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June 2007

Asia: 10 years on
The Africa-Asia connection
The net worth of nations
A primer on microfinance



Unleashing the
**Economic Power
of Women**

Finance & Development, June 2007



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A woman's touch

A HOT topic at summits of global leaders over the past few years has been how the global community is doing in its efforts to meet the eight 2015 Millennium Development Goals (MDGs)—especially those that deal with poverty, hunger, health, education, and the environment. But little discussed is MDG3, which calls for redressing gender disparities and empowering women. The June 2007 issue of *F&D* spotlights gender equality, asking why it matters. We learn that not only is MDG3 a vital development objective but it is also key to achieving several others—such as universal primary education (MDG2), a reduction in under-5 mortality (MDG4), improvements in maternal health (MDG5), and a reduced possibility of contracting HIV/AIDS (MDG6). Moreover, greater gender equality can also help to reduce poverty (MDG1) and promote growth.

As for how countries are doing in meeting MDG3, we learn that there's reason to worry that the four official indicators being used to track progress are inadequate—a startling revelation given that there are only eight years left to meet the goal. And to the extent that progress can be tracked, the results aren't encouraging. One of the hardest-hit groups is the 30 million “excluded” girls, who aren't even enrolled in school. These girls face discrimination and indifference in their own countries because they come from ethnic minorities, isolated clans, and groups in which the majority language isn't predominant. One way for countries to pinpoint policies needed to reduce gender disparities is through gender budgeting, which involves the systematic examination of budget programs and policies for their impact on women. As “Budgeting with Women in Mind” explains, this effort to mainstream gender analysis into government policies has gained prominence in recent years.

* * * * *

Also in the June issue, we look at Asia—a star performer in the global economy—10 years after the Asian financial crisis. A series of articles explores what Asia needs to do to hold onto regained ground and become an ever-greater economic force. An IMF review focuses on two of the challenges facing the region: addressing worsening income inequality and learning to live with potentially unstable capital flows. From Korea, Un-Chan Chung, a former presidential candidate and professor at Seoul National University, calls for a “new social compact” if the globalized system is to achieve success in Korea—and perhaps in other Asian countries as well. And from Malaysia, Central Bank Governor Zeti Akhtar Aziz stresses that “Asia's increasing role in the global economy further reinforces the need for it to have a commensurate voice and representation in the international financial community.” Finally, *F&D* explores the deepening involvement of Asia—especially China—with sub-Saharan Africa (SSA) on the trade, investment, and aid fronts. China is now SSA's single largest Asian trading partner and its fastest-growing trading destination.

Laura Wallace
Editor-in-Chief

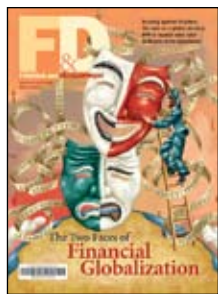
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The merits of private equity

Like virtually everyone who tracks and analyzes financial flows to developing countries, the authors of the otherwise excellent analysis in the *F&D* article, “Financial Globalization, Beyond the Blame Game” (March 2007), completely ignore private equity, which is playing an increasingly important role in developing countries, and focus on FDI and portfolio equity flows.



They are correct that FDI is less likely to head for the exits at the first whiff of crisis. Yet private equity, which is endowed with the same long-term, growth-generating features and arguably makes an even more important contribution to private sector development, merits nary a mention. Most private equity investors target worthy companies with limited or no access to capital, and financial returns materialize only when and if they enhance company performance. These firms are not listed on stock exchanges but have promising prospects for growth and profitability if they could gain access to investment capital.

Between 2003 and 2006, private equity fundraising for emerging markets increased more than 900 percent, far faster than either FDI or portfolio equity investing. Isn't it time for private equity to be a legitimate source of capital for private firms in developing countries? It would be relatively easy to begin tracking and reporting private equity flows as a distinct asset class worthy of its own line item. This modest initiative would more accurately differentiate among developing country capital flows and heighten awareness and understanding of a financing technique that is becoming increasingly significant for those firms that have the greatest difficulty gaining access to the capital they require to thrive.

Roger Leeds

*Professor, Johns Hopkins School of
Advanced International Studies
Washington, D.C.*

Building a solid foundation

I was pleased to read “Africa: Making Its Move” (December 2006). I am convinced that, one day, Africa will make its move. But it won't be as easy as people think. Africa is developing through a series of short-sighted solutions, not on the basis of solid, credible foundations. Since independence in the 1960s, Africans have been unable to change the economic sys-



tem established by the colonizers. Our parents' generation, rather than focusing on development, competed for power.

Today, our generation is going to have to be a generation of sacrifice, and first we must focus on food self-sufficiency. Only then can we discuss a technological transformation. Yes, we have independence, which provides freedom. But freedom without purchasing power is meaningless. African dictatorships simply fed dictators and their accomplices. Africa is largely responsible for its own economic backwardness.

Camille Sitou
Cotonou, Benin

Deciding how to spend the oil windfall

The *F&D* article “Spend Now or Save?” (December 2006), by Paul Toungui, raises a question that has greatly concerned many leaders in African countries whose economies are dependent on windfall revenues from oil.

The author suggests that there is a need to balance spending on social needs and investment to upgrade physical infrastructure with early repayments of debt. Toungui's view that the resources from the oil windfall should be divided into two separate categories seems to imply that investment in African countries may not succeed in laying the foundations of sustainable development, hence his advice to set a part of the earnings from oil aside for future generations.

In my view, this approach of wanting to win everywhere runs the risk of not winning anywhere. In the age of globalization, the adage of not placing all one's eggs in one basket does not apply to developing countries because their chances of competing successfully in the global economy and providing basic social services for their citizens erode year by year.

These countries should not, therefore, dissipate their resources in different directions. African countries should invest all their resources in boosting their future potential for growth, including investments to improve human capital. These investment strategies should be carefully tailored to the characteristics of each country and take into account the global context, and the leaders of those countries should make an unwavering commitment to follow through on their promises. This investment should go hand in hand with transparent governance for all aspects of the government and the public sector.

