financial Sector Assessment Program also relies on an integrated framework to assess various macroprudential risks, as well as the adequacy of countries' crisis management capacity and supervision. The framework can enhance cooperation between central banks and supervisors and is typically tailored to their needs through, for example, the choice of stress-testing methodology and shocks.

Supervisory responsibilities in emerging markets are more likely to be within the central bank. This reflects the closer link between monetary and financial stability and experiences with financial crises. Alexandre Schwartsman (Deputy Governor, Central Bank of Brazil) outlined how success in ending hyperinflation in that country in 1994 sharply cut bank earnings and helped push the banking system into crisis. The subsequent restructuring of the banking system also required a substantial strengthening of the central bank's supervisory powers. A more resilient banking system, in turn, helped Brazil weather its 1999 capital account crisis. Similarly, Bandid Nijathaworn (Deputy Governor, Bank of Thailand) explained that lessons from the Asian crisis contributed to the Bank of Thailand's being given responsibility for both monetary and financial stability.


Michael Spilotro/IMF

Jochen Sanio

Addressing gaps in oversight

Over the past decade, the work of international financial institutions and standard setters has helped put in place the foundations for a new financial system architecture. Stefan Ingves (Director, IMF Monetary and Financial Systems Department) made particular note of the progress that national authorities have made in implementing various codes and standards. Greater cooperation—through consolidated supervision, for example—holds the potential to avoid or contain contagion, but Ingves warned that this effort is weakened by poor implementation of standards and gaps in cross-border or cross-sector oversight.

How can these gaps be closed? Jochen Sanio (President, German Federal Financial Supervisory Authority) discussed two approaches: harmonization of standards and cooperation among supervisors. Harmonization is typically needed to eliminate regulatory arbitrage across sectors and can be done most effectively by an integrated supervisor. Addressing cross-border gaps, however, will require greater cooperation, although the Basel Accord provides some standardization across countries.

Gaps can also arise from the differing interests of home and host supervisors with respect to the activities of big international banks. Guillermo Güémez García (Deputy Governor, Bank of Mexico) noted that the expansion of foreign banks following Mexico's 1995 financial crisis has provided benefits, but is not without risk. His greatest concern was how crises would be managed. In a crisis, a bank's home supervisor may urge subsidiaries to rapidly repatriate funds to the parent, thereby exacerbating the crisis in the host country. García argued that this scenario could be avoided through better harmonization of regulations and greater information-sharing between home- and host-country supervisors.

In Islamic banking systems, the implementation of international codes and standards poses special challenges. Rasheed Al Maraj (Governor, Bahrain Monetary Agency) outlined how supervisors adapt these standards to Islamic principles. The profit-sharing contract used by Islamic banks is more complex than interest-earning deposits, and thus requires stronger transparency and conduct-of-business rules. These contracts also complicate the development of an interbank market. The authorities may need to take a proactive role in developing tradable instruments for bank liquidity management.


Michael Spilotro/IMF

Stefan Ingves

No time for complacency

The current period of exceptional stability should not lull the world into complacency, warned Ingves in his closing remarks. Rapid credit growth and the development of asset price bubbles in many countries suggest that risks are building up. This period of relative calm is best used to build up defenses against these risks.

For many countries, he noted, the immediate priority is addressing gaps in oversight and the weak implementation of standards. Also essential are robust mechanisms that ensure cooperation between central banks and supervisors. And, with global financial systems growing more and more integrated, he urged supervisors to better communicate with colleagues. ■

Sean Craig
IMF Monetary and Financial Systems Department

Reaping the full benefits of tax reform in Mozambique

Since 1996, Mozambique has been pursuing a comprehensive set of reforms designed to modernize its tax system. A recent study by Teresa Dabán (IMF African Department) reflects on progress so far and recommends further steps that would enable the economy to benefit fully from the reformed system. She discussed her findings with Jacqueline Irving of the IMF Survey.

IMF SURVEY: How do Mozambique's tax systems compare with those of other countries at similar development levels?

DABÁN: Mozambique's ratio of tax revenue to GDP, at just over 11 percent last year, is lower than that of other sub-Saharan African countries at a similar development level. So there is significant room to increase this ratio by strengthening tax administration and enforcement, including by improving the capabilities of tax officials through better training, recruitment, and employment incentives.

Henrik Gschwindt de Gyor/IMF

Teresa Dabán

IMF SURVEY: What were the aims of the tax reforms, and how were they implemented?

DABÁN: The main goal was to establish a modern, efficient tax system that would generate enough resources for the government to reduce poverty and maintain a stable macrofiscal framework. The reforms were implemented gradually, with a strong commitment from the Mozambican authorities, and, importantly, with the support of the international community, including IMF technical assistance.

