IMF Publication

What's on

MAY

17–18 African Development Bank Group Annual Meetings, Ouagadougou, Burkina Faso

18 IMF Book Forum, *India's and China's Recent Experience with Reform and Growth*, edited by Wanda Tseng and David Cowen, Washington, D.C., United States

20–22 World Economic Forum on the Middle East, "Embracing the Future: Unleashing the Potential of the Middle East," Sharm El-Sheikh, Egypt

21–22 European Bank for Reconstruction and Development Annual Meeting and Business Forum, London, United Kingdom

22–23 Organization for Economic Cooperation and Development Forum 2006, "Balancing Globalization," Paris, France

22–27 World Health Assembly, World Health Organization, Geneva, Switzerland

23 IMF Book Forum, "Pragmatism: Latin America's New 'Ism'?" with Javier Santiso, author of *Latin America's Political Economy of the Possible: Beyond Good Revolutionaries and Free Marketeers*, Washington, D.C., United States

24–25 IMF High-Level Seminar on Asian Financial Integration, Singapore

29–30 World Bank, Annual Bank Conference on Development Economics, Tokyo, Japan

29–30 "The International Monetary Fund in Transition," co-sponsored by the World Economic Forum, the Reinventing Bretton Woods Committee, and the South African Treasury, Cape Town, South Africa

31–June 2 World Economic Forum on Africa, "Going for Growth," Cape Town, South Africa

JUNE

15–16 World Economic Forum on East Asia, "Creating a New Agenda for Asian Integration," Tokyo, Japan

15 European Research Workshop in International Trade, Joint Vienna Institute, Vienna, Austria

19–23 World Urban Forum III, Vancouver, Canada

19–23 Financial Action Task Force, Third Plenary Meeting, Paris, France

JULY

3–5 High-Level Meeting of the United Nations Economic and Social Council, Geneva, Switzerland

15–17 Group of Eight Summit, St. Petersburg, Russia

SEPTEMBER

10–11 China Business Summit 2006, Beijing, China

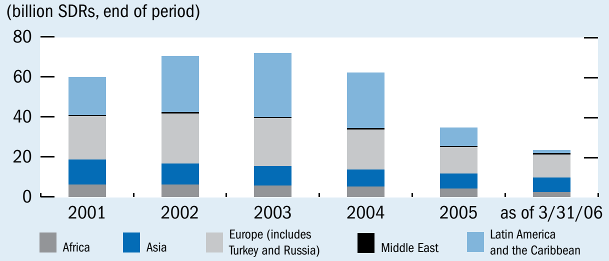
19–20 IMF–World Bank Annual Meetings, Singapore

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)



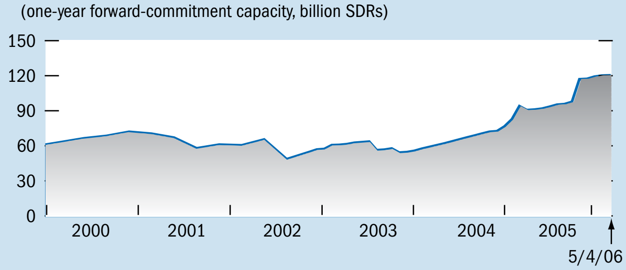
Largest outstanding loans

(billion SDRs, as of 3/31/06)

Nonconcessional		**Concessional**	
Turkey	9.01	Pakistan	0.99
Indonesia	5.19	Congo, Dem. Rep. of	0.55
Uruguay	1.26	Bangladesh	0.28
Ukraine	0.74	Cameroon	0.19
Serbia and Montenegro	0.66	Yemen, Republic of	0.17

Available IMF resources

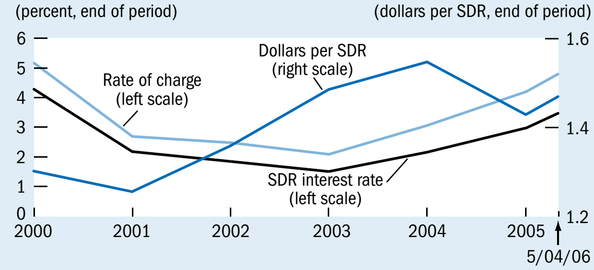
(one-year forward-commitment capacity, billion SDRs)



Related rates

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

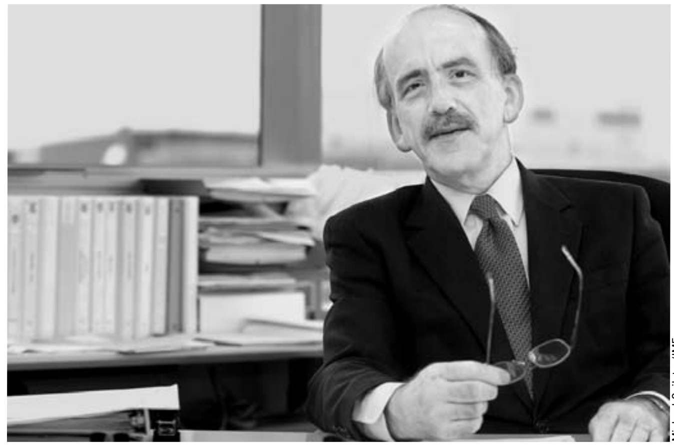
(percent, end of period) (dollars per SDR, end of period)



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.

IMF sets up investment account, examines funding options

The IMF has taken the first steps toward adapting its financing model—essentially unchanged for the past 25 years—to current circumstances and expected future needs, Finance Department Director Michael Kuhn said in an interview with the *IMF Survey*. In an initial move, the IMF announced on May 4 the creation of an $8.7 billion investment account expected to boost IMF income over the medium term.



Michael Spilotro/IMF

Finance Department Director Michael Kuhn says the creation of an investment account is a big step in modernizing management of the Fund's resources.

Like other financial institutions, the IMF earns income from interest charges and fees levied on its loans and uses the income to meet funding costs, pay administrative expenses, and build up precautionary balances. But income has fallen short of target recently because of a significant decline in the level of IMF credit outstanding, reflecting the global financial stability of recent years, the pattern of global imbalances, and the easy access of countries to private capital markets.

The Fund's credit outstanding fell to its lowest level in 25 years, to SDR 19.4 billion ($29 billion) in March this year, following the early repayment of large loans by Argentina and Brazil. Credit outstanding had reached a peak of over SDR 70 billion ($105 billion) in 2003. The SDR, or Special Drawing Right, is the Fund's unit of account—a basket of four major currencies.

The early repayments have been welcomed by the IMF as a sign of progress in countries recovering from economic crisis. "The recent decline in credit outstanding to the IMF is a very welcome development," said Kuhn in the interview. "It has given added impetus to ongoing efforts to develop other sources of funding because our primary job should not be lending, and we cannot live off the margin on lending alone," he added.

Reflecting changes associated with globalization, Managing Director Rodrigo de Rato has outlined a new medium-term strategy for the Fund that gives the 184-member institution a larger watchdog role in the world economy at a time of strong growth but also downside risks related partly to rising oil prices and large global payments imbalances.