The 2015 Millennium Development Goals, mentioned in the article, will not be achieved with overcautious policies that do not take into account the global context in which our continent must operate.

Mohammed Tahraoui
*Société Générale Algérie
Algeria*

Hunger is the real problem

In your recent issue on Africa (December 2006), you overlooked two important issues. When it comes to the encouragement of development, eradicating hunger and making sure that poor people's voices are heard are key to addressing all the other challenges Africa is faced with.

In spite of all the efforts of international organizations such as the World Bank and the IMF, poverty remains a serious problem. This is because poverty reduction initiatives and aid programs focus much more on the symptoms than on the underlying problem itself. Take, for instance, efforts to roll back malaria, combat AIDS, and increase the number of girls in school. All of these initiatives are laudable in themselves. But the real problem—hunger—is often overlooked. Even with the right medication, a body that is starved of food cannot fight off disease. And a child who is hungry cannot engage in learning.

Efforts to reduce poverty will also flounder as long as poor people are not adequately represented in parliament. A person who is not poor has no real interest in reducing poverty. Since there are almost no poor people represented in the parliament and in government, reducing poverty remains elusive.

Boubakar Amadou
Economics student
Benin

Where the grass is greener

In "In Brief" in the December 2006 issue of *F&D*, the item on remittance flows quotes Dilip Ratha as saying that remittances are the largest source of external financing for developing countries. This statement obscures a severe socioeconomic problem: the grass is always greener on the other side.

It is surprising that, in developing countries (in sub-Saharan Africa), happiness is widely seen as coming from outside the continent (in this case, from industrial countries). The outside world is teeming with wealth, and one must get there at any cost. Whether skilled or not, Cameroonians of all ages will state most assuredly: "I'll go and work hard." This

stance is socially and economically dangerous for both the home country (home abandonment, brain drain, customs fraud, and corruption) and the host country (lack of documentation, prostitution, criminality).

What is worse, Ratha ignores the fact that repatriated funds are used more for consumption than for productive investment. They thereby increase growth but do not necessarily lead to development.

Nomo III Faustin Lucien
Economics student
Ngaoundéré University
Cameroon

Fighting HIV/AIDS in Africa

In "Making Aid Work" (September 2005), the author mentions the need to increase financial aid to effectively combat the spread of HIV/AIDS in sub-Saharan Africa. This is a praiseworthy undertaking. Unfortunately, the results have so far been disappointing. In my opinion, this is because the policies that are supposed to fight the disease ignore seemingly insignificant factors that



do go to the heart of the matter. First, we need to change our attitudes toward sex. In Africa, children are seen as a source of wealth; the more children you have, the better off you are. Second, we must address the incompetence and corruption of our national institutions, something that has proved elusive despite government efforts to improve governance.

Combating HIV/AIDS is not just about providing more grants. The starting point for preventing this disease should be a change in the social and cultural norms that govern attitudes toward sex in sub-Saharan Africa.

Brice Hilaire Kemguem
Ngaoundéré, Cameroon

Events in 2007

July 9–11, Brussels, Belgium
International Migration and Development,
First Global Forum

August 2–3, Cooloom, Australia
14th APEC Finance Ministers' Meeting

September 20, New York, USA
G-8 Foreign Affairs Ministers' Meeting

October 19–21, Washington, D.C.
Annual Meetings of the IMF and the World Bank

November 11–15, Rome, Italy
20th World Energy Congress and Exhibition

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Elusive MDGs

With seven years gone and eight to go, the global community has little to celebrate. In 2000, with great fanfare, world leaders pledged to boost living standards by achieving eight Millennium Development Goals (MDGs)—covering poverty, health, education, gender, and the environment—by 2015. But halfway through, although much progress has been made on some fronts, most of the MDGs remain stubbornly out of reach for most regions, according to the fourth annual *Global Monitoring Report*, produced jointly by the IMF and the World Bank.

Continued rapid global growth would help—although for some countries, the sustainability and quality of growth is being undermined by unsustainable resource extraction and pollution. The global community now needs to quickly scale up aid, show greater policy coherence, and better align assistance around national development strategies. It also needs to tackle two major risks to a brighter outlook: an unacceptably high level of gender inequality (see article on page 6) and the greater needs of fragile states (see box).

Poverty: Overall, the world as a whole is on track to meet the goal of halving poverty by 2015 from its 1990 level—in fact, those living in extreme poverty (on less than \$1 a day) number fewer than 1 billion for the first time. But sub-Saharan Africa (SSA) remains way off track, with the region now accounting for 30 percent of the world's extreme poor (up from 19 percent in 1990 and only 11 percent in 1981). The Middle East and North Africa is expected to reach the goal, albeit narrowly, and Europe and Central Asia, and Latin America and the Caribbean are likely to come close. The stars are East Asia and the Pacific and South Asia, which, thanks to spectacular and sustained growth, are projected to overshoot the target.



Liberian children queue for measles vaccinations.

Education: More children than ever before are now completing primary school—the rate rose from 78 percent in 2000 to 83 percent in 2005. But one-third of developing countries are unlikely to reach universal primary completion. Plus, studies show that educational quality, measured as improvements in cognitive skills, has not necessarily followed the expansion in school enrollment. The most intractable groups are those that are “doubly disadvantaged”: female *and* from excluded ethnic, religious, or low-caste groups (see article on page 16).

Health: Deaths from the measles have dropped by 75 percent in SSA following 550 million inoculations since 2000. But 10 million children under the age of 5 in the developing world die each year from diseases that are easy and inexpensive to prevent, and no region is on track to meet the target for reducing child mortality.

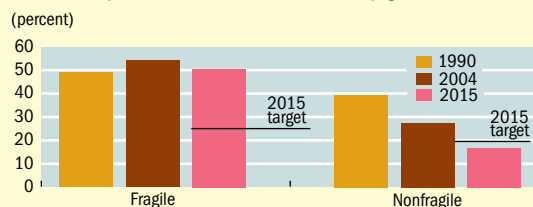
Missing by a long shot

The largest “MDG deficit” is in states with lax law and order, stymied by weak institutions and corruption, and often racked by civil conflict. With 9 percent of the developing world's population—nearly 500 million people—these fragile states account for over 25 of the world's extreme poor.

