

IMF bolsters its financial expertise

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One of the big changes under way at the IMF is a stepped-up focus on financial sector issues. Called in to lead the effort is Jaime Caruana, former Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision. In a wide-ranging interview, he explains how the IMF will integrate the financial sector into its regular review of country policies, and weighs the new risks and complexities of the global capital markets.



Stephen Jaffe/IMF

IMF pushes to modernize surveillance

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The IMF is updating its methods for exchange rate analysis as part of a broader effort to improve its ability to meet the needs of its 184 member countries in today's globalized world. In an interview, Carlo Cottarelli, Deputy Director of the IMF's Policy Development and Review Department, explains the rationale behind these and other changes to the IMF's surveillance tool kit and sheds light on how they fit in with the IMF's overall reform agenda.



Michael Sauter/IMF

Rebalancing is the key to sustaining China's growth

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China's growth remains strong and inflation is under control, according to the IMF's annual review of the economy. Over the medium term, however, China will need to rely less on investment and exports and more on consumption if it is to sustain high growth. The review noted that appreciation of the currency was needed to stem the rapid pace of investment growth now and would also play a key role in helping to rebalance the economy in the medium term.



Freddie L. Brown/IMF Press

Korea sets sights on creating another miracle

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Korea achieved spectacular growth and turned a poor agricultural economy into an industrial powerhouse. But significant longer-term problems loom: output growth potential is slowing as the population ages rapidly, capital accumulation decelerates, and productivity growth falls. To reverse this, Korea needs to further integrate with the global economy by deregulating and opening up its financial and service sectors and labor market and creating a knowledge-based, advanced-technology economy.

총업수기 지수	
현재지수	1,104.72
전월대비	+11.8%
거래	64,158
상장	42
부	13
	47

IMF Press/IMF Press

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Kim Kyung-Hoey/Reuters

DECEMBER

14 143rd (Extraordinary) Meeting of the OECD and Development Conference, Abuja, Nigeria

14 IMF Book Forum, "China and India: Expanding Roles in the World Economy," Washington, D.C., United States

JANUARY 2007

5-7 Annual Meeting, American Economic Association, Chicago, Illinois, United States

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

16-17 12th Euromoney Central and Eastern European (CEE) Forum, "The CEE: Separating Rhetoric from Reality," Vienna, Austria

22 Bank of Japan International Symposium, "Ten Years After the Asian Currency Crisis: Future Challenges for the Asian Economies and Financial Markets," Tokyo, Japan

22-24 World Sustainable Development Forum: "Meeting the MDGs: Exploring the Natural Resource Dimensions," Energy and Resources Institute, New Delhi, India

24-28 World Economic Forum Annual Meeting, Davos, Switzerland

FEBRUARY

7-8 2nd OECD Forum in Mexico: International Forum on Public Policies for the Development of Mexico, organized by OECD, World Bank, UNDP, Inter-American Development Bank, and Economic Commission for Latin America and the Caribbean, Mexico City, Mexico

13-15 Global Forum: Building Science, Technology, and Innovation Capacity for Sustainable Growth and Poverty Reduction, World Bank, Washington, D.C., United States

MARCH

4-6 Institute of International Bankers' 2007 Annual Washington Conference, Washington, D.C., United States

12-18 Annual Conference of the Parliamentary Network of the World Bank, South Africa

APRIL

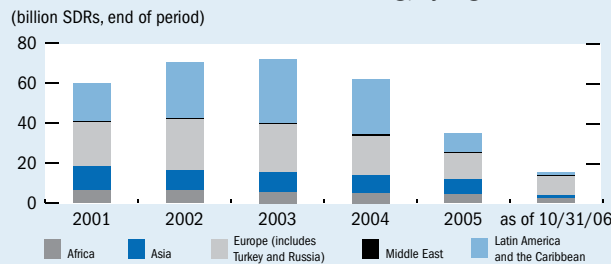
2-4 3rd Secondary Education in Africa Regional Conference, Ghana Ministry of Education, Accra, Ghana

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

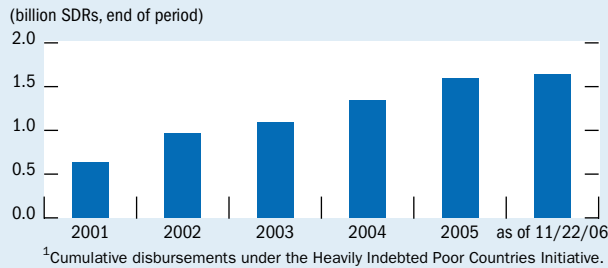
26-27 "New Perspectives on Financial Globalization," conference sponsored by the IMF Research Department and Cornell University, Washington, D.C., United States, see www.imf.org/external/np/seminars/eng/2007/finflo/042607.htm

IMF financial data

Total IMF credit and loans outstanding, by region



HIPC debt relief¹



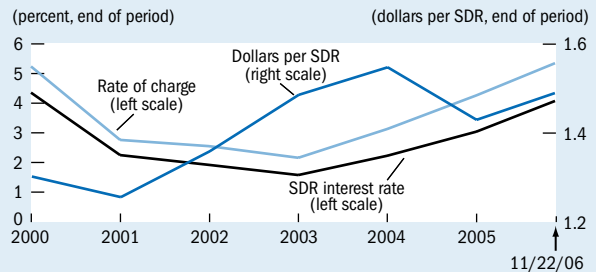
Note: Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also

Major currencies, rates per SDR

	November 15, 2006	Year ago (November 15, 2005)
Euro	1.158810	1.217110
Japanese yen	174.473000	168.697000
U.K. pound	0.785768	0.819914
U.S. dollar	1.485350	1.420010

Related rates

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



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 rigorous work agenda; quota issue is key

Outlining the IMF's work program for the next several months, Managing Director Rodrigo de Rato said in a statement to the Executive Board that the organization must harness the momentum of the Singapore annual meeting and press forward on reforms designed to better align members' quotas with changes in the world economy and protect the participation and voice of low-income countries.

The work program in advance of the IMF's April spring meeting will also focus on putting into action the remaining elements of the Fund's medium-term strategy, notably efforts to strengthen the organization's core work—its monitoring of the global economy and its policy advice to member countries. The IMF is moving to strengthen its surveillance framework and sharpen the focus of surveillance activities (also see page 348). As part of the Fund's commitment to meeting the evolving needs of its members, it will also step up its work on designing policies to provide greater support for emerging market and low-income countries (see related story on improvements in debt sustainability framework, below).

Given the importance and the challenging nature of the IMF's work program, de Rato said, it will be vital to prioritize



Reforms linked to the IMF's medium-term strategy will be a major focus of the Executive Board's work over the next several months.

and sequence it carefully. The agenda is ambitious both because of the staff work and Executive Board discussions that it will entail, and because of the proactive outreach effort that will be a key part of the quota and voice initiative, the reform of the Fund's surveillance framework, and efforts to reach agreement on how the IMF can strengthen its support for emerging market economies and improve its crisis prevention tools. ■

The full text of de Rato's statement on the work program is available online (www.imf.org); see IMF Press Release No. 06/267.

Debt sustainability framework for low-income countries upgraded

After providing debt relief to the world's poorest heavily indebted countries, the IMF and the World Bank have strengthened a key tool—their debt sustainability framework—designed to help low-income countries adopt prudent borrowing strategies and foster better information exchange between creditors and borrowers.