The first step was to reform customs, which were not generating much revenue and were impeded by illegal practices and corruption. The second step was to implement a system of domestic taxes in line with international standards. Now, the latest stage is to improve tax administration and fully benefit from the newly reformed system by encouraging full taxpayer compliance and ensuring full implementation of the reforms.

IMF SURVEY: Have these reforms delivered their goals?

DABÁN: Customs reform has been a success; in fact, Mozambique could be a good role model for other developing countries in this respect. At an early stage of customs reform, in 1996, the government outsourced customs administration to a private foreign firm with previous experience in implementing customs reform in other countries. This firm effectively restructured and managed customs operations without any political interference. Once customs administration had begun working reasonably well, the authorities began taking over the new system in 2003.

The new customs system, which has retained the private firm in an advisory role, has continued to function reasonably well. A revised customs rate system and improved compensation and training for customs officers have reduced corruption. The new system has been lauded for greater efficiency and transparency, and customs revenue has increased considerably in the past few years—despite the elimination of many tariffs and the opening up of the economy.

A second notable achievement has been the reform of indirect taxes, including adoption of a consumption-type value-added tax with a single rate. Now, a challenge is to improve administration of these taxes.

Most recently, in 2003–04, the income tax system was reformed. For the first time, personal income taxation provides for deductions defined according to personal and family status, in line with international best practices. Here, too, the challenge is to improve administration.

IMF SURVEY: What other steps must Mozambique take to increase its tax revenue ratio?

DABÁN: In the short term, the priority really must be to strengthen tax enforcement and auditing. In 2004, there was a shortfall in actual versus expected tax revenues, largely due to the still-narrow tax base. Tax reforms have left Mozambique with a very good tax system, but the focus now must be on putting this system to work.

Over the next three years or so, the national authorities should assess all of the remaining exemptions in the tax system. Exemptions have been granted to provide social protection; encourage certain strategic sectors, such as agriculture; and encourage megaprojects. For example, Mozambique has provided generous tax exemptions to attract investment, particularly in megaprojects related to natural resources. But the authorities should reconsider such exemptions in the future. Otherwise, these projects would not have a significantly positive impact on government revenues, and, because they are not typically labor-intensive, they would not help create many jobs.

Indeed, there has been some progress. Since 2002, the authorities have rationalized and streamlined investment tax incentives and eliminated the granting of tax holidays and exemptions without clear criteria or rules. The new legislation reduces reliance on income-tax holidays by providing alternative incentives in the form of accelerated depreciation allowances and tax credits. At the same time, this incentives policy has been re-geared to attract investment in certain key sectors, such as agriculture and tourism, and to particularly underdeveloped regions of the country.

IMF Survey: A national public survey on governance and corruption cited unemployment as a major problem in Mozambique. What priority should be given to boosting job creation and easing labor market rigidities to widen the tax base?

Dabán: Unemployment and poverty are more a rural phenomena in Mozambique. So it is important to develop the agricultural sector and rural economy, including by improving infrastructure and transportation. Mozambique has access to European and other developed countries' markets on favorable terms, but it is not exporting as much as it could because the high cost of getting goods to market reduces the competitiveness of its exports. Promoting tourism and other labor-intensive sectors will also be important to generate employment and widen the tax base. Revising overly rigid labor regulations—which tend to impede the hiring, reassignment, and dismissal of employees, and depress overall private sector activity—would also help boost employment and expand the tax base.

IMF Survey: Have tax incentives attracted foreign direct investment that contributes positively to fiscal revenues?

Dabán: Aside from megaprojects, there has not yet been much new inbound foreign direct investment. Many of these resource-seeking megaprojects would likely have come to Mozambique even without generous tax incentives. The tax incentives do help reduce risk premiums for many megaprojects and help put Mozambique on the map for this type of foreign investor. But the Mozambican authorities should analyze, on a case-by-case basis, the projected impact of each prospective project on fiscal revenues. And more attention should be given to other types of incentives—notably, improving the business operating environment.

IMF Survey: How have tax revenues been affected by Mozambique's trade commitments as a member of the Southern African Development Community [SADC] and its other international trade agreements?