Twin strategy

Under its current financing arrangements, the Fund is heavily dependent on its loans outstanding for its income, with the interest rate charged on its lending set each year on a cost-plus basis. This system was adopted in 1981 and has been successful in covering the Fund's operating costs and—together with the introduction of surcharges in 1997—building up reserves. However, the current system is not sustainable in a low-lending environment.

To put the Fund on a stronger long-term financial footing, the IMF's Executive Board has adopted a two-pronged strategy. For the current financial year ending in April 2007, the Board decided in an April 28 review on a number of

IMF by the numbers

184 Member countries	**2,700** Staff	**$300 billion** Total quotas paid in by member governments
$985 million IMF's projected operating costs in FY2007	**$85 million** IMF's projected operating deficit for FY2007	**$8.7 billion** Total IMF reserves

immediate measures to address a projected income shortfall and reposition the Fund's sources of income. It rejected a rise in the interest rate on its loans (known as the rate of charge) to cover the revenue shortfall, keeping the margin on loans outstanding at 108 basis points above the SDR interest rate, currently 3.56 percent. Instead, it suspended the accumulation of reserves and decided to put an amount equivalent to its reserves, valued at SDR 5.9 billion ($8.7 billion), to work in an investment account.

Kuhn said the investment account would invest in government bonds of countries whose currencies are included in the SDR basket—the euro area, Japan, the United Kingdom, and the United States—and in marketable obligations of other international organizations. The portfolio would be externally managed, following a 1–3 year government bond index adjusted to reflect the weights of the four currencies included in the SDR basket.

Authority to set up an investment account was created at the time of the Second Amendment of the IMF's Articles of Agreement over a quarter-century ago but had remained inactive. "The establishment of the investment account is a historic step that has the potential to contribute to the IMF's income for many years to come," Kuhn said. "The Executive Board has taken a big step in modernizing the management of the Fund's resources in a manner that is prudent."

Income outlook

The IMF is projected to run operating deficits following a decline in interest earnings from lending to member countries.

(million SDRs, except where indicated[1])

		Projected		
	FY06	FY07	FY08	FY09
A. Income	**761**	**625**	**581**	**512**
Margin for the rate of charge	410	206	157	117
Investment income:				
Implicit return on reserves[2]	166	205	242	248
Additional income from investment account	—	30	30	30
Surcharges	51	118	79	49
Other	134	66	73	68
B. Expenses (administrative and capital)	**646**	**684**	**685**	**701**
Administrative budget	602	633	645	662
Capital budget not capitalized	25	30	17	15
Depreciation expense	19	21	23	24
C. Surplus/shortfall (A–B)	**115**	**–59**	**–104**	**–189**
Memorandum Items:				
IMF credit outstanding (average)	35,600	17,300	13,500	10,700
SDR interest rate path (percent)	2.8	3.5	4.1	4.2

[1]Based on a U.S. dollar/SDR rate of 1.45 for FY06 and 1.44 for FY07–FY09.
[2]Assumes gradual increase in global interest rates.
Data: IMF Finance Department.

Bridging the gap

Despite budget tightening, the IMF will still run an operating deficit of some SDR 59 million ($85 million) in the current financial year, compared with a surplus of SDR 115 million ($167 million) last year (see table).

Even before the projected deficit, the IMF had been considering a number of ways to bridge the gap, in addition to cuts in real spending. Kuhn said these include options that would require a strong consensus among members; some—including an expanded investment authority and a system of annual dues—would require an amendment of the IMF's Articles of Agreement.

Developing a political consensus

In his medium-term strategy, endorsed by the International Monetary and Financial Committee of the Fund's Governors in April, de Rato said a new business model was needed to place the institution on a sound financial footing, based on a stable source of long-term income.

"Although it is true that the current level of reserves could finance budgetary gaps well into the next decade, and it is possible, if by no means certain, that income will pick up with lending, it is incumbent on an institution devoted to financial prudence to aim for a more credible and durable solution," de Rato stated. "However, developing a political consensus around any particular measure—be it conversion of gold into earning assets or an annual fee linked to quota or anything else—will take time. It is therefore proposed to catalyze this process by establishing an external committee, headed by an eminent person, to make recommendations." De Rato has not yet announced who would head the committee.

Kuhn said that there was a clear need to fill the income gap. "Running a long-term deficit is not a sensible approach for an institution that preaches fiscal prudence," he stated. "That said, the Fund has run deficits in the past, but not for the past 25 years. And, although the deficits we are talking about are not huge relative to our financial reserves, we have to run the finances of this institution conservatively and prudently."

Overall, the financial position of the Fund remains strong. "We don't face a cash-flow crisis," Kuhn said. "But we do need to use the time provided by the transitional decisions to reach agreement on a sensible and sustainable arrangement that can last for another quarter-century." ■

Further information on the investment account and the IMF's income outlook is available on the IMF's website (*www.imf.org*). Documents posted on May 4 include "The Fund's Medium-Term Income—Outlook and Options," "Establishment of an Investment Account," and "Review of the Fund's Income Position for FY2006 and FY2007."

Rising oil prices fuel liquidity, stoke reserves

High oil prices and a benign global environment provided the impetus for strong growth in the Middle East and Central Asia over the past year. The region averaged more than 6 percent growth in 2005 and is projected to turn in a similar performance in 2006, according to the IMF's *Regional Economic Outlook: Middle East and Central Asia*. Macroeconomic performance was strong more generally: inflation was muted, fiscal and external balances improved in most countries, and official reserves rose sharply despite hefty external debt repayments.

Sharply higher oil revenues in exporting countries have thus far not translated into correspondingly higher expenditures, and the resulting high rate of saving (see top chart) is showing up, the report notes, in wider global imbalances.

Capital inflows in some instances have helped the region's oil-importing countries finance higher energy bills and postpone adjustment. Indeed, countries in the region, on average, passed through only 50 percent of the higher oil prices to consumers between 2002 and 2005. In oil-exporting countries the pass-through was only 20 percent of the increase; in low-income countries, the pass-through was 80 percent of the increase. Although these actions have helped contain inflation and aid non-oil sectors, the fiscal costs for some oil importers have been high.

High oil prices have also swelled regional liquidity and fueled stock market and real estate booms. The report cautions, in particular, about possible overvaluation of some stock markets—several of which suffered reversals in late 2005 (see bottom chart).

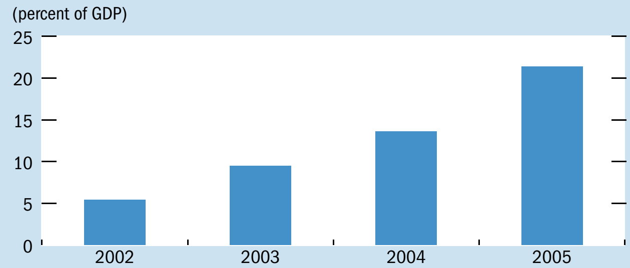
On the horizon

While the report sees good prospects for 2006, it cautions that countries will need to adjust to higher energy costs and be mindful of attendant risks. It urges *oil producers* to reduce oil price subsidies and seize the opportunity afforded by increased revenues to invest in infrastructure and human development. With pressures on exchange rates rising, nominal appreciation, the report says, is certainly preferable to increased inflation. The report also cautions that those countries with pegged exchange rates, open trade regimes, and flexible labor markets may see asset rather than consumer price inflation—making tightened bank supervision and adequate investor protection a priority.