Despite the paucity of recent poverty data for fragile states, it is possible to construct a picture of progress for representative fragile and nonfragile states by inferring poverty rates from the average GDP per capita levels at purchasing power parity for these two groups of countries, and drawing on growth forecasts through 2015. The analysis shows that the average poverty level in fragile states has worsened since 1990, and these states will face an extreme poverty incidence of over 50 percent in 2015, falling far short of their income poverty target of 24.5 percent (see chart). On the health and education fronts, the news is similarly discouraging: fragile states account for nearly one-third of child deaths and for one-third of all 12-year-olds who fail to complete primary school. Moreover, if these states are not helped, they pose risks that may readily cross borders—through civil conflicts, risks to public health, and humanitarian crises.

Too fragile

Fragile states have twice the poverty level of nonfragile states and are way off track for the 2015 poverty goal.



Source: IMF and World Bank, *Global Monitoring Report 2007*.

What can be done? Bilateral donors and multilateral organizations need to step up their efforts to support these countries. Useful steps include a greater field presence, a greater ability to respond rapidly to windows of opportunity, better interagency collaboration, and basing advice and assistance on lessons learned from successful state-building policies elsewhere. The good news is that countries like Mozambique, Uganda, and Vietnam have successfully managed the transition from fragile state status.

IMF adopts new fiscal transparency code

The IMF approved on May 8 a new fiscal transparency code that introduces nine new “good practices” governments should follow to promote better-informed public debate about how they tax and spend. The IMF’s revised *Code of Good Practices on Fiscal Transparency* draws on the real-world experiences of developing countries, emerging markets, and advanced economies, and follows a broad public consultation process.

The revision retains the original code’s four pillars of fiscal transparency: clarity of roles and responsibilities, open budget processes, public availability of information, and assurances of integrity. But it introduces nine new specific good practices and broadens the coverage of others. Among the areas the expanded code covers are revenue from natural resources, government contracts with resource companies, revenue collection, the legal basis for the use or sale of government assets, the impact of budget measures, and publication of a citizens’ guide to the budget.

Richard Hemming, Deputy Director of the IMF’s Fiscal Affairs Department, said the code “provides real value added

because of the link between fiscal transparency, good governance and accountability, the quality and credibility of fiscal policy, and economic performance.” In a teleconference with media and civil society organizations on May 15, he noted that the code is one of the “core economic and financial standards” used by the Reports on the Observance of Standards and Codes that “have been prepared on a voluntary basis by 86 industrial, emerging market, and developing countries worldwide, and they have proved useful in identifying shortcomings and establishing fiscal priorities.”

Jon Shields, who heads the IMF’s Fiscal Transparency Unit, said the new code also emphasizes the need for sufficient time to discuss, consider, and revise a proposed budget and for any supplementary spending proposals to be transparent. He noted that the code calls for periodic reports on long-term finances and that “all information is accessible. It’s not enough that actions should be recorded somewhere in a gazette of which there are usually two or three copies. . . .”

A bigger club

The Organization for Economic Cooperation and Development (OECD) is to start talks with Chile, Estonia, Israel, Russia, and Slovenia that could lead to the five countries joining the 30-member group of advanced industrial economies. The Paris-based OECD also plans to strengthen ties with Brazil, China, India, Indonesia, and South Africa, a move that could culminate in membership.

The OECD was established in 1960 and groups member countries that meet its standards of democratic government and market-based economic policies. After starting out with a core group of advanced industrial economies, the OECD’s membership widened during the 1990s to include Mexico (1994), the Czech Republic (1995), South Korea and Poland (1996), and the Slovak Republic (2000).

Staying warm in Siberia

The European Bank for Reconstruction and Development is lending a municipality in Siberia, Russia, 20 million euros (\$26.8 million) to replace public housing that cannot handle the region’s seven-month, –50 degree winters. The bank’s loan will finance construction of four new housing projects in the western Siberian city of Surgut. The 800 new apartments will be safer, warmer, and 30 percent more energy efficient.



Workers harvest millet in Malamkaka, Niger

Running short

Thirty-three countries, most of them in Africa, will need emergency assistance to support their food supply this year, the United Nations Food and Agriculture Organization (FAO) predicts. The FAO’s *Crop Prospects and Food Situation* report says a combination of hostile climatic conditions, economic crisis, and conflict is set to cut crop production in several vulnerable countries, even as global cereal production hits new records.

The Rome-based FAO said that although world cereal production is on course for a new high of 2,095 million tons this year, demand and prices are also increasing as biofuels use more grain and global cereal stocks slide to 20-year lows. The cereal import bill for low-income food-deficit countries is set to rise by one-fourth from last year, the FAO forecast.

Southern Africa faces a second successive year of reduced cereal production, with production especially affected in Zimbabwe, although a bountiful harvest in Malawi has left a substantial surplus available for export. A sharp decline is forecast in North African grain production.

Other countries with difficulties include Bolivia, where drought and floods have affected large numbers of farmers, and North Korea, where rising domestic production and increased food aid from South Korea have not alleviated food supply concerns.



Smart Economics

Mayra Buvinic and Elizabeth M. King

WITH just eight years remaining to meet the Millennium Development Goals (MDGs), the global community is focused on what's being done to halve poverty from 1990 levels by the target date of 2015 and to meet several other objectives, including improving health and education (see Box 1). But much lower on the radar is the third of the eight United Nations goals (MDG3), which calls for redressing gender disparities and empowering women.

Greater focus on MDG3 is critical because—although valuable in its own right as an important development objective—it is also a key to achieving several others, such as universal primary education (MDG2), a reduction in under-5 mortality (MDG4), improvements in maternal health (MDG5), and reducing the likelihood of contracting HIV/AIDS (MDG6).