Dabán: As a SADC member, Mozambique has been obliged to gradually reduce the rates and streamline the structure of its tariffs. In contrast to many other countries in the region, Mozambique now has a very simple tariff-rate structure, with five rates ranging from 0 to 25 percent. Tariff liberalization has reduced fiscal revenues, but thanks to Mozambique's customs administration reforms, revenues from international trade have been maintained at a reasonable level. Trade liberalization has also benefited the economy by making capital goods and other imported inputs available more cheaply to businesses operating in Mozambique and by reducing the costs of many consumer goods imports. More emphasis will continue to be needed on increasing tax revenues from domestic sources, including by expanding the tax base and improving tax administration. ■

Mozambique needs second wave of reforms

Thanks largely to a strong commitment to sound macroeconomic policies, continued progress with structural reforms, and a stable political situation, Mozambique's economic performance has improved markedly in recent years, supported by substantial donor assistance. Over the past decade, real GDP grew 8 percent a year on average—the fastest growth in a non-oil-producing African country—and year-end 12-month inflation fell to single digits, while international reserves strengthened considerably, according to the IMF's recent economic review. The share of the population living in absolute poverty also declined significantly.

The economic expansion continued to be broad based in 2004, with growth of 7.2 percent, down just over half a percentage point from the previous year. Lower food prices and an easing of inflation expectations helped keep inflation on a downward trend, despite sharp increases in oil prices.

While commending the remarkable results achieved so far, the IMF Executive Board noted that Mozambique is at a critical juncture in its development. A second wave of reforms is now needed to deepen and accelerate structural changes that would sustain high, broad-based economic growth. In particular, the Board urged the national authorities to focus reform efforts on increasing tax revenues, strengthening public sector operations, reducing the costs of doing business, promoting labor-intensive sectors, and implementing an effective rural development strategy.

Mozambique	2003	2004	2005	Proj. 2006
		(percent change)		
Real GDP	7.8	7.2	7.7	7.4
CPI (year-end, 12-month)	13.8	9.1	8.0	7.0
		(percent of GDP)		
Current account, before grants	–19.9	–13.8	–13.9	–12.9
		(year-end, million U.S. dollars)		
Gross international reserves	947	1,159	1,076	1,045

Data: Mozambican authorities and IMF staff estimates.

Nigeria moves to overhaul its system for old-age security

Nigeria launched a major reform of its pension system last year that is likely to be closely monitored by other low-income countries. The new Pensions Act sets up a system that replaces a range of largely unregulated and highly diverse pension arrangements. A recent study by Mauricio Villafuerte (IMF Fiscal Affairs Department) analyzes the implications of the pension reforms and explores challenges that lie ahead. He discussed his findings with Jacqueline Irving of the IMF Survey.

IMF Survey: What prompted Nigeria's pension reform?

Villafuerte: For its public sector workers, Nigeria had a general noncontributory, defined-benefit scheme with very generous pensions indexed to wages. For certain workers, including military personnel, judges, and university professors, there were also special plans with still more generous provisions. These schemes became increasingly costly and unsustainable, leading to accumulated arrears estimated at 1–2 percent of GDP in 2004. Weak financial management and poor administration, including the absence of an integrated personnel and payroll system, contributed to accumulated arrears. These arrears made the system much less generous than it was designed to be.


Henrik Gschwindt de Gyor/IMF

Mauricio Villafuerte

Private sector workers had either funded occupational schemes set up by their employers or a contributory, defined-benefit scheme managed by a trust fund set up by the federal government. The lack of proper regulation and supervision of firms' pension schemes impeded their effective functioning. In fact, no figures are available regarding their coverage and size. The centrally managed scheme, which was aimed at private sector workers in establishments with at least five employees, was partially funded by employer and employee contributions and provided defined benefits, which posed sustainability problems.

IMF Survey: What does the reform aim to do?

Villafuerte: The reform sets up a uniform, mandatory, contributory, and fully funded pension system for federal and private sector workers. The system will be based on individual savings accounts, privately managed by pension fund administrators, with pension fund assets held by separate custodians. A federal entity, the National Pension Commission (PenCom), has been charged with regulating and supervising the pension system.

Public sector employees' contributions are a minimum of 7.5 percent of their basic salary plus allowances, but military personnel contribute 2.5 percent. The government has to contribute 7.5 percent, but 12.5 percent for the military. Employers and employees in the private sector contribute a minimum of 7.5 percent each of the employees' monthly emoluments. Upon retirement, an employee can draw on accumulated savings on a monthly or quarterly basis, purchase an annuity for life through a licensed life insurance company, or both. Contributions and retirement benefits are tax exempt, and there will be a minimum pension guarantee for employees who have contributed for more than 20 years.

As for the accrued pension rights of workers who shift to the new system, public sector workers under the general unfunded scheme will receive nonnegotiable bonds redeemable upon retirement, while private sector employers will have to transfer to their employees' individual savings accounts the funds to which they were entitled under the prereform system's funded schemes.

IMF Survey: How do Nigeria's pension reforms compare with those in other countries at similar development levels?