Oil-importing countries will need to adjust, passing through the full increase in the price of oil and taking steps to protect the poor—measures that will entail substantial fiscal tightening in some countries. It will also be important to tighten monetary policy to limit credit growth and prevent higher inflation from becoming entrenched. ■

Oil exporters' rising surpluses

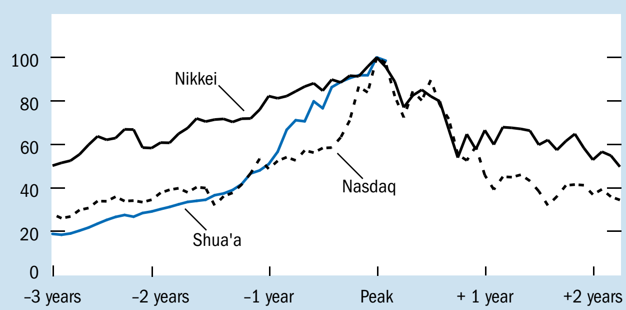
Between 2002 and 2005, the average current account balance—a broad measure of saving—has increased more than fourfold.



Data: Country authorities and IMF staff estimates.

Fundamentals or bubble?

The size of the increase in the Shua'a before the recent correction is daunting compared with the lead-up to the Nasdaq and Nikkei bubbles.



Note: Market peaks—Nasdaq (March 2000), Nikkei (December 1989), and Shua'a (February 2006). Shua'a is a market-weighted index of the most active stocks in 12 Arab stock markets.
Data: Bloomberg.

Middle East and Central Asia

The *Middle East and Central Asia Regional Economic Outlook* covers countries included in the IMF's Middle East and Central Asia Department. The countries are grouped as *oil exporters* (Algeria, Azerbaijan, Bahrain, Iran, Iraq, Kazakhstan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Syria, Turkmenistan, and the United Arab Emirates), *low-income* (Afghanistan, Armenia, Djibouti, Georgia, Kyrgyz Republic, Mauritania, Sudan, Tajikistan, Uzbekistan, and Yemen), and *emerging markets* (Egypt, Jordan, Lebanon, Morocco, Pakistan, and Tunisia).

The full text of the *Regional Economic Outlook* is available on the IMF's website (*www.imf.org*).

Globalization: choice or fact of life?

Is globalization the norm today? In his new book, *Global Capitalism: Its Fall and Rise in the Twentieth Century*, Harvard University Professor Jeffry A. Frieden explores the evolution of globalization since the 1880s, arguing that globalization is a choice formed by politics and policy decisions, rather than a fact of life. At a March 29 Book Forum sponsored by the IMF and moderated by Steven Pearlstein (*Washington Post*), panelists Harold James (Princeton University) and Virginia Haufler (University of Maryland) joined Frieden for a discussion about globalization.

For Frieden, the problem of globalization during the 20th century was whether to restore international economic integration and, if so, how to do it. The issue today, as it was circa 1900, is "how to build and sustain both international and domestic political and economic orders that allow societies to reap the fruits of international integration while maintaining the commitment to social cohesion and social insurance that is necessary to cement support for a globalized international economy."

Henrik Gschwindt De Gyor/IMF

Frieden: The issue today is how to enable societies to reap the fruits of international integration, while maintaining the commitment to social cohesion and social insurance.

We've been here before

Before 1914, there were large movements of goods, capital, and information. In some ways, Frieden said, the world economy was more tightly integrated because of the gold standard. Tensions were similar, as industrial countries worried about the flow of cheap products from developing countries and feared the loss of national identity, the outbreak of ethnic conflict, and antiglobalization sentiment. Governments saw international economic commitments as a priority and were willing to allow restructuring of domestic economies for the greater global good, convinced that the long-run benefits far outweighed any short-run costs.

So what happened? The commitment to international economic integration became less feasible between the wars, Frieden said, because of significant economic and political changes resulting from the modernization of industry, the organization of labor, and "an ever-increasing march of countries committed to nationalism and self-sufficiency and increasingly hostile to the idea of building an internationally integrated economy." Although globalization provided enormous benefits, it also imposed severe costs on people, firms, countries, and regions. History showed, he said, that "ignoring the discontent of those harmed by the international economy . . . could quickly and stunningly lead to a reversal of fortune on the part of those who benefited from it."

Globalization and its discontents

Globalization produces discontents that need to be managed effectively, Harold James said. He described two mutually exclusive ways of looking at today's world that also existed before 1914 and during 1919–39—one that accepts an international order with common rules and standards, called "globalization"; and one that sees the world in terms of arbitrariness and empires. "In the world of empire, rules are imposed by a hegemon" to reflect its interests, and "those who have the rules imposed on them do not feel those rules are morally binding or legitimate." According to James, a search of newspapers revealed that, since 2000, references to globalization have declined, whereas references to empire or imperialism have increased. This indicates, he said, that "the world thinks more of empire now than in terms of global rules," leading people to resist globalization because "there is nothing good about securing global goods on an international level." James welcomed the timing of Frieden's book because, he warned, the more people who hold the second view, the "greater the likelihood the world will become more dangerous."

Virginia Haufler agreed that "market integration needs to be embedded in a society" to compensate those negatively affected, but felt that Frieden did not present the available choices boldly enough. Strengthening global governance and connecting free trade to social issues like the environment and human rights are possibilities, she suggested. Haufler championed measures like corporate social responsibility and private-public partnerships to strengthen support for globalization. A greater understanding of its costs and benefits is required, she said, to better gauge the impact of such initiatives on those adversely affected by it. ■

Ina Kota
IMF External Relations Department

Latin America: the quest for sustained reform

For many countries in Latin America, the search continues for sustainable reform agendas that can deliver poverty reduction. In some countries, disillusionment with the results of recent efforts has prompted policy reversals and renewed debate over the policies needed to achieve not only sustained growth but also substantial improvements in the living standards of the poor. On April 27, a group of 17 professors of economics from 10 Latin American countries—Bolivia, Brazil, Chile, Ecuador, Honduras, Mexico, Paraguay, Peru, Uruguay, and Venezuela—participated in a one-day seminar with IMF officials in Washington to explore the region's economic challenges.

Structural measures are typically essential in bringing the benefits of growth to the poor. And "there are plenty of reforms still to be done in Latin America," IMF Managing Director Rodrigo de Rato said in remarks to the academics. He highlighted policy actions in the financial sector as one way that countries could develop a stronger private sector.

But most participants agreed that reforms are rarely simple. In Latin America, as several participants noted, a lack of political consensus and policy continuity is limiting the effectiveness of these steps. In some cases, time is also a constraint. "Policymakers are now given shorter and shorter periods. Results won't be there in six months," de Rato cautioned. IMF First Deputy Managing Director Anne Krueger noted that reforms are essential to realize growth potential and raise long-term growth rates. She cited the views of Roger Douglas, the architect of major changes in New Zealand in the 1980s. He argued that the aim should be to do as much as possible, as rapidly as possible.

Eugene Salazar/IMF

Gonzalo Chávez, Director of Graduate Studies in Development, Universidad Católica Boliviana (left), addresses the seminar.