Moreover, greater gender equality (see Box 2 on page 11) can also help in the battle to reduce poverty (MDG1) and promote growth—*directly* by boosting women's participation in the labor force and increasing both productivity and earnings, and *indirectly* through the beneficial effects of women's empowerment on children's human capital and well-being (see Chart 1). The empirical evidence on these benefits is compelling. Whether self-employed or earning wages, working women help their households escape poverty. Women are more likely than men

to face constraints to access credit markets, but when they are the direct users of credit rather than men, the impact of credit on several measures of household welfare is greater. When women have more schooling, the returns flow not only to themselves but to the next generation as well. And when they have greater control over resources in the family, they are more likely than men to allocate more resources to food and to children's health care and education, a finding from as diverse a set of countries as Bangladesh, Brazil, Côte d'Ivoire, Ghana, Indonesia, and South Africa. Indeed, studies have shown that

More needs to be done to promote the economic power of women

Box 1

What are the MDGs?

In September 2000, at the United Nations Millennium Summit, world leaders agreed to a set of time-bound and measurable goals and targets for combating poverty, hunger, disease, illiteracy, environmental degradation, and discrimination against women. Placed at the heart of the global agenda, they are now called the Millennium Development Goals (MDGs).

The eight goals for 2015:

1. Halve extreme poverty and hunger
2. Achieve universal primary education
3. Empower women and promote equality between men and women
4. Reduce under-5 mortality by two-thirds
5. Reduce maternal mortality by three-fourths
6. Reverse the spread of diseases, especially HIV/AIDS and malaria
7. Ensure environmental sustainability
8. Create a global partnership for development, with targets for aid, trade, and debt relief

giving women more access to education, to markets (labor, land, credit), and to new technology, and giving them greater control over household resources often translates into greater well-being for themselves and their families. For women, their families, and their communities, this is smart economics.

This article examines progress so far toward achieving MDG3 and looks at ways that policies could make a difference. It measures gender equality in rights, resources, and voice, in three domains: the household, the economy and markets, and society (see Chart 2). There is still a long way to go to attain MDG3. A first important step is to improve the official indicators and data being used to monitor progress.

Progress with MDG3

So how is progress on this MDG measured? To begin with, there is an official target: “the elimination of gender disparities in primary and secondary education, preferably by 2005, and at all levels of education not later than 2015.” In addition, there are four official indicators dealing with enrollment, literacy, jobs, and voice (see Table 1). Together they provide an important, albeit incomplete, snapshot of progress toward gender equality.

Enrollments. Thanks to global efforts to achieve universal primary education (MDG2), girls’ enrollments at all levels of schooling have risen significantly. By 2005, 83 developing countries (of 106 with data) had met the intermediate MDG3 target of parity in primary and secondary enrollment rates (see Table 2). In all, 22 countries are off track to meet the MDG3 target by 2015—16 of them are in sub-Saharan Africa and 9 are fragile states (of 14 fragile states with data). Enrollment at the tertiary level is a more complex picture. Enrollment rates of women lag behind those of men in 63 countries (of 130 countries with data), but *exceed* those of men in 65 countries. When girls achieve very high enroll-

Table 1

Partial snapshot

Current indicators used to measure progress on MDG3 provide an incomplete picture of what is being achieved.

Household	Economy and markets	Society
Ratio of girls’ to boys’ enrollment in primary, secondary, and tertiary education	Proportion of women in wage employment in the nonagricultural sector	Proportion of seats held by women in national parliaments
Ratio of literate females to males among 15- to 24-year-olds		

Source: United Nations.

ment rates at the primary and secondary levels, they are more likely than boys to continue to higher education—the case in East Asia and in Latin American and the Caribbean. In these countries, there are generally no significant social barriers for girls to continue schooling, whereas young men are faced with choosing between further schooling and many more opportunities for paid work after secondary school than girls have.

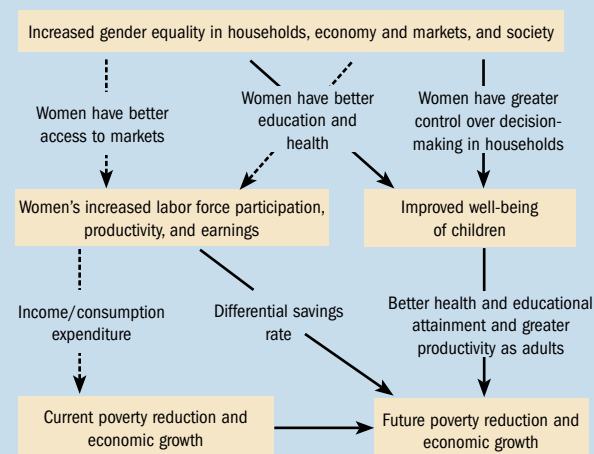
Literacy. There is evidence of higher literacy rates and greater gender parity among youth (ages 15–24). But gender gaps remain: the United Nations Educational, Scientific, and Cultural Organization estimates that of the nearly 137 million illiterate youths in the world, 63 percent are female. The female-to-male literacy ratio is lowest in sub-Saharan Africa, the Middle East and North Africa, and South Asia—regions that also had female disadvantages in primary and secondary enrollment.

Jobs. Women’s share of nonagricultural wage employment increased in all regions during 1990–2005 (see Chart 3). In

Chart 1

Compound effects

Gender equality can help reduce poverty and encourage growth in a variety of ways.

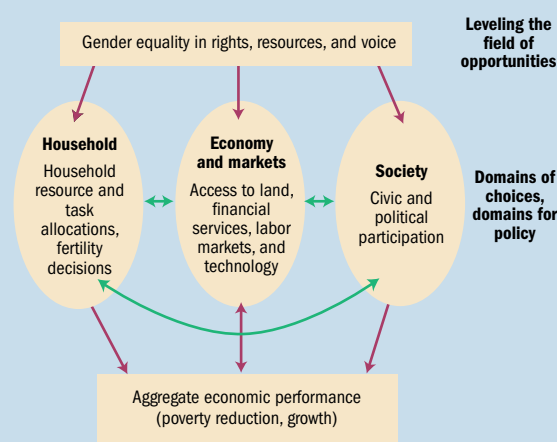


Source: World Bank staff.