Villafuerte: Among sub-Saharan African countries, Nigeria is at the forefront in implementing systemic and comprehensive pension reforms aimed at improving the sustainability and reducing the vulnerability of the system for future pensioners. Most countries in the region continue to operate the type of schemes that Nigeria had in the past. While some African countries have implemented changes in their pension schemes, the main characteristics generally have not been altered, pension promises remain largely unfunded, and separate schemes for the public and private sectors tend to be maintained. Changes have been mostly limited to the computation of benefits and the management of pension reserves. Other low-income countries are expected to take a keen interest in Nigeria's experience in implementing the reforms.

IMF Survey: Is implementation of these reforms premature given that detailed laws still must be prepared and the regulatory authority's capacity must be further developed?

Villafuerte: In an ideal world, laws would be passed along with proper accompanying regulations and administrative capacity. In the real world, however, ambitious reforms face political pressures. In many instances, governments must pass important legislation when there is adequate political support while building the capacity over time to make the reform operational.

The pension reform is being implemented gradually. PenCom has begun issuing preliminary licenses to prospective asset managers and custodians. It will issue final licenses once those firms comply with certain requirements. Federal government employees' pension contributions are being held at the central bank until pension fund administrators are licensed and each employee can choose a pension fund administrator.

The implementation challenges are considerable. PenCom's regulatory and supervisory capacity needs to be built up, reliable systems must be implemented to keep track of individuals' contributions and accounts balances, and accrued pension rights of federal workers must be properly audited and valued.

IMF Survey: Recent World Bank studies find that the multipillar model for pension reform in Latin America has not been that successful in delivering benefits for the region's working populations because many workers—particularly the poor, those working in the informal sector, and the young—remain uncovered. Many workers remain outside these reformed pension systems because they are struggling to meet high mandatory contribution rates and administrative charges. The studies recommend augmenting the public safety-net pillar while scaling back the compulsory savings pillar. Nigeria's reformed system provides for a relatively high mandatory contribution. Should further reforms take into account this new evidence?

Villafuerte: Nigeria's pension reforms were targeted to the segment of the population already covered by a pension scheme. In that sense, they do not address the need to expand the social safety net to support the vulnerable and elderly. There is obviously a case for establishing a basic income-support scheme to alleviate old-age poverty. But this needs to be assessed against the competing demands of other vulnerable groups and the government's financing constraints.

Despite Nigeria's relatively high mandatory contribution rate, the reforms are expected to substantially reduce the replacement rate—the portion of previous wages that initial pension benefits replace—for current and future public sector

IMF urges continued fiscal restraint for Nigeria

Good progress in implementing the authorities' homegrown reform program led to Nigeria's commendable macroeconomic performance last year, the IMF said in its most recent annual review. Real GDP increased by about 6 percent in 2004, more slowly than in 2003 when there was an unusual surge in oil production, but with growth in the non-oil sectors, particularly agriculture, strengthening significantly.

Increases in both the production and price of oil, as well as a reduction of the price subsidy on domestic crude oil sales to the Nigerian National Petroleum Corporation, boosted oil revenues last year. The consolidated government's fiscal stance, meanwhile, remained prudent. Oil revenues of some $6 billion were set aside, and public spending was kept in check, resulting in a significantly stronger overall fiscal position and a sharp increase in reserves.

Prudent macroeconomic policies prevented the Nigerian currency, the naira, from appreciating strongly as in previous oil-boom periods. The naira did appreciate somewhat, however, and this, along with the fiscal restraint and a tightening of monetary policy, helped the Central Bank of Nigeria to meet its disinflation objectives. In 2005, however, more expansionary macroeconomic policies, combined with a sharp increase in food prices related to food crises in neighboring countries, pushed 12-month inflation back up to 26 percent by July.

The IMF Executive Board commended the Nigerian authorities for the economy's strong performance last year and noted the achievement of a number of priority aims, including more predictable and transparent policies, and reduced vulnerability to oil price shocks. The Board warned that formidable challenges remain in the way of Nigeria's economic transformation—because of weak institutions, administrative and technical capacity constraints, resistance from entrenched interests, and the legacy of decades of mismanagement.

Underscoring the role of prudent fiscal policy in last year's macroeconomic policy success, the Board said it was concerned about the move to a more expansionary fiscal stance this year and the resulting larger non-oil deficit. This would complicate the management of monetary policy, it warned, and could crowd out export activities and private investment.

Executive Directors welcomed the creation of a virtual poverty fund for tracking poverty-reducing spending and a cost-benefit analysis unit in the Ministry of Finance, which will examine large investment projects. If passed, provisions of the Fiscal Responsibility Bill would enhance fiscal transparency and accountability at all government levels, introduce formal fiscal rules into the budget process, and lay the foundations for medium-term fiscal sustainability.