Speaking to reporters on December 7, Adnan Mazarei and Martine Guerguil of the IMF's Policy Development and Review Department explained that a dramatic reduction in debt burdens under the Multilateral Debt Relief Initiative had created opportunities for low-income countries to invest more in achieving the Millennium Development Goals, but it also raises new sources of vulnerabilities that could lead to another round of debt problems.

While the rise of “emerging donors,” such as Brazil, China, India, and oil producing countries, offers the potential for greater resources for economic development, it also requires informed decisions on the part of borrowers, and better information exchanges among creditors to avoid misuse of these resources.

Enhancing the framework

To help borrowers and lenders better take into account this new environment, the upgraded framework provides

- a stronger basis for the growth projections used in the framework. Debt distress is often triggered by low growth.
 - alerts when debt buildups or growth assumptions are abnormally high.
 - careful assessment of nonconcessional financing packages. Low-income countries should continue to rely on concessional finance, with nonconcessional debt considered on a case-to-case basis.
 - a vehicle for better data dissemination and coordination.
- All borrowers and creditors should be familiar with this tool, and the Fund will make an extra effort to ensure it is used better by staff.

The ultimate objective of the framework is to help authorities in low-income countries design their own borrowing strategies. The framework will be a central part of the Fund's policy discussion with member countries, and a technical assistance program will be developed to bolster countries' capacity to use this framework on their own. ■

Please see the IMF website (www.imf.org), for more detailed information on the debt sustainability framework—including IMF Policy Paper *Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief*, and Public Information Notice No. 06/136, *IMF Executive Board Discusses the Application of the Debt Sustainability Framework for Low-Income Countries Post Debt Relief*.

Interview with Jaime Caruana

Giving the IMF's financial sector work a higher profile

In August, Jaime Caruana, former Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, took up the reins as Director of the IMF's new Monetary and Capital Markets Department (MCM). Caruana, who has been a member of the Financial Stability Forum, also served as Director of the Spanish Treasury. Earlier, he worked in the private sector, heading up investment services and fund management companies for some 10 years. Laura Wallace of the IMF Survey spoke with him about the IMF's increased focus on financial sector issues, the global financial markets outlook, and simmering regulatory issues.



Eugene Salazar/IMF

Caruana: "There's a concern that markets aren't fully pricing in risks, given the very low spreads and volatility in many markets."

IMF SURVEY: You've been asked to head up a new IMF department that is meant to serve as a center of excellence on capital markets and financial sector work. What do you see as the main intrinsic challenges in MCM's work?

CARUANA: The first challenge is that we have to be on top of key trends in the financial sector and the markets. We're not market participants—we don't have a dealing room and we're not trading—and that means we'll have to develop a different kind of network. But, more important, we must help integrate all this knowledge into the mainstream work of the IMF, and that means collaborating better with the rest of the departments. Second, we have to provide member countries and area [the IMF's regional] departments with the support they expect in terms of both surveillance and capacity building. Third, we must keep, attract, and train the best people on a continuous basis. We have very good people in the department whose expertise and advice I rely on heavily.

IMF SURVEY: How will the IMF integrate capital market and financial sector work into its traditional macroeconomic surveillance?

CARUANA: We have very pragmatic proposals that have come out of an IMF task force that has studied the integration of financial issues into our Article IV consultations—our regular bilateral checks of members' economies. These proposals take an eclectic approach and have a few key elements: analyzing markets in a way that can extract relevant, early signals that would inform our policy dialogue with mem-

bers; continuing and systematizing the kind of analysis that the IMF has been doing on the soundness and efficiency of financial sectors; and doing a thorough analysis of risks, including exploring the exposures, the probability of these risks, and their potential macroeconomic impact. This work would be supported by the global analysis of risks contained in the department's semiannual *Global Financial Stability Report [GFSR]*.

IMF SURVEY: The recent GFSR warned that, although capital markets have weathered recent turbulence, many downside risks remain. A few months later, how do things look?

CARUANA: Financial systems continue to be underpinned by the positive global central scenario, but as the September *World Economic Outlook* and the *GFSR* signaled, there are some macroeconomic risks. These include slower growth—due, in part, to the U.S. housing slowdown, inflation, and global imbalances. In addition, there's a concern that markets aren't fully pricing in risks, given the very low spreads and volatility in many markets. Also, markets are becoming more complex. While this complexity is a by-product of financial instruments that contribute to stability, they might also amplify turbulence should it occur. Plus, emerging markets have been enjoying lower spreads—and there are very good fundamental reasons for that—but challenges could reappear if more turbulent conditions return. And there are some concerns, both macro related and prudential, about rapid credit growth in some markets, especially when

the credit growth is accompanied by significant foreign exchange exposures.

IMF SURVEY: You mentioned the increasing complexity of the markets. Are derivatives and hedge funds reducing risk by spreading it across a broader array of investors, or increasing risk by concentrating it and making it more difficult to monitor?

CARUANA: Derivatives and hedge funds have helped a lot to transfer risk to a much wider variety of investors. In that sense, they've contributed to stability. They've also increased liquidity and helped reduce market inefficiencies. But we don't know enough about the distribution of risks, and these new structures have yet to be tested in really difficult circumstances.

IMF SURVEY: Are there risks in the massive increases in private equity, and will this trend lead to much more vulnerable financing structures—debt-laden companies—and short-termism?

CARUANA: Private equity is a concept that encompasses many kinds of financing—such as venture capital, seed financing, and buyouts—that can contribute to the restructuring and growth of firms. This type of financing is growing very rapidly—especially buyouts, which, as you said, may lead to more debt. Some concerns arise because these buyouts are more leveraged and because, in some cases, recovery of the investment is sought in shorter and shorter time periods. But it's too soon to say that there's a systemic issue. We need to follow these developments closely, and regulators are paying greater attention to possible excesses in these markets.

IMF SURVEY: Going back to your new department, how can MCM get the balance right between its market and institutional sides? In other words, how can it juggle the demands of monitoring daily market news with building a long-range perspective?

CARUANA: Both sides are important, and, frankly, I don't see many conflicts there. It's a good idea to have merged the two departments—one responsible for capital markets, and the other for monetary policy and financial sector issues—to create MCM, so that a single department now deals with these issues. With this structure, we'll be better able to monitor and integrate developments in both areas. We'll have the synergies within the same department to strike the right balance between capital markets and financial systems and institutions, as well as between surveillance and capacity building.

IMF SURVEY: What is MCM's role in helping the international community resolve global imbalances? Will it be asked to focus on capital flows, exchange regimes, and central banks' role in the flows, including balance sheet risk?

CARUANA: What we have to bring to this analysis is the market perspective, both the supply and the demand side. The supply side is particularly important because a number of investors are holding huge amounts of foreign assets in their portfolios. We have to analyze their positions, understand their motivations and the changes in their behaviors, and explore the implications for subsequent capital flows.

IMF SURVEY: Will MCM also have a role to play in financial deepening and financial market development in developing and emerging market countries?

CARUANA: Helping local and regional markets become stronger, more resilient, and more able to work in good and bad conditions is one of our priorities. It's extremely important to reduce vulnerabilities, increase the stability of financial systems, and foster growth. We've worked on this in the past and will continue to do so—collaborating, of course, with the World Bank.