Chart 2

Spheres for improvement

Besides improving individuals’ lives, greater gender equality can help boost aggregate economic performance.



Source: World Bank staff.

2005, the share of women in nonagricultural employment was highest in Europe and Central Asia (47 percent) and lowest in South Asia and in the Middle East and North Africa (20 percent). The trends and patterns in this indicator are difficult to compare across countries, however, without considering the size of a country's nonagricultural employment relative to total employment. A favorable score on this indicator in a country that has a small nonagricultural sector would mean less for women than in a country with a large nonagricultural sector.

Voice. Between 1990 and 2005, all regions except Europe and Central Asia and East Asia saw an increased presence of women in national parliaments, especially in sub-Saharan Africa and Latin America and the Caribbean. However, in no region did the average proportion exceed 20 percent (see Chart 3).

New indicators needed

As helpful as these indicators are, however, they fall well short of what is needed to measure progress on MDG3. They do not monitor key elements of gender equality, such as health outcomes and disparities in access to such productive resources as land, credit, and new technology. They are far better at measuring how females fare relative to males than whether females are able to better their lives. And changes in indicators based on parity ratios are difficult to interpret without a sense of the absolute levels of these indicators. When female-to-male ratios increase, this could be the result of scores rising for females or scores falling for males. Rising female rates of school enrollment or literacy are undoubtedly welcome, but falling rates of male enrollment or literacy are not.

Moreover, national-level indicators—whether parity ratios or absolute levels—can mask large inequalities between groups. For example, data across countries show that disparities in school enrollment rates between boys and girls are much larger in rural areas than in urban areas. Indeed, there are other sources of exclusion besides gender and those sources can exacerbate gender inequalities, and vice versa.

Table 3

Fuller snapshot

Recommended additional indicators for MDG3

Household		Economy and markets
Modifications of official MDG indicators	Additional indicator	Additional indicator
Primary school completion rate of girls and boys (MDG2) ¹	Percentage of 15 to 19-year-old girls who are mothers or pregnant with their first child ²	Labor force participation rates among women and men aged 20–24 and 25–49 ²
Under-5 mortality rate for girls and boys (MDG4)		
Percentage of reproductive-age women, and their sexual partners, using modern contraceptives (MDG6)		

Source: World Bank staff.

¹Recommended by the UN Millennium Project Task Force on Education and Gender Equality.

²Under consideration by the Inter-Agency and Expert Group for MDGs.

For these reasons, the 2007 *Global Monitoring Report*—an annual report of the IMF and the World Bank that monitors progress on meeting the MDGs—has proposed the immediate adoption of five supplemental indicators (see Table 3). These indicators, complementary to the official MDG3 indicators, meet three criteria: data availability (wide country coverage), strong link to poverty reduction and growth, and amenability to policy intervention. Indicators that met all three criteria but were highly correlated with other indicators were dropped from the list. Although additional indicators pertaining to markets (availability of credit, for example) and society (for example, voice in the community or local politics) would provide a much more complete picture of gender equality, the unavailability of data that are collected in a comparable and timely manner across developing countries has made this infeasible now.

Disaggregating the other MDGs by sex adds valuable information about gender equality. For example, under-5 mortality rates are typically higher for boys than for girls in countries where there is no significant discrimination against girls because of biological differences between the sexes. In four countries known for gender equality (Denmark, Finland, Norway, and Sweden), the female-to-male ratio

Table 2

Passing grade

Most countries, except in Africa, will attain primary and secondary enrollment targets by 2015.

	Achieved target by 2005	On track to achieve target by 2015	Off track or unlikely to achieve target by 2015	No data	Total
Sub-Saharan Africa	10	1	16	21	48
East Asia and the Pacific	13	0	0	11	24
Europe and Central Asia	22	0	1	4	27
Latin America and the Caribbean	27	0	0	4	31
Middle East and North Africa	8	0	3	3	14
South Asia	3	0	2	3	8
Total	83	1	22	46	152
Of which: Fragile states ¹	5	0	9	21	35

Source: World Bank estimates using data on enrollments between early 1990s and 2004/2005.

Note: The column showing countries with no data indicates the number of countries with missing data either at the start of the period, at the end of the period, or both.

¹Fragile states are countries scoring 3.2 and below on the Country Policy and Institutional Assessment (CPIA).

is between 0.81 and 0.88. In contrast, not only is female under-5 mortality in the South Asia region double that in other developing regions, except sub-Saharan Africa, but the female-to-male ratio is also higher than in any other region and far exceeds the range seen in the Scandinavian countries. And the East Asia region exhibits a worryingly high female-to-male ratio combined with overall low under-5 mortality rates (see Chart 4).

MDG3 development challenges include

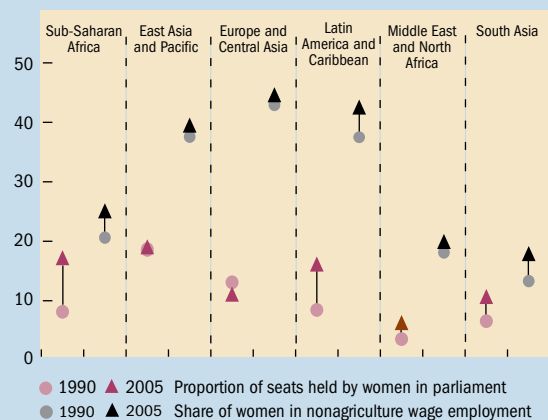
- closing gaps in well-being (health and education) and opportunities for girls and women who are doubly disadvantaged because of their sex as well as their race, ethnicity, caste, disability, and location (rural versus urban);
- giving priority to improving and monitoring gender equality and women's empowerment in sub-Saharan Africa, which consistently lags behind in most areas measured by MDG3;
- paying special attention to gender equality and women's empowerment issues in fragile states, where progress on gender equality is hampered by slow economic advancement and conflict; and
- scaling up significantly the collection and analysis of sex-disaggregated data to measure more accurately and fully the progress in achieving MDG3. Data on all the official indicators of MDG3 are available for only 59 out of 154 countries for 2000–05; even fewer countries have time-series data that would allow tracking the indicators over time. For the official and expanded list of indicators discussed here, only 41 countries have data for the same period, considerably limiting the ability to monitor progress, learn from success, and, ultimately, make informed decisions regarding investments and policy.