Nigeria	2003	Prel. 2004	Proj. 2005	Proj. 2006
		(percent change)		
Real GDP	10.9	6.1	4.0	5.0
Oil GDP	26.5	3.5	2.0	5.1
Non-oil GDP	4.4	7.4	4.9	5.0
		(year-end, 12-month change)		
Consumer price index	23.8	10.0	18.5	8.5
		(percent of non-oil GDP)		
Consolidated government non-oil primary balance	–33.8	–36.4	–41.4	–38.0
		(percent of GDP)		
Overall fiscal balance	–1.3	7.7	9.9	17.9

Data: Nigerian authorities and IMF staff estimates.

workers. Therefore, a lower contribution rate would probably not be feasible. This is an additional argument for further reforms that would reduce the very generous benefits for current public sector pensioners, which have remained unchanged.

IMF Survey: In industrial countries, the trend more recently has been to raise the minimum retirement age, in some cases, toward 70. Does Nigeria's reformed system—which allows employees to begin withdrawing funds from retirement accounts without penalty at age 50—take adequate account of demographic trends and the likely impact on public finances?

Villafuerte: The new Pension Act does not actually stipulate a minimum retirement age per se. Fifty is the minimum age at which individuals can withdraw money from their retirement account, provided that the amount remaining is sufficient to set up programmed withdrawals of no less than 50 percent of an individual's monthly remuneration at the time of retirement.

IMF Survey: So what impact do you expect the new system to have on public finances in the near and medium term?

Villafuerte: In the short term, the government's contribution to public sector employees' individual retirement accounts and the reform's transition costs will increase fiscal outlays substantially. Transition costs include pension benefits for existing public sector pensioners and the recognition of accrued pension rights under the old system for active workers migrating to the new system.

While the transition costs will fall over time and the government's total pension bill will be lower in the long run than if the reform had not been undertaken, research by World Bank and IMF staff shows that long-term fiscal savings (in net present value terms) are limited because the generous benefits still available to certain workers under the old system have not been reduced. There is also a sizable reduction in benefits for future pensioners relative to current beneficiaries, which suggests the need to reduce statutory benefits for current pensioners and accrued rights of workers shifting to the new system. Moreover, the design of the minimum pension guarantee scheme has not been completed, but it could create a substantial contingent liability for the government in the long run. ■

Chile's pension system faces growing pains

Chile's pioneering pension reform—which replaced its public system with one based on individual accounts managed by the private sector—has served as a model for other countries across Latin America and the rest of the world. How is it doing after nearly a quarter century in operation? Using the findings of a comprehensive household survey, a recent IMF *Selected Issues Paper* takes stock of progress and concludes that changes, including a broadening of the old-age social safety net, may be required.

Under Chile's pension regime, it is the individual—not the state—who is responsible for saving for retirement. While working, participants in the system contribute 10 percent of their wages to an individual retirement account each month and pay additional fees—averaging around 2 percent of wages—to private pension fund administrators (*Administradoras de Fondos de Pensiones,* or *AFPs*) to manage these accounts and invest in financial assets. The retirement age is set at 60 for women and 65 for men.

From the beginning, Chile's reformers realized that retirees would face a substantial risk of outliving their assets. To limit this risk, they created rules that barred retirees from withdrawing all of their money immediately upon retirement. Funds would have to be withdrawn slowly over time or used to purchase an annuity that would provide a guaranteed stream of income for life. The reformers also created a social safety net that would provide a minimum pension guaranteed (MPG) to all participants who contributed to the system for at least 20 years. Currently, this minimum pension is set at around US$140 a month and is indexed to inflation to help protect retirees' purchasing power.

Growing pains

Since its introduction, the privatized pension system has grown rapidly. With around two-thirds of all workers participating in the system, total assets under management by the AFPs amount to US$59 billion—equivalent to just over 60 percent of GDP at the end of 2004 (see chart).

What accounted for the system's strong growth? One important factor was its impressive returns during the early years, thanks to very favorable circumstances in the domestic financial markets. Gross returns averaged 12 percent a year from 1981 to 1997, reflecting two categories of windfalls. First, the AFPs held a large stock of bonds, whose prices surged as inflation fell and interest rates declined. Second, pension funds realized large capital gains on stocks bought during the privatization drive of the 1980s. Since 1997, however, returns have fallen quite significantly, averaging only about 6½ percent over 1998–2003.

With overall strong returns, current retirees appear to have sufficient income to maintain their standard of living. According to staff estimates, accountholders should aim to have a pension income that replaces around 50 percent of final gross salaries. By this measure, the system appears to be performing well; estimates suggest a replacement rate of around 60 percent in 2002.