IMF SURVEY: At this point, most countries have now completed evaluations under the IMF–World Bank Financial Sector Assessment Program [FSAP]. What role do you expect FSAPs to play going forward?

CARUANA: The FSAPs are playing a very important role. So far, initial assessments for about two-thirds of the countries have been completed. Not all of the systemically relevant countries have had an FSAP, so there's still a bit more work to complete the first round of assessments. In the future, we'll want to update our knowledge of each country's financial sector every few years—maybe every five years would be a normal cycle—and the update side of the FSAP program is starting to accelerate. The aim is to make these updates much more focused. They should zero in on relevant risks raised in the initial, broad FSAP and in any subsequent information gathered.

IMF SURVEY: What lessons have you learned from your time as Governor of the Bank of Spain and Chairman of the Basel Committee that have been most useful as you've settled into the IMF culture?

CARUANA: There have been many, but the two most relevant ones relate to markets and uncertainty. As a central banker, you learn the importance of good communication in helping

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inform market expectations. It's vital to understand what the markets are doing, get as much information as possible from the markets, and close the gaps between your expectations and those of the markets. That doesn't mean that central banks have to validate all of the markets' expectations, but they must do a good job of explaining their policies, objectives, and decisions. I learned a lot about that at the European Central Bank Governing Council. On the supervision side, I learned how essential it is to be forward looking, to be risk based in the supervisory approach, and to get the structure of incentives right in any standard or regulation so that financial institutions continue to improve and develop better risk management systems.



Jaime Caruana, with MCM Deputy Director Hung Tran, briefs the press at the September IMF–World Bank Annual Meetings in Singapore on the latest *Global Financial Stability Report*, which highlights the continuing risks facing the capital markets.

IMF SURVEY: What is your view of the downward competition to regulatory standards, with companies fleeing to London to escape the new requirements imposed under the U.S. Sarbanes-Oxley Act of 2002, which was adopted following major corporate and accounting scandals?

CARUANA: Competitiveness issues aren't easy to deal with. We have to be careful here because there are many factors, not one piece of regulation. The U.S. administration is looking into what elements of their regulations may be relevant for the competitiveness of U.S. financial markets. More generally, it's true that, with globalized markets, regulators have to pay greater attention to competitiveness issues, level playing fields, and incentives in regulations. Again, we need a more multilateral approach that underlines the merit of international standards.

IMF SURVEY: Does the IMF stand to gain from closer collaboration with the World Bank, the regulatory standard setters—such as the Basel Committee and International Organization of Securities Commissions—the Bank for International Settlements, and the private sector?

CARUANA: Actually, the collaborative effort is already working quite well. On the FSAPs, we're collaborating well with the World Bank. And on standards, it's also a good arrangement. The regulatory agencies prepare the standards, and the IMF, through its work with individual countries, helps implement them and also gives these agencies valuable feedback. In fact,

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the IMF played an important role in helping to improve the Basel and International Association of Insurance Supervisors' core principles on banking and insurance supervision. That said, the markets are moving continuously, so we can't feel that this is a static collaboration.

IMF SURVEY: Financial supervisors are subject to national boundaries, whereas financial groups are becoming international. Given this globalization, how do you see cross-border supervision and crisis management? Do you support regional supervision—in the European Union, for example?

CARUANA: It's true that there's a tension between large financial institutions needing to manage risks in a global way yet being subject to national regulations. What's the solution? First, it's important to have global standards, such as those we have for banking, insurance, and securities. And, second,

it's vital to increase collaboration among supervisors, and that's already happening to some extent—take, for example, the agreements among supervisors to exchange relevant supervisory information on transnational institutions. As for the European Union, it's a very special case. It's moved further than others, due in part to its ability to develop and issue directives and regulations that apply to all member states. But the decentralized system of cooperation among supervisors should work as effectively as a single regional supervisory system, and additional work needs to be done on the coordination of crisis resolution and deposit insurance schemes. ■

Costa Rica will pursue strategy to sustain high growth and reduce poverty

Costa Rica's economy has performed well in 2006, supported by large foreign direct investment, improved business confidence, and robust domestic consumption, the IMF said in its annual review. Real GDP growth could reach at least 6½ percent for the year, while inflation would fall. The overall public sector deficit declined in 2005 and fell further in the first half of 2006, thanks to buoyant tax receipts.

The IMF Executive Board welcomed Costa Rica's continued strong performance but noted challenges posed by double-digit inflation, high public debt, and financial dollarization. Directors commended the authorities for their commitment to a comprehensive reform program, including implementation of CAFTA-DR, a substantive tax reform, greater exchange rate flexibility, recapitalization of the central bank, and a strengthening of financial regulations and supervision. Implementation of these policies will go a long way toward laying the foundation for faster growth and poverty reduction.

Tax reform, Directors emphasized, is critical to reduce public debt; allow higher spending on education, infrastructure, and social needs; and provide needed support to monetary policy. They encouraged the authorities to focus the reform on the value-added tax and income tax. While recognizing the need for

Costa Rica	2004	Prel. 2005	Proj. 2006	Proj. 2007
		(percent change)		
GDP at constant prices	4.1	5.9	6.5	5.0
Consumer price inflation (average)	13.1	14.1	12.0	9.0
		(percent of GDP)		
Total public debt	55.8	52.0	48.8	46.8
External account balance	-4.3	-4.7	-4.9	-4.8

Data: Central Bank of Costa Rica and Ministry of Finance, and IMF staff estimates.

increased spending in priority areas, Directors urged the authorities to limit expenditure growth until the benefits of the tax reform materialize.

Directors endorsed the central bank's recent move to a crawling band regime and welcomed the decision to allow for a gradual widening of the band. They also supported the planned recapitalization of the central bank, which, combined with a prudent fiscal stance and greater exchange rate flexibility, would help bring inflation gradually down to low single digits.

Finally, Directors encouraged the authorities to foster regional cooperation and, in particular, to pursue efforts to achieve consensus on a code of conduct in tax incentives for investment, which would help forestall harmful tax competition in the region. ■

Trinidad and Tobago must wisely invest windfall from high energy prices

In 2005, Trinidad and Tobago's economy grew by about 8 percent, underpinned by strong growth in the energy sector, according to the IMF's annual economic review. The nonenergy sector, also vibrant, expanded by 7¾ percent, thanks to public infrastructure spending and rapid credit growth that fueled private spending. With global energy prices still high, the economy is on pace to expand by 12½ in real terms in 2006.

Trinidad and Tobago has one of the highest per capita incomes in Latin America and the Caribbean, with much of its wealth stemming from oil and gas reserves. The energy sector accounts for over 40 percent of GDP, about 90 percent of exports, and over half of government revenues. Rising energy revenues have

Trinidad and Tobago	2003	2004	Est. 2005	Proj. 2006
		(percent change)		
Real GDP	13.9	9.1	7.9	12.5
Energy	31.3	8.4	8.2	20.7
Nonenergy	5.2	9.5	7.7	7.5
		(percent of GDP)		
Current account balance	8.0	13.3	24.5	25.7
External public sector debt	13.4	10.3	8.5	7.8
		(million dollars)		
Gross reserves	2,258	2,993	4,787	7,787

Data: Trinidad and Tobago authorities and IMF staff estimates and projections.

helped improve the government's balance sheet. But the underlying fiscal position has deteriorated. Rapid increases in public spending—reflecting rising transfers and subsidies on utilities and fuels and mounting public investment—contributed to a nonenergy deficit that widened by about 2 percentage points to 10¼ percent of GDP in 2004–05.