Seeking stability

The academics broadly agreed with these views but expressed doubt that structural measures alone could bring faster growth to the region. Some observed that reforms never seem to end—with one always seeming to follow another—and that they are sometimes so poorly designed that they may need to be completely reversed shortly after implementation. According to recent research on the effects of policy volatility in Latin America—presented by Ratna Sahay of the IMF's Western Hemisphere Department—repeated reform reversals, as well as macroeconomic policy volatility, have a negative effect on growth and poverty reduction.

What steps would now benefit Latin America the most? Anoop Singh, Director of the IMF's Western Hemisphere Department, stressed that the kinds of fiscal measures being recommended are designed to make tax and spending systems more progressive and supportive of the poor.

Beyond agendas that strengthen social safety nets and reduce poverty, there is also, Singh said, a need to focus on long-term macroeconomic stability. Latin America has a long record of macroeconomic crises, which must be avoided if reforms are to take hold. "If a region has to go through a crisis every 5 or 10 years," he noted, "all sorts of reforms can be done, and they will not work. Latin America needs to be able to tell the world that crises will not happen again."

Improving communication

Singh noted growing agreement among Latin American policymakers as to the benefits of macroeconomic stability and low inflation. The academic community has contributed to this positive consensus, Singh told the professors. What is needed now, he said, is agreement on how to translate this consensus into growth. That is where academics have an important role to play.

The IMF, in turn, could contribute to the needed consensus, some professors said, by enhancing its dialogue with the academic community and with society in general. The Fund could do a better job explaining its views, particularly on social spending. As one participant noted, "It's not that the IMF's message has not been understood; it's that it hasn't been heard."

The IMF concurred, pointing out that it is continuing its efforts to improve communication. A more fluid but independent relationship with academics in member countries is what the IMF is working for, de Rato told participants. To help build consensus, "we need to explain why we say what we say." ■

Public Affairs Division
IMF External Relations Department

Exploring the costs and benefits of trade liberalization

Trade policy, immigrants' labor market performance, and the benefits of trade liberalization were among the topics discussed at an April 13 conference on international trade sponsored by the Trade and Investment Division of the IMF's Research Department. The event, the third in a series, drew researchers from inside and outside the Fund and was designed to deepen participants' understanding of the patterns and economic implications of various international flows of goods and capital.

The conference led off with Andrei Levchenko (IMF) presenting "Openness, Volatility, and the Risk Content of Exports," a study he coauthored with Julian di Giovanni (IMF). Motivated by the observation that countries that are more open to trade experience higher volatility of output growth, they used an industry-level panel data set of manufacturing production and trade to analyze the mechanisms through which trade can affect the volatility of production. Their findings indicated that sectors that trade more are more volatile and that trade leads to increased specialization. These two forces increase overall volatility.

Levchenko and di Giovanni also found that output in sectors that are more open to trade is less correlated with output in the rest of the economy, a factor that reduces aggregate volatility. They showed that each of the three factors has an appreciable effect on aggregate volatility. When the three effects are combined, they imply that a one-standard-deviation change in trade openness is associated with an increase in aggregate volatility of about 15 percent of the mean volatility observed in the data. The authors used these results to provide estimates of the welfare cost of increased volatility under several sets of assumptions. Finally, they developed a summary measure of the riskiness of a country's pattern of export specialization and analyzed its features across countries and over time. The risk content of countries' exports varies greatly but does not have a simple relationship to the level of income or other country characteristics.

Lowen Jackson/Gamma

Few other international organizations evoke more diverse sentiments than the World Trade Organization; many people believe their welfare is unfairly squeezed by its promotion of globalization.

A country's trade pattern is, of course, often heavily influenced by the domestic political process. Professor Doug Nelson (Tulane University and IMF Visiting Scholar) and Carl Davidson and Steve Matusz (both of Michigan State University) examined the issue of perceived fairness and its relation to trade policy in "Fairness and the Political Economy of Trade." They argued that, as a matter of positive political economy, fairness plays a nontrivial role in the politics of trade policy. Widely held notions of fairness, which are identifiable at the micro level, have macro effects not only on a country's social and political systems but also on the economy. They went on to argue that these notions systematically constrain public officials in formulating and pursuing trade policy.

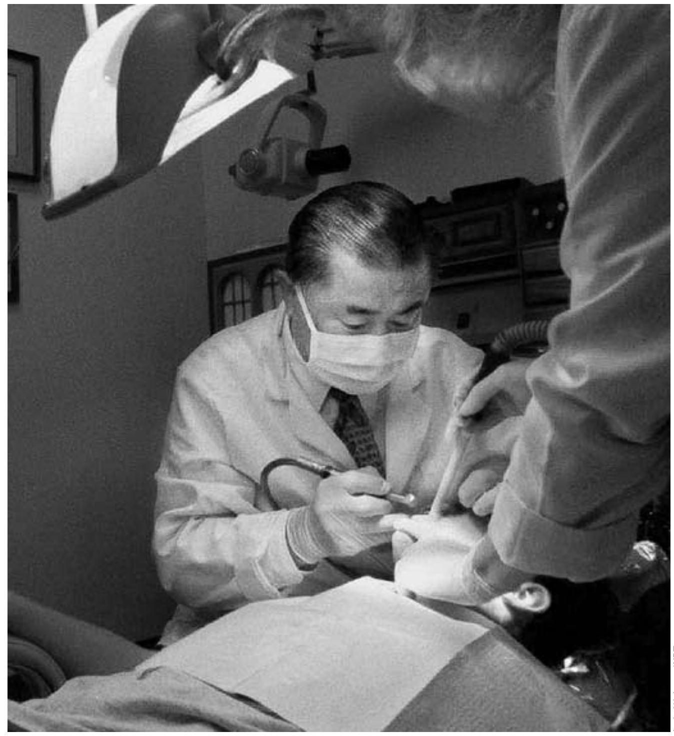
Paradox of international capital flows

Shifting to the topic of capital flows, Professor Jiandong Ju (University of Oklahoma and IMF Visiting Scholar) and Shang-Jin Wei (IMF) confronted two issues in international economics in their study "A Solution to Two Paradoxes of International Capital Flows." Depending on the model used, international capital flows from rich to poor countries can be regarded as either too small (the Lucas paradox in a one-sector model) or too large (when compared with the logic of factor price equalization in a two-sector model).

To resolve the paradoxes, the authors proposed a non-neoclassical theory that marries a model of financial contract between entrepreneurs and investors conceived by Holmstrom and Tirole (1998) with the Heckscher-Ohlin-Samuelson framework. In their model, the return to financial investment and the marginal product of physical capital are naturally separate. The model generated a number of interesting predictions that seem to fit the data well. For example, between rich and poor countries, there can be massive, two-way gross capital flows but only a small net flow. In fact, in the unique equilibrium in the world capital market, the relatively inefficient financial system is completely bypassed.

Few other international organizations evoke more diverse sentiments than the World Trade Organization (WTO) or its predecessor, the General Agreement on Tariffs and Trade (GATT). Although entry to the world trade body is often regarded as a stepping-stone in a country's economic ascent, many people believe their welfare is unfairly squeezed by the organization's promotion of globalization. Others, between the two extremes, doubt that this organization really matters.