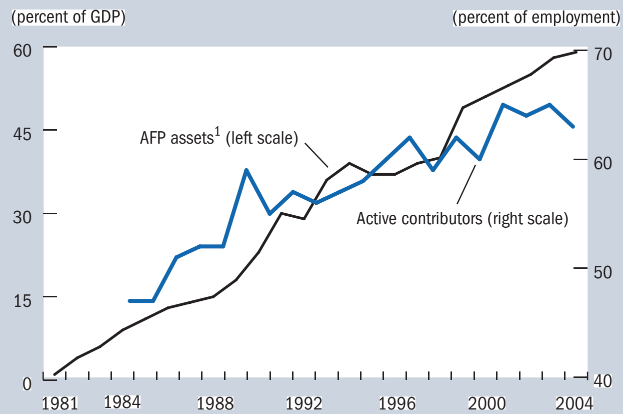
Nevertheless, the system has experienced growing pains—including from insufficient competition. Currently, there are only six AFPs, and they dominate the financial system. Also, the costs of administering the system have remained quite high. During the early 1990s, the AFPs engaged in a costly marketing war to convince contributors to switch funds, offering such incentives as free household goods or sporting equipment. These abuses have since been reined in, but costs still average around 2 percent of wages and tend to be highest for lower-income workers. International comparisons suggest that these costs could be reduced by up to 25 percent (according to staff estimates). Indeed, the IMF's 2004 Financial System Assessment for Chile recommended consideration of reforms that would unbundle common operations that are subject to economies of scale—such as collecting contributions and account management. Such reforms would then allow the AFPs to focus solely on maximizing risk-adjusted returns.

Over the past several years, participation in the new system has stagnated. The 2002 *Social Protection Survey* of 17,000 Chilean households helps explain why. First, most self-employed—about 25 percent of all workers—are choosing not to participate in the system because their income varies considerably from month to month and many find it difficult to contribute consistently. The self-employed also have a financial incentive to opt out; if they do so, they can avoid all other social insurance deductions—pension and nonpension withholdings total 23 percent of wages.

The second reason for low coverage is that the proportion of women who contribute regularly is low. Labor force participation among Chilean women is only 37 percent because of a lack of part-time work and, more important, a shortage of day-care facilities that make it difficult for women to work during child-rearing years. Indeed, women tend to remain out of the labor market for extended periods during their late 20s and early 30s.

Pension reform takes root

By 2004, two-thirds of all workers participated in the system, which had total assets under management of US$59 billion (60 percent of GDP).



[1]Administradoras de Fondo de Pensiones—private pension fund administrators.
Data: Superintendency of Pension Funds and Central Bank of Chile.

Too little?

Chile's pension reformers may have been overly optimistic in thinking workers would vigilantly save for retirement. The pension system was designed under the assumption that most would contribute for just over two-thirds of their working lives. In reality, most are active contributors for only about half of the time. As a result, just over 1 million accounts (15 percent of all accountholders) have a balance of less than US$175, and the median account is worth just US$3,000—suggesting that many may reach retirement age without enough assets to stop working.

Women are likely to face an additional difficulty, due to their extended absences from the labor market. Since these episodes of nonparticipation occur during their 20s and 30s, women tend to miss out on much of the benefit of compound interest with its associated accumulation of returns over time. As a result, some estimates suggest that women's pensions are 50 percent lower than if they had continued working.

Future retirees will also face the likelihood that gross real returns from the AFPs will revert to more moderate levels. Until now, high yields from the early days of the system have partially offset the effects of infrequent contributions. The impact of these exceptional circumstances will gradually wane, however. As returns drift lower, the average replacement rate could decline significantly—so that in the long run pensions would replace a substantially lower share of pre-retirement income.

At the same time, many retirees will likely find that they cannot count on government help, because they will not have contributed long enough to qualify for the MPG. Existing rules require workers to contribute for a minimum of 20 years to benefit from the minimum pension. However, the 2002 *Social*

Protection Survey shows that one-fourth of men and one-half of women contribute for about 10 years—substantially less than the minimum needed.

What's next?

Given the long lead time for changes in pension policies to take effect, IMF staff recommend that the government take action now to increase participation and broaden benefits. Some of the adjustments will need to be made by workers who have become accustomed to avoiding contributions. These could include:

Increasing the retirement age. While not popular politically, the retirement age could be raised, particularly for women, who in Chile live five years longer than men on average. To help limit future fiscal costs, the retirement age (or the age to qualify for government support) could be linked to future increases in life expectancy.

Removing the "opt-out" provision for the self-employed. To help cushion the impact of this measure, the government could phase in changes over time, reduce the administrative burdens (by making contributions quarterly, for example), and exempt the self-employed from all nonpension social insurance withholding, which would halve deductions.