Executive Directors welcomed Trinidad and Tobago's strong economic performance while stressing that the current favorable environment presents both opportunities for economic development and challenges for macroeconomic management. Raising living standards for current and future generations involves striking a delicate balance between investing energy windfalls efficiently to promote economic diversification and social objectives, and pacing the use of energy revenues to avoid overheating the economy.

In view of the rapid increase in public spending, Directors supported high-quality spending on human and physical infrastructure but recommended greater overall budgetary restraint to avoid further upward pressure on inflation and the real exchange rate. They advised that industrial diversification efforts should concentrate on industries that are viable without the benefit of government subsidies. Directors saw containing mounting inflationary pressures as a top priority and encouraged the central bank to continue to tighten monetary policy. ■

For more information, please refer to IMF Public Information Notices No. 06/135 (Costa Rica) and No. 06/125 (Trinidad & Tobago) on the IMF's website (www.imf.org).

The IMF updates its surveillance framework

The IMF is in the midst of implementing a detailed medium-term strategy (MTS) that will improve its ability to meet the needs of its 184 member countries in today’s globalized world. As part of this initiative, the Fund is modernizing its surveillance—that is, its methods for monitoring economic developments and policies and for providing advice to member states. As part of its work to update its surveillance tool kit, the IMF has just released a series of papers, including one on exchange rate analysis. Carlo Cottarelli, Deputy Director of the IMF’s Policy Development and Review Department, discusses the push to modernize the IMF’s surveillance framework with Jeff Hayden of the IMF’s External Relations Department.

IMF SURVEY: What is the motivation behind efforts to modernize surveillance?

COTTARELLI: We would like to move surveillance to a higher level—to the best practice level—taking into account the progress that best practice has made in the past 30 years. There are many initiatives under way as part of the IMF’s MTS [see box]. One important one is a review of what we call the foundation of surveillance: the 1977 IMF Executive Board decision on surveillance over exchange rate policies. Like many foundations, this one is pretty old, so the question is to what extent the decision needs to be revised and modernized.

The world was very different 30 years ago. Many countries now have floating exchange rate regimes, and there’s been an enormous increase in capital movements. We think it’s worth considering whether there’s a case for a revision of the decision to reflect these changes. It’s complex, and we need to do it carefully, but the payoff could be high.

IMF SURVEY: What else is the IMF doing to bolster its surveillance?

COTTARELLI: We are also discussing with our membership whether it would be helpful to draw up a list of operational goals—a so-called remit—that surveillance should try to achieve over the next three years and for which staff and management could be accountable. In addition, we are working on strengthening the methodology for assessing the effectiveness of our surveillance. We want to be in a better position to assess whether we are achieving what surveillance is expected to achieve. Our key responsibility, as staff, is to provide candid monitoring of what countries are doing and offer sound policy advice. There is also a need to assess more systematically whether the overall surveillance framework is able to affect policies. With respect to the actual practice of surveillance, there are also many initiatives that we are taking.



Cottarelli: “Streamlined consultations . . . reflect the recognition that you can allocate resources differently across countries and still obtain high-quality results.”

IMF SURVEY: For example?

COTTARELLI: Well, first, we have the multilateral consultations. The *World Economic Outlook* [the IMF’s flagship publication, published twice a year] has always addressed multilateral surveillance issues, but this is the first time we are actually discussing policy actions at the *multilateral* level. Second, we are paying more attention to exchange rate issues. You can see this emphasis in a variety of papers and staff reports. Related to this, the work of the IMF’s Consultative Group on Exchange Rate Issues, which has recently been extended to emerging markets, is important because it generates mutually consistent exchange rate assessments. We have also recently published an important econometric paper assessing the impact of the exchange rate on the trade balance of emerging market countries.

Finally, financial sector surveillance is a key element of the MTS. The Monetary and Capital Markets Department has been created, and a staff group is developing proposals for better integration of financial sector work in surveillance [see article on page 344]. And, in general, there’s much more attention to financial sector issues in staff reports.

IMF SURVEY: There’s been much talk of the IMF streamlining its country consultations. What is a streamlined consultation?

COTTARELLI: Streamlined consultations are not at all a kind of surveillance “lite.” Streamlined consultations simply reflect the recognition that you can allocate resources differently across countries and still obtain high-quality results; in fact, sometimes looking at too many issues makes our messages less effective. For example, it might not make sense to send a fully staffed mission of six economists to a country each year or to prepare a long report if that country is not presenting any new issues or if the country simply does not have important vulnerabilities. The streamlined consultation simply acknowledges

that some country teams can be smaller and that some reports can and should be more focused and shorter.

The Policy Development and Review Department also recently took stock of the IMF's monitoring of exchange rate issues. That analysis has attracted some attention.

IMF SURVEY: What are its key points?

COTTARELLI: Based on our assessment, the treatment of exchange rate issues is much better than what people perceive outside. And it is substantially better than what it was, say, two or three years ago. But, yes, we can do even better.

First, progress has been made in the description of exchange rate regimes—whether countries are floating or pegging or whether they have a managed float. Outside observers sometimes say that the Fund reports only on the de jure [stated] regime—that we do not comment on what countries are doing de facto [in practice]. We found that in almost all of the 30 countries we examined, the staff report had a pretty accurate description of the de facto exchange rate policies.

Second, progress has been made in our assessment of the appropriateness of the regime. Countries can choose their regime, but we can express views on it, and this discussion of the implication of regime choice was present in almost all staff reports. A third area of progress is the assessment of the consistency of economic policies, including exchange rate policies, with external and macroeconomic stability. That was also present in almost all staff reports. So, in these three areas, by and large, the quality is pretty good.

This is the most important change for surveillance since I joined the Fund 18 years ago.

—Carlo Cottarelli

Then there is the level of the exchange rate—that is, assessing whether an exchange rate is overvalued, in balance, or undervalued. Also, here we found that the results are better than some observers think. Some believe we ignore the issue. We found that not to be the case: our view on exchange rate levels is present in almost all cases. That said, we also found that in about one-third of the cases, we could do significantly better in explaining how the staff view was reached. That is very different, though, from saying we don't assess.

So it is fair to say that, in dealing with exchange rate issues, we are now doing better. Indeed, there may be a perception lag in how our work on these issues is viewed from outside.

IMF SURVEY: Activity seems spread across a wide range of issues. Could you put the scope of this modernization in context?

COTTARELLI: I think this is the most important change for surveillance—in terms of breadth—that has been introduced since I joined the Fund 18 years ago. I don't remember any comparable change. ■

The three reports mentioned in the interview, *Methodologies for CGER Exchange Rate Assessments*, *Exchange Rates and Trade Balance Adjustment in Emerging Market Economies*, and *Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stock-Taking*, are available in full text on the IMF's website (www.imf.org).