In their paper, "Is Bitter Medicine Good for You? The Economic Consequences of WTO/GATT Accessions," M.K. Tang (IMF) and Shang-Jin Wei addressed the debates about the value of WTO/GATT membership. They showed that countries acceding to the WTO/GATT during and after the Uruguay Round tended to experience a significant increase in economic growth and the investment-to-GDP ratio around the time of their accession. Countries that did not undergo rigorous accession procedures, however, did not seem to derive any beneficial effects. Moreover, Tang and Wei offered evidence that accession-induced policy commitments benefit the acceding countries, especially those that scored low on the governance quality index. Overall, the paper suggested that the policy reforms associated with WTO/GATT accession spurred a country's economic performance.



Judy Walgren/KRT

Educated Asian immigrants are more likely to be employed in skilled occupations than educated immigrants from Latin America and Eastern Europe.

People on the move

Besides goods, services, and physical capital, there are also significant cross-border movements of people (human capital). In presenting their joint study "Brain Waste? Educated Immigrants in the U.S. Labor Market," Caglar Ozden, Aaditya Mattoo, and Ileana Cristina Neagu (all of the World Bank) focused on these international movements and investigated the occupational destinations of individuals immigrating to the United States. They found that immigrants of similar age, education level, and work experience but having different countries of origin tend to end up with very different occupations. For instance, educated Latin American and Eastern European immigrants are more likely to be employed in unskilled occupations than immigrants from Asian and developed countries.

Their findings suggested that two forces are at play in shaping the immigrants' labor market performance. First, the quality of human capital, influenced by how much immigrants' countries of origin spent on tertiary education and whether English was used as a medium of instruction, is an important factor. Second, because of the relative difficulty of migrating to the United States from many Asian countries, especially relative to Latin America, only the more skilled college graduates are likely to come and their performance is likely to be higher.

The conference ended with a quantitative assessment of the benefits of trade liberalization. Although it is commonly believed that openness to trade leads to increased efficiency, countries are often put off partly by the short-term macroeconomic adjustment costs that can be associated with trade liberalization. In the paper "Trade Liberalization, Macroeconomic Adjustment, and Welfare: Unifying Trade and Macro Models," Ehsan Choudhri (Carleton University) and Hamid Faruqee and Stephen Tokarick (both of the IMF) argued, by means of a dynamic general equilibrium model, that the short-term adjustment costs are small compared with the long-term gains in efficiency. Their model also showed that adjustment costs tend to be even lower under flexible exchange rates or an interest rate rule that targets flexible price levels. Their results thus not only pointed to the desirability of trade liberalization but also offered constructive suggestions about how to magnify the overall liberalization benefits through appropriate exchange rate and monetary policies. ■

Phil McCalman and M.K. Tang
IMF Research Department

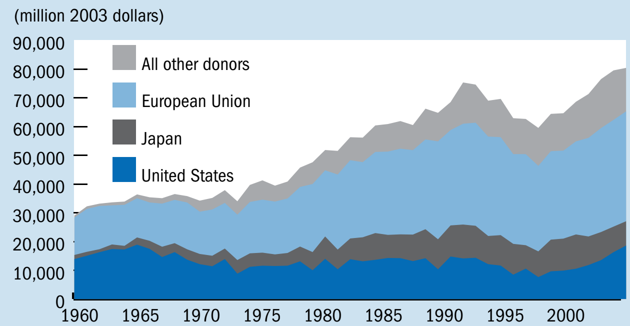
The full texts of the papers are available on the IMF's website *(www.imf.org)*.

Aid effectiveness: what can donors do?

The sometimes heated debate over the effectiveness of increased aid has typically centered on what recipient countries can do to make the best use of it. But donors can play a more constructive role, too. A new IMF Working Paper takes a closer look at the implications of long-term changes in the volume, form, and types of aid and argues that donor choices can make a difference.

Picking up

Real flows of official development assistance dipped in the 1990s but have increased since the 2002 Monterrey conference.



Data: Organization for Economic Cooperation and Development.

Many analysts see aid as crucial in promoting the development of low-income countries that have little access to private capital. Aid can help build human capital and improve productive and export capacities. But persistently low growth and stubborn poverty in a number of developing countries have sparked a debate about the conditions under which aid is effective. In the past few years, the global community has acknowledged that a new approach is needed—one that couples greater country ownership of needed reforms in recipient countries with donor initiatives to increase aid, open markets to developing country products, and, most recently, provide extensive debt relief.

With scaled-up aid now in the offing, the debate has shifted to how to ensure that these resources translate into growth-enhancing measures, including longer-term investments in education and health care. Clearly, recipient countries will need to take more ambitious steps to improve governance and reduce corruption. Should more be asked of donors also? The Working Paper examines issues surrounding more generous and less volatile aid, as well as the types of aid that would be most conducive to helping recipient countries reach the UN Millennium Development Goals.

Volume and volatility

The 2002 Monterrey, Mexico, International Conference on Financing for Development reiterated a call for developed countries to allocate 0.7 percent of their gross national product (GNP) to official development assistance (ODA). As of 2004, however, only Denmark, Luxembourg, the Netherlands, Norway, and Sweden were disbursing assistance equaling or surpassing that target. The unweighted average of the aid effort in 2004 for the OECD's Development Assistance Committee donor countries was 0.42 percent of gross national income (GNI), whereas the income-weighted average ratio of ODA to GNI stood at 0.25 percent, suggesting that smaller donors are leading the aid effort.

The paper found that aid flows (dollar-denominated at 2003 prices) grew at about 3 percent a year from the 1960s through the 1980s (see chart above), experienced a significant reversal in the mid- to late 1990s (when aid flows dipped by 1 percent a year, on average), but picked up noticeably in the new decade after some countries responded positively to appeals made at the Monterrey summit.

Resource flows must also be predictable to enable recipient countries to formulate and implement long-term poverty reduction strategies. Aid tends to be procyclical and more volatile than GDP or fiscal revenues in developing countries. The study finds that disbursements by major donors, which were relatively stable between 1970 and the early 1990s, became more volatile between 1995 and 1999 and between 2000 and 2003.

Some part of the recent increase in volatility can be attributed to donors' debt forgiveness, which, as a onetime event, is inherently volatile. However, volatility remains high even when debt relief is excluded from aid flows, implying that the flows of development assistance have been less consistent in the new millennium. In general, aid from a specific donor is not distinctly more or less volatile than average. In the past, however, aid flows from Denmark and Norway were somewhat less volatile, whereas those from Italy and the United States were somewhat more volatile than the median. Since the 1990s, however, U.S. aid has become more stable.

There is also evidence that donors have responded to changing recipient needs over time, although differences in regional destinations are also likely to reflect evolving donor motivations. The sharpest regional shifts involve sub-Saharan Africa's rise and Asia's decline as aid recipients. Sub-Saharan Africa was the largest recipient of aid in 2003, with almost

30 percent of total ODA—a substantial increase from the 13 percent share it received in 1960. By contrast, Asia's share fell to 25 percent of total ODA in 2003—a sizable drop from the 40 percent of total assistance that the region accounted for in the 1960s and 1970s.

Composition concerns

To what extent does the composition of aid influence local ownership and leadership of development plans and, hence, aid effectiveness? The paper analyzes this question in the context of recent long-term changes in the various components of aid.