Encouraging labor market participation by women. The government may need to recognize time spent working in the home. It could do so by offering subsidies, tax credits, or tax deductions to fund contributions to retirement accounts. Alternatively, it could make broader changes to labor and social policies, such as introducing more flexibility for part-time work and high-quality day care.

Broadening government participation in the overall pension regime. Previously, the government had budgeted for a sharp rise in spending on the MPG, but this is not likely to materialize under the existing system because so few qualify. As a result, the rules on the MPG could be modified, allowing workers to receive the MPG if they contribute for fewer years than the mandatory 20-year period. Furthermore, the government's other anti-poverty programs could be strengthened to take care of those who do not qualify for an MPG. ■

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This article is based on IMF Country Report No. 05/316, *Chile: Selected Issues.* Copies are available for $15.00 each from IMF Publication Services. Please see page 316 for ordering details. The full text is also available on the IMF website (*www.imf.org*).

Chile's consistent economic policies reap rewards

Chile's sound and consistent policy framework over the past two decades has helped entrench low inflation, sustain economic growth, and reduce poverty, the IMF said in its annual economic review. The "structural surplus rule"—a fiscal innovation that requires a cyclically adjusted government surplus of 1 percent of GDP—along with a highly regarded inflation targeting framework, increasing trade and financial integration, and a robust financial system have strengthened the economy's resilience to external shocks. As a result, with a favorable external environment, real GDP grew by 6.1 percent in 2004, the strongest rate in seven years. Despite steady employment growth, however, the unemployment rate is still relatively high, at about 8 percent of the labor force.

The IMF's Executive Board noted that a favorable global environment, continued strong mineral prices, the ongoing rebound in private investment, and pickup in domestic consumption will contribute to strong economic growth in 2005 and 2006. Risks to the outlook appear manageable, and the Board commended the authorities for their prompt action to mitigate the impact of disruptions due to cuts in natural gas supplies from the region, as well as for their spending restraint—despite higher revenues from a surge in copper prices. It advised continued fiscal discipline and supported the gradual tightening of monetary policy under way, which is consistent with the inflation objective in the context of a closing of the output gap.

While the banking sector is robust, the Board saw room for further improving the financial system's efficiency and oversight, and supported efforts to deepen the domestic financial market. It also encouraged improved supervision of the insurance sector and steps to foster competition among private pension funds, such as fewer restrictions on the investment of these funds. It welcomed reforms to improve preschool coverage for low-income groups, provide education subsidies to low-income households, and enhance funding for tertiary education. More flexibility in the labor market, the Board said, would also help expand employment opportunities.

Chile	2001	2002	2003	2004	Proj. 2005
			(percent change)		
Real GDP	3.4	2.2	3.7	6.1	5.9
Consumer prices (average)	3.6	2.5	2.8	1.1	2.9
			(percent of GDP)		
Current account balance	–1.6	–0.9	–1.5	1.5	0.3
Central government balance	–0.5	–1.2	–0.4	2.2	2.8

Data: Central Bank of Chile, Chile's Ministry of Finance, Haver Analytics, and IMF staff estimates.

HIPC debt relief (status as of October 6, 2005)

IMF member	Decision point	Completion point	Amount committed	Amount disbursed[1]
			(million SDRs)	
Heavily Indebted Poor Countries (HIPC) Initiative				
Under original 1996 Initiative				
Bolivia	September 1997	September 1998	21.3	21.3
Burkina Faso	September 1997	July 2000	16.3	16.3
Côte d'Ivoire	March 1998	—	16.7[2]	—
Guyana	December 1997	May 1999	25.6	25.6
Mali	September 1998	September 2000	10.8	10.8
Mozambique	April 1998	June 1999	93.2	93.2
Uganda	April 1997	April 1998	51.5	51.5
Total original HIPC			**235.3**	**218.6**
Under the 1999 Enhanced HIPC Initiative				
Benin	July 2000	March 2003	18.4	20.1
Bolivia	February 2000	June 2001	41.1	44.2
Burkina Faso	July 2000	April 2002	27.7	29.7
Burundi	August 2005	Floating	19.3	0.1
Cameroon	October 2000	Floating	28.5	5.5
Chad	May 2001	Floating	14.3	8.6
Congo, Democratic Republic of the	July 2003	Floating	228.3[3]	3.4
Ethiopia	November 2001	April 2004	45.1	46.7
Gambia, The	December 2000	Floating	1.8	0.1
Ghana	February 2002	July 2004	90.1	94.3
Guinea	December 2000	Floating	24.2	5.2
Guinea-Bissau	December 2000	Floating	9.2	0.5
Guyana	November 2000	December 2003	31.1	34.0
Honduras	June 2000	April 2005	22.7	26.4
Madagascar	December 2000	October 2004	14.7	16.4
Malawi	December 2000	Floating	23.1	11.6
Mali	September 2000	March 2003	34.7	38.5
Mauritania	February 2000	June 2002	34.8	38.4
Mozambique	April 2000	September 2001	13.7	14.8
Nicaragua	December 2000	January 2004	63.5	71.2
Niger	December 2000	April 2004	31.2	34.0
Rwanda	December 2000	April 2005	46.8	50.5
São Tomé and Príncipe	December 2000	Floating	—	—
Senegal	June 2000	April 2004	33.8	38.4
Sierra Leone	March 2002	Floating	98.5	66.0
Tanzania	April 2000	November 2001	89.0	96.4
Uganda	February 2000	May 2000	68.1	70.2
Zambia	December 2000	April 2005	468.8	508.3
Total Enhanced HIPC			**1,622.5**	**1,373.3**
Combined total			**1,857.8**	**1,591.9**