Reassessing the role of the IMF in a rapidly changing world

The IMF has a critical role to play in fostering international economic cooperation and helping all countries benefit from the opportunities presented by globalization. But to do so, it must remain in step with a rapidly changing world. Mindful of this imperative, IMF Managing Director Rodrigo de Rato presented a medium-term strategy (MTS) to the IMF's membership in September 2005. Operational proposals for its implementation were set out in a report published in April 2006, where the Managing Director offered new directions for IMF surveillance of member countries' policies and global developments; an evolving role in emerging markets; more effective engagement in low-income countries; and rebalancing the way the Fund is governed.

In terms of surveillance, the MTS aims to increase the IMF's ability to address risks to economic stability stemming from payments imbalances, currency misalignments, and financial market disturbances. To this end, at the country level, the Fund is sharpening its

analysis of issues with cross-border spillover effects, in particular exchange rates and financial sector vulnerabilities, and focusing its advice on issues and countries that matter the most for global or regional stability. The MTS also emphasizes the need for the Fund to leverage cross-country experience more and do more outreach to enhance the impact of its policy advice.

In addition, a new multilateral consultation vehicle has been created to facilitate discussions within groups of countries on issues of systemic importance, with the first consultation focusing on global imbalances. The IMF is also broadening its econometric analysis of equilibrium exchange rates to all major emerging market currencies and is strengthening the analysis of macroeconomic and financial risks and their interactions in its two flagship publications, *World Economic Outlook* and *Global Financial Stability Report*. Finally, it is formulating regional work plans, focusing on the main policy issues facing various regions.

To sustain rapid growth, China needs to rebalance its economy

China's economic growth is projected to remain strong, with inflation well under control. But the latest annual assessment of the economy argues that, for rapid and stable growth to be sustained over the medium term, China should rebalance the economy so that growth is driven more by consumption than by investment and exports.

The IMF's most recent forecast shows China's real GDP growth reaching 10.5 percent in 2006, up from 10.2 percent last year. Inflation is projected to dip to 1.4 percent this year from a recent peak of 3.9 percent in 2004, while China's trade balance continues to climb and its large stockpile of international reserves grows further (see table and Chart 1).

According to the IMF staff report, released on October 31, the key immediate concern is rapid credit and investment growth (see Chart 2, panel 1). "Abundant liquidity in the banking system could touch off further increases in lending growth and investment, with the probable consequence of creating new nonperforming loans and undoing some of the progress made in reforming the banking sector," the report says.

Tightening monetary policy

The Chinese government recognizes the need in the near term to contain investment and credit growth and has instituted a number of administrative actions and a tightening of monetary policy in response. However, the report calls for additional steps to be taken, given substantial liquidity in the banking system, continuing large capital inflows, local government pressure on banks to expand lending, and diminish-

Full steam ahead

China's growth is continuing unabated, along with a buildup of its trade surplus and reserves.

	2003	2004	2005	Proj. ¹ 2006	Proj. 2007
	(percent change)				
Real GDP	10.0	10.1	10.2	10.5	10.0
Consumer prices (period average)	1.2	3.9	1.8	1.4	2.2
	(billion dollars)				
Current account balance	46	69	161	219	259
Trade balance	45	59	134	196	241
Exports	438	593	762	959	1,168
Imports	394	534	628	763	928
Capital and financial account balance	53	111	63	36	25
Change in net international reserves (increase -)	-117	-206	-207	-259	-284
Gross international reserves ²	412	619	826	1,085	1,369
	(percent of GDP)				
Overall budget balance ³	-2.4	-1.5	-1.3	-1.2	-1.1

¹As of November 17, 2006.

²Includes gold, SDR holdings, and reserve position in the IMF.

³Central and local governments, IMF definition.

Data: National Bureau of Statistics of China and IMF staff estimates and projections.

ing restraint on credit growth by the large banks as they complete their recapitalizations (see Chart 2, panel 2).

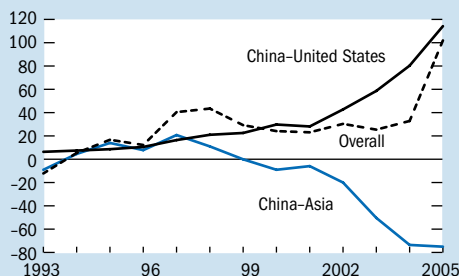
At the same time, having to tightly manage the exchange rate has created a major conflict in monetary policy implementation. To deal with this, the authorities have relied on administrative controls and moral suasion; but the effectiveness of the controls is diminishing, and the government's use of moral suasion to influence bank lending decisions directly contradicts its goal of creating a banking sector operating on a sound commercial basis. Thus, allowing the exchange rate to move more flexibly

Chart 1

Heading up

China's trade balance continues to climb, but its market is drawing in Asian imports.

(billion dollars, customs data)



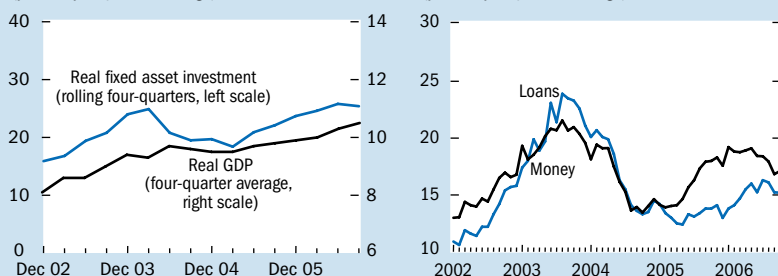
Data: National Bureau of Statistics of China and IMF staff estimates.

Chart 2

Strong performance

Growth, led by investment (panel 1), has been strong, with liquidity in the banking system remaining high (panel 2).

(year-on-year percent change)



Data: National Bureau of Statistics of China and IMF staff estimates.

and be increasingly determined by market conditions would enhance monetary policy independence. The insufficient discretion given to the central bank to set interest rates is another important impediment to timely monetary policy action.

Rebalancing growth

The report points out that an appreciation of the currency will also contribute to the sustainability of China's growth. It would help avert the buildup of short-term foreign currency liabilities that will occur if the exchange rate remains undervalued and if administrative controls on the financial system are maintained. In addition, a currency appreciation will help improve the allocation of investment and its efficiency by giving the right price signals to potential investors. By increasing households' purchasing power, and thereby boosting consumption, it would aid in rebalancing the economy over the medium term. The report urges China to more fully use the flexibility afforded by the current exchange rate system and allow greater movement in the renminbi-U.S. dollar exchange rate to enable a further significant appreciation of the currency in nominal effective terms (see Chart 3). "This is in China's best interest and the timing is right, as such an appreciation is unlikely to create significant economic disruptions, given the strength of the Chinese economy," the report says.

In addition to serving China's own interest, greater exchange rate flexibility would contribute to an orderly process for resolving global current account imbalances. Dealing with global imbalances requires a concerted effort by all countries, because a disorderly correction would be bad for everyone, the report adds.