Chart 3

Gaining ground

Women are making progress in many regions in getting jobs outside agriculture and in winning parliamentary seats.

(percent of women)



Source: World Bank, *World Development Indicators*.

Note: The regional averages are calculated using the earliest value between 1990 and 1995 and the latest value between 2000 and 2005. The averages are weighted by country population size in 2005.

Policies that promote gender equality

To promote gender equality, policies need to address inequalities in rights, resources, and voice. In many cases, what is needed are policies that remove gender-specific barriers, thus ensuring a more level playing field for males and females. In other cases, gender-targeted policies that provide extra incentives for more investments in girls' human capital, for example, are needed to counteract initial inequalities between males and females. Even

“Greater gender equality in access to opportunities, rights, and voice can lead to more efficient economic functioning and better institutions.”

countries that score poorly on gender equality are adopting a range of policies to do better.

Promoting equal rights. High-performing countries generally have eliminated discriminatory laws condoning differential treatment of men and women, whereas many low-performing countries have not. Women in low-performing countries are often treated as minors in family law; for instance, they cannot pass on citizenship to a child, and their options for employment and ability to own productive assets are directly or indirectly constrained.

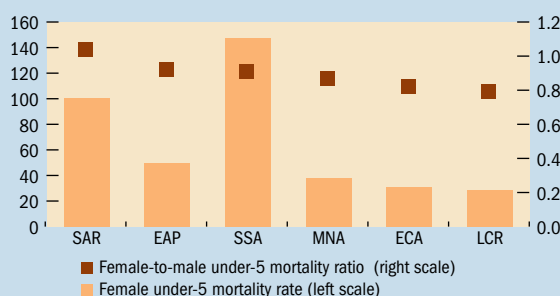
In addition, while many high- and low-performing countries have enacted constitutional or legal reforms to level the playing field for men and women, high-performing countries have stronger institutional frameworks to enforce

Chart 4

Favoring boys

The female under-5 mortality rate remains worryingly high in both South Asia and sub-Saharan Africa.

(deaths per thousand live births)



Source: World Bank, *World Population Prospects* (2004).

Note: SAR = South Asia, EAP = East Asia and Pacific, SSA = Sub-Saharan Africa, MNA = Middle East and North Africa, ECA = Europe and Central Asia, LCR = Latin America and Caribbean.

What do we mean by gender equality?

The 2006 *World Development Report* on equity and development refers to gender inequality as the “archetypal inequality trap.” The sharp differences between men and women in access to assets and opportunities in many developing countries restrict women’s basic freedom to choose and have negative consequences for the well-being of their children, families, and communities. These differences entrench inequality and are unfair (World Bank, 2005).

Gender equality does not necessarily mean equality of *outcomes* for males and females; it means equal access to the “*opportunities* that allow people to pursue a life of their own choosing and to avoid extreme deprivations in outcomes”—that is, gender equality in rights, resources, and voice (World Bank, 2001 and 2005). Equality of rights refers to equality under the law, whether customary or statutory. Equality of resources refers to equality of opportunity, including equality of access to human capital investments and other productive resources and to markets. Equality of voice captures the ability to influence and contribute to the political discourse and the development process.

those laws. Many legal changes ensuring equal rights for men and women are quite recent, and they underscore the fact that legal changes often follow and reflect social change. Pakistan illustrates this close connection between social and legal changes. Its national assembly passed the Protection of Women Bill in November 2006 after much debate and controversy. Removing rape from the jurisdiction of Islamic laws, the bill makes rape a crime punishable under the country’s penal code. And despite its overall low scores on gender equality, Pakistan improved gender parity ratios considerably in secondary and tertiary schooling and increased women’s representation in parliament from 10 to 22 percent during 1990–2003. These gains quite likely set the stage for the bill’s passage into law.

Enabling equal access to resources. Gender-informed investments in human capital are central to promoting gender equality, and low-performing countries with aggressive education policies are on a good track. Malawi, for instance, has achieved significant increases in gender parity ratios at all levels of schooling, thanks both to universal free primary education (1994) and to a specific emphasis on girls’ schooling.

A number of factors are associated with providing greater opportunities for women in the labor force. In the European transition countries, gender equality is the legacy of explicit state policies that emphasized employment as both a right and a duty for men and women. Years after the transition to a market economy, women in these countries appear to have maintained their position in the labor market, though there is a concern that barriers to access of productive resources and constraints imposed by household duties prevent women in Central and Eastern Europe from taking full advantage of economic liberalization.

In the Latin American countries that record high rates of female participation in wage employment, the rise in women’s participation in the 1990s does not seem to have resulted from specific government policy or economic growth (because it occurred despite widespread economic stagnation in the region in the 1990s). Instead, this rise seems related to profound changes in women’s roles in the household and in the labor market that may have resulted from their better education, later age at marriage, and lower fertility. But cultural and social factors can undermine as well as reinforce the impact of structural changes in the economy. Cultural norms about the role of women outside the home seem to constrain women’s employment options in countries in the Middle East and North Africa that have otherwise achieved high levels of female schooling.

Providing equal voice. Increases in women’s representation in parliament in several countries can be directly attributed to affirmative government action. Two countries with high representation of women in parliament are Argentina and Costa Rica, which adopted quota laws for women’s representation in parliament in the early 1990s. In Argentina, the current female membership in the National Congress is the highest ever attained—42 percent in the Senate and 33 percent in the House. Quota laws, although they have drawbacks, appear to help solidify women’s gains in parliamentary representation; without them, women’s gains in representation seem quite volatile. Other countries, such as India, the Philippines, Rwanda, and Uganda, have followed suit with variations on this policy.