Definitions

Decision point: Point at which the IMF decides whether a member qualifies for assistance under the HIPC Initiative (normally at the end of the initial three-year performance period) and decides on the amount of assistance to be committed.

Completion point: Point at which the country receives the bulk of its assistance under the HIPC Initiative, without any further policy conditions. Under the Enhanced HIPC Initiative, the timing of the completion point is linked to the implementation of pre-agreed key structural reforms (that is, floating completion point).

[1]Includes interest on amounts committed under the Enhanced HIPC Initiative.

[2]Equivalent to the committed amount of $22.5 million at decision point exchange rates for March 17, 1998.

[3]Amount committed is equivalent to the remaining balance of the total IMF HIPC assistance of SDR 337.9 million, after deducting SDR 109.6 million representing the concessional element associated with the disbursement of a loan under the Poverty Reduction and Growth Facility following the Democratic Republic of the Congo's clearance of arrears to the IMF on June 12, 2002.

Data: IMF Finance Department.

Political connections: How much do they matter?

There is much anecdotal evidence to suggest that political connections play an important, even pivotal, role in business. As international financial institutions such as the IMF and the World Bank pay increasing attention to corruption, gaining a better sense of how political connections work is crucial. In a September 7 seminar organized by the IMF Institute, Professor Raymond Fisman from Columbia University suggested that political connections may account for as much as 20 percent of some companies' value in countries with high levels of corruption.

For politically connected firms, personal relations with people in political power are important. The most obviously connected firms have an elected official as owner or board member, but relations can also be more distant—maybe a politician's cousin or daughter is in charge of the company. And then, of course, there is lobbying, the most common form of political connections in the United States.

Massoud Etemadi/IMF

How do companies benefit from their political connections? And how do they reward their friends in high places? The answers vary widely across countries. Benefits may include gaining access to state or local subsidies, cheap loans from public sector institutions, lower taxes, licenses granted or tariffs imposed on competing goods, or influence over industry regulation. Politicians, in turn, often receive their payoffs in the form of campaign contributions, cash, or some form of in-kind remuneration (possibilities are legion).

The press may report on such dealings, but measuring the actual value of political connections is difficult.

Test case

To gauge this value, Fisman set out to estimate the degree to which firms rely on connections for their profitability. Using Indonesia under President Suharto as a case study, he correlated reports in the Indonesian press of rumors related to the president's declining health with movements in the shares of the 25 largest industrial groups listed on the Jakarta stock exchange (JSX). He found that companies known to have close links with the Suharto regime consistently declined much more steeply on adverse news reports than did less well- connected firms.

Fisman also tried to ascertain the full value of these companies' connections with the Suharto regime by asking a number of investment bankers how much they thought the JSX would fall if Suharto died or was unexpectedly removed from office. Most bankers thought the fall would be on the order of 20 percent.

What does this tell us about other countries? According to Transparency International's corruption index, Indonesia, in 1998, was then perceived as less corrupt than, among others, Bangladesh, China, India, Nigeria, and Russia. To the extent that perceived corruption is a reasonable proxy for the prevalence of political rent-seeking, Fisman concludes that "political connections may play an important role in many of the world's largest and most important economies."

Cure worse than the disease?

Are political connections always bad? After all, southeast Asia grew very fast for many decades even though relational capitalism is widespread there. In fact, new research into related lending (an important piece of the political connections puzzle) shows it may in some cases be a response by bankers to high information and contract enforcement costs.

A different, but related, point is that trying to get rid of relational capitalism may create new problems, says Fisman. For that reason, it is at least worth asking whether stable corruption is better than the chaos that may ensue in attempting to undo an existing web of political connections. ■

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