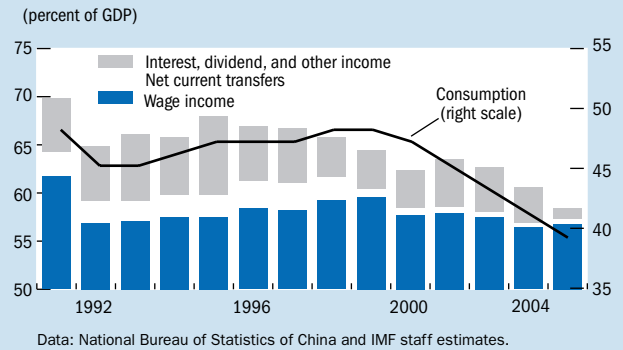
Boosting consumption

Domestically, China's government will have to play an important role in rebalancing the country's growth. It can help boost

Chart 4

Underweight

Personal consumption declined to less than 40 percent of GDP in 2005, coinciding with a fall in the share of disposable income.



consumption through further reform and development of the financial sector. Additional steps are needed to develop China's capital markets and improve the banking system. Developing bond and equity markets is important for improving intermediation and increasing incentives for banks to seek out small and medium-size enterprises. It will serve to boost consumption by providing greater opportunities for direct and indirect household participation in the financial markets.

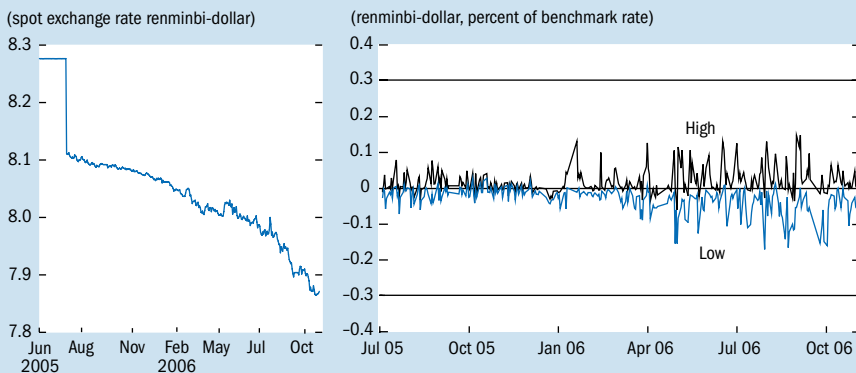
The government also can play a critical role through increased spending on health care, education, and pensions, which would encourage households to reduce high precautionary savings. Household consumption has dropped to less than 40 percent of GDP (see Chart 4). Boosting consumption will serve to rebalance growth in the economy and provide an opportunity to spread the benefits of growth more equitably across all levels of society.

The report says that income disparities across regions continue to widen, with some localities facing difficulties in funding expenditure mandates, especially in health care and education. These structural imbalances in subnational finances need to be addressed, including by assessing the possibility of reforming tax assignments across levels of government, rebalancing expenditure responsibilities in line with resources, and reforming the transfer system to move toward a more rule-based system that ensures that all local governments have enough resources to meet their spending responsibilities. ■

Chart 3

Small appreciation

The renminbi has appreciated against the dollar by 3 percent since China's exchange rate reform in July 2005 (left panel), while intraday fluctuations remain within a narrow band (right panel).



Korea: Toward a knowledge-based economy

In the 50 years since Korea had its first Article IV consultation with the Fund, the country has relied on outward-oriented policies to achieve spectacular growth and turned a poor agricultural economy into an industrial powerhouse. Looking ahead, Korea faces major longer-term challenges stemming from rapid population aging and growing income inequality. Dealing with these challenges formed the crux of this year's Article IV discussions between the IMF and the authorities.

To all appearances, the “Goldilocks” period that Korea enjoyed from early 2005 until early 2006 has come to an end. During that period, growth was at a 6 percent rate on the back of strong exports and consumption, while inflation declined to 1½–2 percent. In the past few months, however, the economy has been slowing, as the consumption boom has matured.

The IMF anticipates a soft landing, with GDP growth declining to an estimated 5 percent in 2006 and 4.3 percent in 2007 (see table). But the risks are to the downside. In particular, a serious slowdown in the United States would have a major impact, because Korea's exports are 40 percent of GDP and the United States is Korea's largest market after China. Also, a tightening of global liquidity and the associated higher lending rates would hurt households and small and medium-sized enterprises, which are heavily indebted. To guard against these risks, the authorities are maintaining a neutral fiscal stance and a data-dependent monetary policy, under which interest rates will be adjusted based on the accumulating signs of where the economy is heading.

Spurring long-term growth

Beyond these immediate challenges, longer-term problems loom. With the population aging more rapidly than in any other OECD country, labor supply growth has begun to slow, and the absolute size of the labor force should start to shrink in about a decade (see Chart 1). Meanwhile, capital accumulation has been decelerating, with investment as a share of GDP declining by 2 percentage points since 2000 (and by 6 percentage points since the Asian crisis in 1997). Overall productivity growth has also been falling, despite a strong performance in manufacturing, because of a poor performance in services. If these trends continue, potential output growth would slow from an average of 8 percent before the crisis to just 2 percent by the middle of the 21st century.

How can this trend be reversed? The key lies in further integrating Korea with the world economy. Just as the manufacturing sector was thrust into the global arena with great success some decades ago, now the same remedy needs

Manageable short-term challenges

A soft landing is in the cards, and inflation is expected to remain moderate.

	2002	2003	2004	2005	Proj. 2006	Proj. 2007
	(percent change)					
Real GDP	7.0	3.1	4.7	4.0	5.0	4.3
CPI Inflation (end of period)	3.7	3.4	3.0	2.6	3.0	2.7
	(percent of GDP)					
Consolidated central government balance ¹	2.3	2.7	2.3	2.1	2.4	2.5
Current account balance	1.0	2.0	4.1	2.1	0.4	0.3

¹Excluding privatization receipts and rollover of KDIC/KAMCO bonds.
Data: Korean authorities and IMF staff estimates and projections.

to be applied to the financial and service sectors and the labor market.

Building an advanced financial sector. Korea's financial sector is sound. Its banking sector has advanced, but its capital markets remain underdeveloped. To correct this situation, the government plans to integrate Korea's financial system with the global economy, eventually building a financial hub for northeast Asia.

The plan rests on deregulation, accompanied by strong measures to contain risks, as well as complete liberalization of the foreign exchange system. Under the planned Financial Investment Services and Capital Market Act, the government will remove restrictions that separate companies involved in capital market activities and redivide the financial system into three subsectors: banks, insurance companies, and investment banks. At the same time, the sector would shift to a system of regulation that allows all activities that are not expressly forbidden.

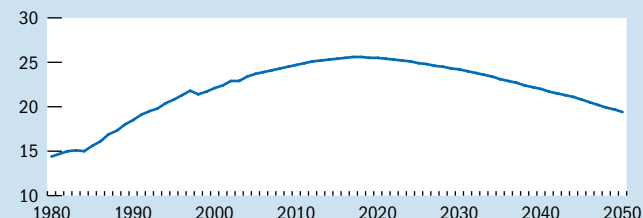
This reform should spur competition and innovation, but steps will need to be taken to limit risks. Specifically, a legal separation between investment banks and asset managers

Chart 1

Shrinking labor pool

Within a decade, Korea's labor supply is projected to decline, with significant implications for economic activity.

(million workers, constant participation rate)



Data: CEIC Data Company Ltd; and Korea, National Statistical Office.

should be maintained, and legal penalties should be increased and class action lawsuits allowed for conflict-of-interest violations. It will also be important to continue to prevent industrial groups from owning banks—a practice that could lead to connected lending, the most damaging conflict of interest of all.