Rising concerns about the heavy debt burdens of poor countries and increasing awareness of the length of time it takes for aid to have a positive effect on health care and education outcomes have led some donors to enlarge the share of grants. Since 2000, bilateral grants (see chart below) have grown, on average, by almost 7 percent a year—up from a growth rate of less than 2 percent a year in the 1990s. In the year after the Monterrey summit, for example, the United States increased bilateral grants by more than 40 percent in real terms.

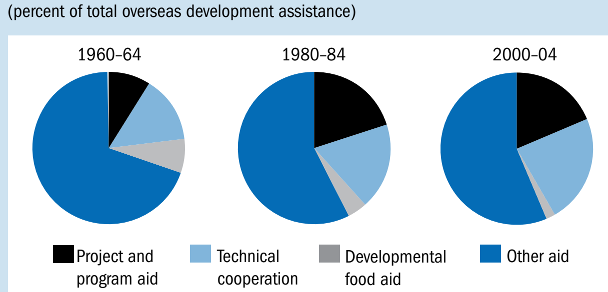
The share of project lending in total lending has waned, whereas budget support has grown in importance. The latter affords recipient countries the flexibility to align their aid spending with national priorities and is more effective in countries with well-designed public spending programs. Budget support is also significantly more flexible than project aid, but tied aid is the least flexible of all. The paucity of donor-specific data makes detailed comparisons difficult, but the data indicate that donors such as Denmark, the Netherlands, and Sweden were tying less than 25 percent of their aid even in the 1980s, when about half of all aid was tied.

Since 1995, about 70 percent, on average, of all donor commitments of budget support have been in the form of debt relief. Has increasing debt relief been associated with reductions in other types of aid? This is a complex issue, but a simple analysis indicates that, although debt relief was negatively correlated with aid excluding debt relief during 1995–99, that correlation was positive for 2000–03. Put another way, this suggests that, although components of aid other than debt relief may not have grown as rapidly as total aid, there appears to be no evidence that debt relief has crowded out other forms of aid in the new millennium.

Particularly of note, too, is the rising use of technical cooperation, whose share of aid has nearly doubled (see chart above) since the 1960s. What implications might this have for recipients? Technical cooperation is a form of aid largely controlled by donors, who provide a great majority of this aid in the form of personnel or administrative costs, which accrue to donor-appointed agents. In a bid to make technical cooperation more results-oriented, donors now favor a short, production-oriented planning horizon. However, these arrangements afford recipients little control over the planning, implementation, or monitoring of the process. ■

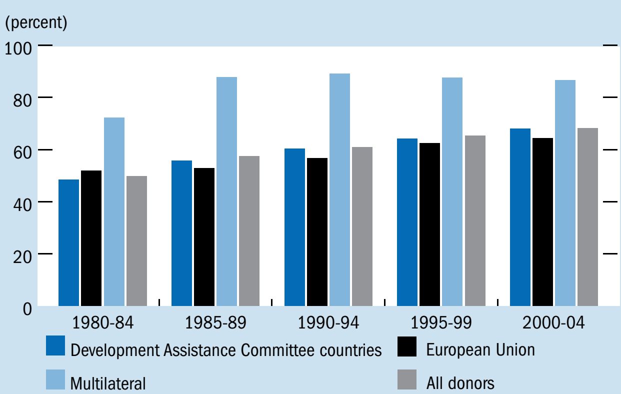
Sanjeev Gupta, Catherine Pattillo, and Smita Wagh
IMF African Department

Shifting composition
Technical assistance now forms a larger part of donor aid.



Data: Organization for Economic Cooperation and Development.

Rising grants
As a portion of overall aid, grants have been increasing.



Data: Organization for Economic Cooperation and Development.

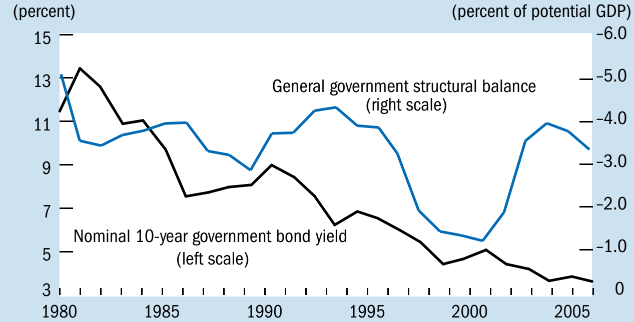
Copies of IMF Working Paper No. 06/1, "Are Donor Countries Giving More or Less Aid?" by Sanjeev Gupta, Catherine Pattillo, and Smita Wagh, are available for $15.00 each from IMF Publication Services. Please see page 144 for ordering details. The full text of the reports is also available on the IMF's website (*www.imf.org*).

Why are long-term interest rates low?

Long-term interest rates have remained low in the Group of Seven (G7) major industrial countries despite large fiscal deficits and rising public debts. Is this a sign that the factors affecting interest rates have changed? In this era of global capital mobility, is there, as some observers claim, a "new economy" of interest rates that involves a radically different relationship between interest rates and what have traditionally been considered as their determinants, including fiscal imbalances? A new IMF Working Paper argues that factors that are likely to be transitory have masked the effects of traditional determinants and lulled policymakers into a false sense of security. There may be a rude surprise in store, argue authors Manmohan Kumar and David Hauner.

High deficits, low interest rates

While Group of Seven government deficits have soared, long-term bond yields have stayed unusually low.



Source: IMF World Economic Outlook database.

Recent discussions of the evolution of global long-term interest rates have tended to ignore a marked deterioration in the fiscal positions of some of the largest industrial economies since the mid- to late 1990s. The ratio of public debt to GDP has risen very significantly over the past 10 years in Japan; in the other G7 countries the rise has been far less dramatic but still quite noticeable: in the United States it has risen by more than 4 percentage points since its trough in 2001, and in several large European Union countries, it has risen by between 5 and 10 percentage points.

While deficits and debts have risen, nominal and real long-term interest rates have remained very low (see chart) despite an up-tick in early 2006. Low long-term rates—by allowing government debt to rise without much increase in interest expenditures—reduce the incentive to address budgetary imbalances; in addition, the subdued behavior of bond yields—in the presence of fiscal imbalances as well as strong economic growth and a tightening of monetary policy in some cases—has prompted renewed doubts about the underlying links between government deficits and debt and interest rates.

Why rates could be low

While it is clear that long-run real interest rates should be determined by *ex ante* rates of saving and investment, empirical studies show that the determinants of both saving and investment, and, thereby, of real interest rates vary significantly across countries and over time. This is particularly true for the effects of government borrowing on interest rates. According to a widely cited survey (Gale and Orszag, National Tax Journal, 2003, "Economic Effects of Sustained Fiscal Deficits"), about half of 60 studies found that fiscal deficits had a "predominantly positive significant" effect on interest rates, with an increase in the deficit of 1 percent of GDP raising interest rates by about 30–60 basis points on average (the other 30 studies found mixed or predominantly insignificant effects).

Nominal interest rates have trended downward during the past two decades. There is wide agreement that this trend reflects expectations of lower inflation, underpinned by greater policy credibility and the increasingly competitive environment in the global economy. There is less agreement, however, on why long-term rates have recently stayed unusually low despite the cyclical upswing of world economic activity.