* * * * *

The long-term benefits of these and other policies to promote gender equality come with costs in the short run. These include budgetary expenditures to scale up policies and monitor progress in attaining MDG3. In addition, there may be short-term political and economic costs. In the long run, however, greater gender equality in access to opportunities, rights, and voice can lead to more efficient economic functioning and better institutions, with dynamic benefits for investment and growth. The business case for investing in MDG3 is strong—it is nothing more than smart economics. ■

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Budgeting with Women in Mind

A woman is in charge of the Gullfaks oil rig, owned by Norway's Statoil company, in the North Sea.

Why using the budget to empower women makes good economic sense

Janet G. Stotsky

WHEN leaders in developed and developing countries alike ponder ways to boost growth, reduce inequality, and improve living standards, the enduring battle of the sexes is most likely the last thing on their minds. But they might want to think again.

Gender differences have long been incorporated into economic analysis at the microeconomic level in such fields as public finance, labor, and development economics. For instance, different migration patterns for men and women in developing countries from rural to urban areas have long been a staple of models in development economics and contribute to our understanding of the overall development process. But more recently, the focus has turned to the potential macroeconomic implications of gender differences in behavior—both for understanding economic developments and for formulating sensible policies (Grown, Elson, and Cagatay, 2000). Gender differences in behavior that are the outcome of private decisions or reflect the influence of public policies may lead to different outcomes in the macroeconomy, with implications for aggregate

consumption, investment, and government spending and, hence, national output. Yet fiscal policies are rarely formulated to take account of gender.

Although much of the work is innovative, the literature is incomplete in two areas. First, it does not always draw out the macroeconomic implications, even when drawing on microeconomic evidence on gender differences in behavior. Second, because it is somewhat disjointed from the broader macroeconomic literature, scholars working in either field often fail to fully recognize each other's contributions. Two recent IMF studies focus on the interaction between gender and macroeconomics and gender and budget processes. This article gives a snapshot of both these topics.

Improving women's opportunities

Women remain disadvantaged, especially in the poorest countries. Their opportunities for educational, social, and economic advancement are usually markedly inferior to those of men, and they often face barriers in gaining access to good education and health care for both economic and cultural reasons. The

end result—in low and some medium human development countries—is a lower level of educational attainment for girls than boys and a lower life expectancy for women relative to men than would be expected (see Table 1). The so-called missing women phenomenon, where there are fewer women than would be expected on the basis of biological norms, is also indicative of the continuing bias against women. In the job market, women face lower wages and fewer job opportunities, and they continue to encounter discrimination in financial markets. Women also usually have fewer opportunities to participate in public decision making.

The eight UN Millennium Development Goals (MDGs)—which were adopted in 2000 to sharply reduce poverty and improve living standards by 2015—explicitly link economic progress to creating equal opportunities for all men and women. One of them, MDG3, calls for redressing gender disparities and empowering women (see article, page 6).

Incorporating gender into macroeconomics

It is not that obvious how to go about incorporating gender differences in economic behavior and policy outcomes into macroeconomic policymaking. After all, in macroeconomics, one typically looks at the aggregate, or overall, economy. But economists are now taking a much stronger interest in how gender affects aggregate income as well as key components of overall economic demand, focusing on household decision making.

Although the evidence about the relationship between women's inferior status and growth is not fully conclusive—measuring the degree of inequality or disadvantage in comparison with men is a complex topic in itself—research findings suggest that countries that take steps to increase women's access to education, health care, employment, and credit, thereby narrowing the differences between men and women in terms of access to economic opportunities, increase their pace of economic development and reduce poverty (Klasen, 2007; and World Bank, 2001).

Consumption. One of the best-documented findings, with evidence spanning many developing countries, is that when women have greater control over the spending of their households' resources, they devote a larger share of spending to foster the potential of their children and purchase household necessities. Because greater investment in education is linked to higher growth and because spending on necessities is more stable than spending on luxuries, raising women's economic influence within the household may enhance overall growth and reduce economic instability. In countries where women's opportunities to earn a living are limited by economic and cultural factors, public policies could therefore benefit from being geared to enhancing women's employment and

earnings possibilities. Examples of policies that encourage women to work outside the home include subsidies for pre-school programs and a reduction in high marginal tax rates applying to secondary earners within the household.

Savings and investment. Theory suggests a number of reasons why women might have different savings preferences than men, including the need to provide for a longer life expectancy. The empirical work on savings and investment is scarcer than on consumption. Some evidence suggests that enhancing women's control over resources does in fact lead to a higher saving rate, but further study is needed to draw any firm conclusions. Evidence from microcredit lending indicates that women tend to have superior repayment records and invest more productively. Data from developed nations on the allocation of financial assets suggest that women tend to be more averse to risk. Although this may slow growth economy-wide, it may at the same time impart greater stability to investment and financial markets. The external balance, which reflects the gap between domestic savings and national investment, may also be altered by the influence of gender on saving and investment decisions.

Public choice. Recent research suggests that expanding women's political voice and power may increase the demand for redistributing income and for public insurance, for instance, through increased spending on social security programs and maternity or unemployment compensation. Such preferences could lead to a larger overall size of government, with uncertain implications for overall economic growth.

Taken together, these gender-based differences suggest that raising women's economic power can lead to higher rates of economic growth and reduce volatility. Much of the evidence is microeconomic in nature, but macroeconomic conclusions can be drawn from microeconomic modeling as long as the behaviors are systematic and pervasive and thus have an impact at the aggregate level.

In countries with the lowest average income and in which agriculture remains the main source of economic activity—such as in sub-Saharan Africa—women's lack of education, health care, and employment opportunities prevents them from being able to fully benefit from improved macroeconomic and structural policies, hindering economic growth

Table 1

Gender inequalities persist

On a global scale—especially in low human development countries—girls do less well in school enrollment than boys, and women's life expectancy relative to men's is lower than would be expected.