Improving service sector productivity. Korea’s nonfinancial service sector is large and growing: it accounts for about half of GDP and almost two-thirds of employment. But its labor productivity is only about half that of manufacturing—the largest gap among the OECD countries—largely because the sector has been sheltered from competition, both domestically and globally. Only nonprofit institutions, for example, can establish schools or hospitals, and the retail sector remains dominated by inefficient mom-and-pop shops.

To spur productivity in nonfinancial services, the government has developed a strategy to open up and deregulate the sector. A key element is trade liberalization, including planned free trade agreements with the United States and other countries. But for such bilateral agreements to spur efficiency, they need to be as nondiscriminatory as possible. And even more critical to Korea’s future would be a successful conclusion to the multilateral Doha Development Round. Beyond trade liberalization, measures will also be needed to improve the financing of small but promising service firms—notably by allowing intellectual property and supply contracts with other firms to be used as collateral.

Fixing Korea’s labor market. As Korea shifts toward a knowledge-based economy, labor market flexibility has become vital. But the regular labor market remains relatively rigid, so Korean firms have been replacing permanent employees with fixed-term staff. This shift has provided firms with the needed flexibility, but at a large social and economic



The aging of Korea’s population could cost the budget more than 15 percent of GDP for health care and pensions.

cost. Since 1997, the Gini measure of income inequality has risen by more than 0.04 point, compared with less than 0.01 point in the United States and Canada (see Chart 2). Meanwhile, the associated increase in income uncertainty has dampened consumption.

Addressing this problem will require making the regular labor market more flexible, which could be done either by changing the current system or by introducing a new labor contract while grandfathering those already employed under the existing one. At the same time, the social safety net needs to be bolstered, which is why the authorities have been expanding the proportion of workers eligible for unemployment benefits and plan to introduce an earned income tax credit in 2008, thereby ensuring a minimum standard of living for all wage earners.

Addressing long-term fiscal issues. Even if these issues are addressed, one major long-term challenge will remain: the prospective deterioration of the fiscal position. Under current parameters, the aging of the population could cost the budget more than 15 percent of GDP for health care and pensions, according to OECD projections. To deal with this long-term problem, it will be important to preserve as much fiscal space as possible. For the coming several years, this will mean maintaining the ratio of government debt to GDP at its current low level while taking swift action to restore the national pension system to viability by raising contributions and reducing replacement rates.

Korea is heading toward greater deregulation and greater integration with the world economy. This strategy, applied to manufacturing, produced the “Miracle on the Han” in the 20th century. By extending this strategy now to the other sectors, Korea should be able to create another “miracle”: a knowledge-based, advanced-technology economy for the 21st century. ■

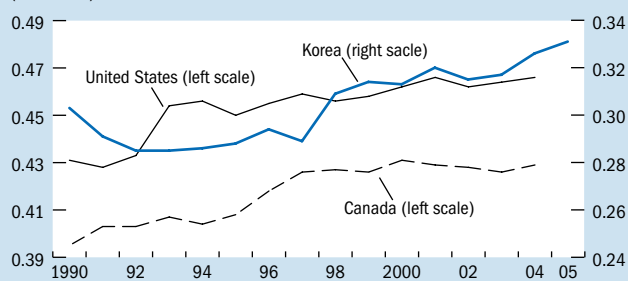
Tarhan Feyzioglu

IMF Asia and Pacific Department

Chart 2

Growing income disparities

The increasing use of fixed-term employees in Korea has widened income disparities and contributed to dampened consumption. (Gini index¹)



¹The Gini index measures income inequality on a scale of 0 to 1, with higher numbers indicating greater inequality.

Data: U.S. Bureau of Labor Statistics, Statistics Canada, and Korea Development Institute.

Jacques Polak Annual Research Conference IMF spotlights new thinking on capital flows

Capital flows are now at the heart of the global financial system and, because of the Fund's new strategic emphasis on multilateral surveillance, of keen interest to the IMF. Unsurprisingly, capital flows were the theme of this year's Jacques Polak Annual Research Conference. In his opening remarks to the seventh annual conference, IMF Research Director Raghuram Rajan said the topics sorted themselves into three main categories: global imbalances; the role of international capital in promoting growth, entrepreneurship, and institutions; and whether foreign capital heightens risk and volatility.

Global imbalances were the focus of the keynote Mundell-Fleming address by Olivier Blanchard (Massachusetts Institute of Technology (MIT)). The U.S. current account deficit dominates the numbers and the news, he said, while China and some other Asian countries are running large surpluses. But the problem of large current account deficits is not limited to the United States: it also affects smaller advanced countries, such as Portugal. A growing number of international economic policymakers, including the Fund, believe the imbalances are too large and that "government intervention to reduce these deficits is desirable."

Blanchard, however, was reluctant to draw that conclusion without further research. If the deficits reflect "private sav-

ing and investment decisions" by firms and people exhibiting "rational expectations," how are policymakers to decide whether any interventions are justified? The call for public intervention should be based on a diagnosis of the distortions that lead to excessive current account deficits.

Blanchard discussed various sources of distortions—for example, in the export sector, the domestic labor market, or domestic credit markets. He also explained how these distortions might contribute to excessive current account deficits and noted the need for an appropriate policy response. In some cases, it might be optimal to mitigate the current account deficit through a fiscal restriction. But the presence of distortions does not necessarily require policies aimed at reducing the current account deficit. Blanchard concluded that more research is needed to identify what distortions, if any, might lead to excessive imbalances and what kind of policy response they require.

All together now

At the heart of the capital flows issue, IMF Managing Director Rodrigo de Rato said in a luncheon address, is "economic interdependence." And, because of that interdependence and the trade and financial linkages among the major countries, any orderly resolution of "global imbalances requires simultaneous policy actions on several fronts and in a number of countries."

The pros and cons of liberalizing capital accounts

Capital account liberalization and its impact on growth is a subject that has, at times, sparked heated debate among policymakers. Many developing countries open up their capital accounts to help them finance growth and development with foreign savings. But some contend that, unlike trade in goods and services, free flows of capital across borders can cause bubbles and crashes and thus undermine the domestic institutions and policies that make growth sustainable.

In an Economic Forum that closed the conference, panelists Kristin Forbes (MIT), Joaquim Levy (Inter-American Development Bank), Eswar Prasad (IMF), and Dani Rodrik (Harvard University) debated the relative merits of capital account liberalization. As Rodrik saw it, countries that have not liberalized should not rush to do so, given the scant evidence that it promotes growth and the concern that liberalization can lead to an overappreciated domestic currency that can undermine export-led growth. Furthermore, once countries have liberalized, it is difficult, he said, to "put the genie back in the bottle." Instead, Rodrik urged countries to explore the selective use of capital controls, and he called on the IMF to advise countries to undertake "intelligent capital account management."

Forbes expressed much more confidence in capital account liberalization. Opening up the capital account, she said, is much like driving a car—in both cases, you have to worry about crashes. Still, she saw capital account liberalization as a key part of growth and development. Although the macroeconomic evidence is not convincing, she said, the emerging microeconomic literature seems to show the benefits of capital account liberalization on growth.