Some observers also attribute this recent behavior at least partly to lower inflation expectations. But long-term inflation expectations have not, in fact, declined over the past few years, at least in the United States, the country with the widest range of available measures of long-term inflation expectations.

If the decline in nominal interest rates did not reflect a decline in inflation expectations, real interest rates must have fallen. To some extent a fall in real rates could reflect the effects of rising liability-driven investments in the fixed-income markets by pension funds and insurance companies. More fundamentally, low real interest rates may be expected to result from a shortfall of planned investment relative to planned saving. An element of the explanation may therefore lie in the highly unusual fact that the corporate sectors in the United States and many other industrial and emerging market economies have become large net savers.

Another factor on which some observers have focused is the large current account surpluses of fast-growing emerging market or oil-exporting economies. They have emphasized the unprecedented accumulation of industrial country government securities by their central banks. Motivated by the need for "insurance" or being a side effect of the exchange rate regime, these purchases are likely to be relatively insensitive to expected returns.

In many large industrial countries, then, the effects of a "savings glut" may have more than offset the effects of rising fiscal deficits. So is there a "new economy," in which domestic factors, particularly fiscal policy, are outweighed by global forces? To constitute a new economy, the drivers of interest rates would need to have changed.

No evidence of a new economy

An empirical analysis of the drivers of long-term interest rates in the G7 over 1960–2005, based on a model of interest rate determination in large open economies, finds no evidence that the relative importance of the drivers has changed. Rather, it is the *evolution* of some of the key drivers that accounts for the recent low interest rates. Though government borrowing has had a significant upward effect on interest rates, this has been outweighed by the downward effect of reserve accumulation. While fiscal deficits have added an estimated 50 basis points to G7 long-term interest rates, on average, during 2001–05, reserve accumulation subtracted up to 90 basis points.

Though government borrowing has had a significant upward effect on interest rates, this has been outweighed by the downward effect of reserve accumulation.

The results are of concern because they suggest that the major downward influence on interest rates has been a factor that many observers believe to be transitory: unprecedented transfers of savings from the developing to the industrial world, prompted by insurance or exchange rate regime rather than investment motives and invested in fixed-income government securities.

Opinions vary on how long this phenomenon is likely to last, but the opportunity cost of accumulating these reserves (see *IMF Survey*, June 6, 2005) suggests that the process will at least need to slow down. Another element that is likely to slow the process is the medium-run prospect of an adjustment in global current account imbalances, which have been a key element in reserve accumulation.

As these transitory factors, or expectations about them, wane in significance, other determinants of interest rates, notably fiscal policy, may be expected to come to the fore again.

In for a rude awakening?

Debt-to-GDP ratios were higher in 2005 than in 1990 in all G7 countries except Canada and the United States, and in the United States the ratio has risen substantially since its trough in the late 1990s. While higher debt usually means a higher interest bill, governments have been insulated from this effect this time: Italy, the United Kingdom, and the United States had to pay much smaller interest bills in percent of GDP in 2005 than on average during most of the 1990s. And France, Germany, and Japan still bear the same interest burden relative to GDP as they did 15 years ago, even though their debt has risen substantially. The quiescence of long-term interest rates is likely to have encouraged complacency about the long-term macroeconomic cost of higher deficits.

Once fiscal policymakers see interest rates return to "normal" levels, their awakening from the current benign environment could be made all the ruder by the consequences of continued recent fiscal deficits, which have added to public debt. Analysis shows that an increase of 100 basis points in the average interest rate on G7 countries' debt would raise the G7 interest burden—expressed as a ratio to GDP—by 0.8 percentage point. Of course, the impact of higher interest rates would filter down to the interest burden only gradually. But even small increases in interest rates have a large cumulative long-term effect on debt developments.

Furthermore, in the long run, population aging in G7 countries may also push interest rates up, exacerbating the debt burden. This effect will be compounded if aging also drives up deficits as pension and health care costs accelerate. Though there is no consensus on the net effect of aging on interest rates, such a scenario is far from unlikely. And, given the high likelihood of a reversal in the factors that currently keep global long-term interest rates in check, recent budgetary developments in most of the G7 countries underline the need for budgetary consolidation over the medium term. ■

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This article is based on IMF Working Paper No. 06/112, "Fiscal Policy and Interest Rates—How Sustainable is the "New Economy?"" Copies are available for $15.00 each from IMF Publication Services. Please see page 144 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

How rigid wages, with low inflation, can worsen unemployment

Countries usually consider low or moderate inflation an important goal, but can it, in certain situations, have harmful side effects? A recent IMF Working Paper by intern Shintaro Yamaguchi looked at the role played by wage inflexibility in labor market performance in Central and Eastern Europe, particularly Poland. He finds that reduced inflation after 1998, in conjunction with downward nominal wage rigidity, did indeed contribute to a higher unemployment rate in Poland.

Flexibility allows wages to adjust to equilibrate supply and demand. If wages are flexible, labor can be allocated more efficiently across sectors, skill categories, and geographical regions, and can enable an economy to absorb shocks more effectively and adjust to structural changes. Flexible wages can also help shorten the transition period in economies undergoing profound structural adjustments.

In many countries of Central and Eastern Europe, labor market performance has failed to improve in recent years, with unemployment remaining high even though the transition to a market economy is almost complete in some countries and growth has picked up. Has wage rigidity played a part in the region's ongoing weak labor performance? Has wage flexibility worsened over time?

Katarina Stoltz/Reuters

An unemployment center in Elblag, northern Poland.

Real wage sensitivity to unemployment

To answer these questions, Yamaguchi modified the conventional measure of the sensitivity of real wages to unemployment (also known as the wage curve approach—referring to the curve showing how real wages depend on the unemployment rate), compared this sensitivity internationally, and traced its evolution over time. The extent to which real wages respond to changes in labor market conditions is particularly relevant in Central and Eastern European countries because differences in unemployment are large.

The region has shifted from an environment of high inflation and high wage growth to one of moderate or low inflation and wage growth. Because the inflation environment has changed, the flexibility of real wages may also have changed. A standard assumption by economists is that the responsiveness of real wages to changes in the unemployment rate is the same at different unemployment levels. In a high-unemployment, low-real-wage environment, however, real wages may be relatively unresponsive to changes in unemployment. It is also important to understand how real wage rigidity is related to nominal wage rigidity and inflation. A common assumption when economists measure nominal wage rigidity is that the sectoral distribution of nominal wage rate changes is stable over time; but, in fact, that is unlikely to be true in countries undergoing turbulent transition.

To gain a better understanding of wage flexibility in a turbulent environment, Yamaguchi modified these standard approaches to take into account instability in the sectoral distribution of nominal wage changes, comparing the actual distribution of nominal wage changes to a hypothetical case with no rigidities. If the two were different, he concluded, it would provide *prima facie* evidence that rigidities play a significant role.

The case of Poland

Yamaguchi's modified approach makes it possible to understand real wage rigidities in Central and Eastern Europe. Using sectoral data for Poland, it confirmed that real wages were less flexible when unemployment was high and real wages were low. Notably, the wage curve in Poland was almost flat—with no variation in real wages—when the unemployment rate was high (above 14 percent) but fairly steep when the unemployment rate later fell.

Comparing wage-change distributions in the two periods, Yamaguchi concluded that the effects of nominal wage rigidities on real wages and, thus, on the labor market and the economy were small until 1998 but quite significant thereafter. Before 1998, high average wage growth and high inflation shielded the Polish labor market from the negative consequences of downward nominal wage rigidities. As reforms proceeded, the source of rigidities started to disappear at the local level, and wages became more flexible after 1998.

After 1998, however, low average wage growth, low inflation, and downward nominal wage rigidity hindered real wage flexibility. This means Yamaguchi found that adjustment took place through a rise in unemployment rather than through downward adjustment in real wages. In Poland, downward nominal wage rigidity in an environment of low inflation thus prevented the type of adjustment that did the trick in the labor market before 1998. The result was high unemployment. ■

Copies of IMF Working Paper No. 05/134, "Wage Flexibility in Turbulent Times: A Practitioner's Guide, with an Application to Poland," by Shintaro Yamaguchi, are available for $15.00 each from IMF Publication Services. Please see page 144 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Stand-By, EFF, and PRGF arrangements as of April 30, 2006

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Bulgaria	August 6, 2004	September 5, 2006	100.00	100.00
Colombia	May 2, 2005	November 2, 2006	405.00	405.00
Croatia	August 4, 2004	November 15, 2006	99.00	99.00
Dominican Republic	January 31, 2005	May 31, 2007	437.80	288.94
Iraq	December 23, 2005	March 22, 2007	475.36	475.36
Macedonia, FYR	August 31, 2005	August 30, 2008	51.68	41.18
Peru	June 9, 2004	August 16, 2006	287.28	287.28
Romania	July 7, 2004	July 6, 2006	250.00	250.00
Turkey	May 11, 2005	May 10, 2008	6,662.04	4,996.53
Uruguay	June 8, 2005	June 7, 2008	766.25	588.48
Total			**9,534.40**	**7,531.76**
EFF				
Albania	February 1, 2006	January 31, 2009	8.52	7.31
Total			**8.52**	**7.31**
PRGF				
Albania	February 1, 2006	January 31, 2009	8.52	7.31
Armenia	May 25, 2005	May 24, 2008	23.00	16.44
Bangladesh	June 20, 2003	December 31, 2006	400.33	117.27
Benin	August 5, 2005	August 4, 2008	6.19	5.31
Burkina Faso	June 11, 2003	September 30, 2006	24.08	3.44
Burundi	January 23, 2004	January 22, 2007	69.30	28.60
Cameroon	October 24, 2005	October 23, 2008	18.57	15.92
Chad	February 16, 2005	February 15, 2008	25.20	21.00
Congo, Republic of	December 6, 2004	December 5, 2007	54.99	39.27
Dominica	December 29, 2003	December 28, 2006	7.69	2.32
Georgia	June 4, 2004	June 3, 2007	98.00	42.00
Ghana	May 9, 2003	October 31, 2006	184.50	79.10
Grenada	April 17, 2006	April 16, 2009	10.53	8.97
Guyana	September 20, 2002	September 12, 2006	54.55	9.25
Honduras	February 27, 2004	February 26, 2007	71.20	30.52
Kenya	November 21, 2003	November 20, 2006	225.00	150.00
Kyrgyz Republic	March 15, 2005	March 14, 2008	8.88	6.35
Malawi	August 5, 2005	August 4, 2008	38.17	27.83
Mali	June 23, 2004	June 22, 2007	9.33	4.01
Mozambique	July 6, 2004	July 5, 2007	11.36	4.88
Nepal	November 19, 2003	November 18, 2006	49.91	35.65
Nicaragua	December 13, 2002	December 12, 2006	97.50	27.85
Niger	January 31, 2005	January 30, 2008	26.32	14.57
Rwanda	August 12, 2002	June 11, 2006	4.00	0.57
São Tomé and Príncipe	August 1, 2005	July 31, 2008	2.96	2.11
Tanzania	August 16, 2003	August 15, 2006	19.60	2.80
Zambia	June 16, 2004	June 15, 2007	220.10	33.01
Total			**1,769.78**	**736.35**

EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Finance Department

Joint External Debt website launched

A one-stop source for comprehensive external debt statistics is now on the web—a product of the joint efforts of the IMF, the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), and the World Bank. Rob Edwards, who heads the IMF's Statistics Department, called the creation of the Joint External Debt Hub (www.jedh.org) an important milestone "in using technological innovation to bring timely and high-quality external debt statistics to global users."

The new website—which replaces the Joint BIS-IMF-OECD–World Bank Statistics on External Debt initially launched on the OECD website in 1999—provides timely access to quarterly external debt statistics. The information is expected to be particularly useful for macroeconomic analysis and for cross-country and data source comparisons.

What's on the site

The new hub offers comprehensive national external debt data provided by 54 subscribers to the IMF's Special Data Dissemination Standard (SDDS); data from creditor and market sources for external debt and selected foreign assets for 175 countries; and information describing the data provided (metadata). The new website—through its national and creditor and market series—also allows users to compare individual country data for three broad categories: loans and deposits, debt securities, and trade credits.

The website collects information from two sources. National data are drawn from the SDDS reports, redisseminated on the World Bank's Quarterly External Debt database (QEDS). The BIS, the IMF, the OECD, and the World Bank provide creditor and market data, including loans and other credits, debt securities, international reserves, cross-border deposits with foreign banks, and portfolio investment assets (drawn from the IMF's Coordinated Portfolio Investment Survey). While creditor and market sources offer incomplete coverage of external debt, they do cover a wider range of countries than do national sources.

The Inter-Agency Task Force on Finance Statistics was created in 1992 under the auspices of the United Nations Statistical Commission. Its current members are the Bank for International Settlements, the Commonwealth Secretariat, the European Central Bank, Eurostat, the IMF, the Paris Club Secretariat, the Organization for Economic Cooperation and Development, the UN Conference on Trade and Development, and the World Bank.

Shaida Badiee (left), Director, World Bank Development Data Group, and Rob Edwards, Director, IMF Statistics Department, sign the agreement creating the Joint External Debt Hub.

Continuing pursuit of better data

The Joint External Debt Hub builds on a number of initiatives that the Inter-Agency Task Force on Finance Statistics (see box) has taken to make comprehensive and consistent external debt statistics more available. In addition to the OECD website created in 1999, the task force's work led to the publication in 2003 of *External Debt Statistics: Guide for Compilers and Users*; the dissemination, since September 2003, of quarterly data on national external debt positions (with a one-quarter lag) by SDDS subscribers; the launch of the QEDS website in 2004; and the IMF's recently developed framework for assessing the quality of external debt statistics.

The new website also reflects a determination to apply technological innovation to generate efficiencies—in this case by converging data flows into a common framework. The hub is a pilot project of the Statistical Data and Metadata Exchange, which, under the sponsorship of the BIS, the European Central Bank, Eurostat, the IMF, the OECD, the UN, and the World Bank, is fostering standards for the exchange of statistical information. The participating agencies see the new website as a mechanism to enhance the transparency, timeliness, and availability of external debt statistics for a global user community. ■

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