Capital account liberalization also has collateral benefits, observed Prasad. It encourages financial market development, better institutions, improved governance, and macroeconomic discipline. These benefits seem more important, he argued, than increasing the stock of capital and should receive more attention in future research. For his part, Levy tapped the experience of countries that have liberalized and found that, once they decide to liberalize, it is important to minimize potential costs and self-insure against crises. The international community has a role to play, he added, in insuring countries against the risks induced by an open capital account. ■

Sabina Bhatia
IMF External Relations Department

There was evidence of this interdependence in the long-term markets. Francis E. Warnock and Veronica Cade Warnock (both University of Virginia) noted that many observers had predicted that the tightening of short-term rates that the U.S. Federal Reserve began in 2004 would spill over into the long-term market. That effect has been muted in large part, their research found, by large-scale foreign capital inflows. For the 12 months that ended in May 2005, the yield on 10-year treasury bonds would have been 90 basis points higher without capital flows from foreign governments. About two-thirds of foreign purchases of treasury securities, the Warnocks said, were made by East Asian sources.

And further evidence of the interdependence? Gian Maria Milesi-Ferretti (IMF and Center for Economic Policy Research (CEPR)) reported that even though European countries might not contribute significantly to global imbalances, any reduction in the U.S. deficit and Asian surpluses would have a bigger spillover effect on Europe than it would have had two decades ago. His paper, coauthored with Philip R. Lane (Trinity College, Dublin, and CEPR), also cautioned that the exposure of Europe to external shocks should not be overstated, because global integration in trade and finance remains limited.

Continuing on the topic of global imbalances, Enrique Mendoza (University of Maryland and IMF) argued that these imbalances “need not be a harbinger of world financial collapse.” They reflect the differing levels of development in financial markets, he said. Countries with deeper financial markets, like the United States, have lower savings and “accumulate net foreign liabilities,” but they also invest “in high-return assets.” His paper, coauthored with Vincenzo Quadrini (University of Southern California) and Jose-Victor Rios-Rull (University of Pennsylvania), found that the countries with deeper financial markets may receive “positive factor payments even if the net foreign position is negative.” That is a pattern consistent with what has happened in the U.S. current account imbalance since the 1980s.

Why capital flows discriminate

The conference also wrestled with the question of why more capital does not flow from rich countries to poor countries if—as the literature suggests—investment opportunities and the return on capital are higher in developing countries.

Francesco Caselli (London School of Economics) investigated whether rich countries are attracting capital that

should be going to developing countries and found that, in general, this has not been the case. Caselli, presenting research that he coauthored with James Freyer (Dartmouth College), said that, whereas a simple model suggests that the marginal product of capital is much higher in developing nations, his work indicated that after adjustments are made for returns to land (a much larger sector in developing nations) and the price of equipment, there is little difference in the marginal product of capital across countries, with richer nations having a slight edge. The counterintuitive policy prescription from this, he said, is that increasing aid to developing countries will not add much to their capital stocks and income because many of the official flows will exit through private channels to more productive uses.

Shang-Jin Wei (IMF) made the case that credit markets influence capital flows. In countries with underdeveloped credit markets—the case in most poorer countries—domestic savers invest abroad to gain the higher returns that deeper credit markets can offer.

Wei’s work, coauthored with Jiandong Ju (University of Oklahoma), argues that in countries with passable investor protections, some or all of that outflow will be offset by foreign direct investment (FDI). Multinational firms will finance that FDI with funds they raise abroad. Wei cited China and India as examples of countries in which domestic savings flow abroad while foreign companies inject investment. Countries with inefficient credit markets and inadequate investor protections, however, will experience domestic flight capital without offsetting foreign direct investment.

Case for flexible exchange rates

As for risks and volatility, Herman Kamil (IMF) found that when countries move from a fixed to a floating exchange rate, companies respond by hedging their foreign currency risks. Many observers have identified a buildup of unhedged foreign currency debt as a cause of currency crises, because the perception of assured exchange rate stability has induced firms in those countries to borrow too much or underestimate future currency risks. His analysis, based on data from seven major Latin American countries between 1992 and 2005, suggests that when flexible exchange rates replace fixed rates, “firms match more firmly the currency composition of liabilities and income streams,” and that, in turn, reduces their exposure to exchange rate fluctuations. ■



Blanchard: More research is needed to determine whether public sector involvement to reduce current account deficits is justified.

Eugene Salazar/IMF

Focus on fiscal federalism

Until the early 1990s, fiscal federalism—fiscal relations between different levels of government—was a largely unexplored area of fiscal policy. But over the past decade a trend toward decentralization and institutional reforms in the European Union, selected east European countries (including the former Yugoslavia), and Latin American and African countries has helped make fiscal federalism an increasingly hot topic. The *Handbook of Fiscal Federalism*—edited by the IMF’s Ehtisham Ahmad and the University of Turin’s Giorgio Brosio, and the focus of a November 15 IMF book forum—collects the latest thinking and applies a practical approach to a topic that clearly has political economy implications.

Moderator Teresa Ter-Minassian (IMF Fiscal Affairs Department) and panelists Ahmad, Vito Tanzi (Italian Ministry of Finance and former Director, IMF Fiscal Affairs Department), and Danny Leipziger (World Bank) highlighted the importance of devising appropriate and effective solutions for the many challenges that arise from devolving responsibilities and sharing resources across federal, provincial, and local jurisdictions.

Digging deeper

Hailing the handbook as “a major new contribution” to the field, Ter-Minassian noted that her own 1997 book, *Fiscal Federalism in Theory and Practice*, had broken ground in analyzing the macroeconomic implications of fiscal federalism. This new handbook, she said, digs deeper into intergovernmental fiscal issues, including recent developments in theory, and covers special issues such as the distribution of natural resources, environmental concerns, governance, corruption, and the importance of institutions.

Ahmad argued that there needs to be more effective and realistic modeling of fiscal federalism’s political economy elements—particularly legal, political, and administrative issues; information flows; and incentives and sanctions. Traditional approaches, he said, cannot explain present-day institutional arrange-

ments, which may range from federalism (Brazil, India) to unitary states with considerable autonomy (China, Indonesia) to the European Union’s supranational arrangement. Distinctive challenges also confront postconflict countries (the Balkans, Sudan) and formerly planned economies. Down the road, emerging issues will include managing the sharing of natural resources, environmental concerns, corruption, and poverty reduction.

Different problems, different solutions

Describing the handbook as “valuable and a useful guide for practitioners,” Leipziger said he particularly welcomed its focus on issues important to the World Bank, such as contracting and decentralization. Weak accountability and corruption, he explained, make the job tougher for the Bank. He also valued the book’s cogent reasoning on why traditional approaches and assumptions may not hold true, particularly the presumption that information typically flows easily between levels of government. And he, too, shared the handbook’s concern with a lack of accurate data and an inability to track financial flows, which he considered major impediments to fiscal relations.

Tanzi complimented the handbook on its fair and balanced account of the work to date on fiscal federalism. He lamented, however, that much of the literature on federalism and decentralization “reflects a U.S. bias.” Many who study fiscal federalism, and “economics in general,” do so in the United States, he said, and they are naturally influenced by U.S. institutions. In fact, many countries have a different legacy and grapple with different problems that will require different solutions. Tanzi described this volume, many of whose authors have European and Asian backgrounds, as an “essential reference to the field.” ■

Ina Kota

IMF External Relations Department



Ahmad: Politics cannot be divorced from fiscal federalism.

Copies of the *Handbook of Fiscal Federalism* are available for \$245.00 each from IMF Publication Services. Please see this page for ordering details.



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