(unweighted average; percent, unless otherwise noted)

	Primary school enrollment			Secondary school enrollment			Life expectancy at birth (2002)		
	Male ratio	Female ratio	Ratio of females to males	Male ratio	Female ratio	Ratio of females to males	Male years	Female years	Ratio of females to males
High human development	96	96	1.00	84	87	1.03	73.35	79.44	1.08
Medium human development	90	88	0.98	58	60	1.04	64.33	68.97	1.07
Low human development	63	55	0.86	21	15	0.73	44.69	46.52	1.04

Sources: World Bank, *World Development Indicators*; United Nations, *Human Development Report* (2004); and IMF staff calculations.
Note: Data are from 2001–02 and cover the whole world.

(Collier, 1988; and Blackden and Bhanu, 1999). Where women have broader opportunities, the growth of export-oriented industries, supported by trade liberalization, has been shown to stimulate growth in many developing countries and increase women's employment. South Asia and Southeast Asia—where export trade has led to a dramatic increase in women's paid employment opportunities—are examples of this phenomenon. Financial liberalization has also improved economic opportunities for women, in part through greater access to credit. But greater volatility may be burdensome to households with marginal finances, which are disproportionately headed by women.

Budgeting for gender

One way for countries to pinpoint policies needed to reduce gender disparities is through gender budgeting, which involves the systematic examination of budget programs and policies for their impact on women. This effort to mainstream gender analysis into government policies has gained prominence in recent years, in part thanks to a big push by the 1995 Beijing World Conference on Women. This type of budgeting promotes greater accountability on how governments are doing in terms of promoting gender equality and helps ensure that budgets and policies are geared toward achieving gender equality. It is not intended to analyze only programs that are specifically targeted to females or to produce a separate “women's” budget. Rather, it is intended to examine the gender effects of all government programs and policies.

One might ask: Why budget with only gender in mind? What about other groups in the population whose interests may have received insufficient attention? In principle, budget processes should take into account the elimination of any disparities that are socially harmful. Some groups, such as the elderly and some racial minorities, have in fact organized themselves to assert their interests.

What is clear is that there is no such thing as a gender-neutral government budget. For instance, cutting back on clean water spending may disproportionately harm women and girls because they typically bear the time and physical burden of providing clean water to households when it is not readily available. Similarly, increasing school fees may disproportionately reduce girls' opportunities to attend school, just as reducing a tax credit for child-care expenses may disproportionately burden women, who are responsible for the greater share of child-rearing activities.

Is there an economic justification for gender budgeting? This article has argued that reducing the disadvantaged status of women can be linked to a higher rate of economic growth and to greater economic stability, which yields benefits that the private market, when left to itself, may not fully take into account. And, because some of the benefits of reducing these inequalities, such as the influence of better education on fertility and child health, may manifest themselves only over the medium term, it is essential to place gender budgeting in the medium-term context of the budget. Even if reducing gender inequalities does not necessarily improve growth but simply creates a fairer society, there is a justification for public intervention.

How does gender budgeting work in practice? Individual initiatives have taken a wide variety of forms. They can entail the preparation of a separate document that assesses the implications of government programs for women, which is then presented with the budget. They can be integrated into departmental processes and program analysis on an ongoing basis so that all programs and policies are assessed on how they contribute to raising the status of women and girls. And they can be formal budget submissions or simply “white” papers drawn up by interested groups outside the government.

Evaluating expenditure effects. Specific tools have been developed to integrate gender budgeting into the standard budget process (Budlender and Hewitt, 2002; and Budlender and others, 2002). In its typical application, the expenditure incidence is evaluated by disaggregating government spending into those categories that are seen as benefiting women and girls and those that have more general purposes (which tend to comprise the vast bulk of spending). Gender-budgeting initiatives may also focus on public employment.

Evaluating revenue effects. More recent initiatives attempt to assess revenue policies. The personal income tax is one of the taxes that fit easily into this framework because it is personalized to individuals, who file on the basis of their own (or joint) income. In the past, many countries discriminated explicitly against women in the personal income tax, but today that number is falling. In developed countries, discrimination is almost entirely gone, but in developing countries, it is still possible to find personal income taxes with

Table 2

What a gender budget might look like

Two hypothetical examples of gender analysis in a national budget

Education ministry				
Objective	Gender dimensions	Activities	Budget	Performance indicators and benefits
Expand primary education	Girls have a lower enrollment rate than boys, and the goal is to equalize this rate and achieve universal primary education	Subsidize parents who send their daughters to primary school, with eligibility based on a means test	Derived from an estimate of the number of parents who would make use of this subsidy on an annual basis	Ratio of boys to girls in primary education and total enrollment rate of boys and girls Improved earning power for girls because of better education and other social benefits
Health ministry				
Reduce HIV/AIDS exposure	Girls have a higher exposure to HIV/AIDS than boys because of cultural practices that limit the ability of girls to protect themselves against unsafe sex	Develop programs that teach men the dangers of unsafe sex to women and girls	Derived from an estimate of the cost of training health care workers to deliver this message	Changes in girls' infection rate Reduction in treatment costs and improvement in health and life expectancy

Source: The author.

such gender-biased attributes as assigning, for tax purposes, all nonwage income to the husband regardless of who owns the property (embodying the assumption that a woman's property belongs to her husband); or assigning larger allowances to men, reducing their effective tax rate; or applying a reduced tax rate on the same income. Indirect taxes, such as the value-added tax, corporate income taxes, and international trade taxes are not personalized. Yet an implicit gender bias can be found in such taxes through patterns of incidence that may differ by gender. There may, for example, be a bias against men in excise taxes that fall heavily on alcoholic beverage consumption, smoking, and gambling—activities that are undertaken disproportionately by men in virtually every society.

How gender budgets have fared

Since 1984, some 40 countries from all regions of the world have tried some form of gender budgeting, typically at the national level but in some cases at the subnational level. The initiatives have been led by the government (the executive or legislative branch) or by civil society. Most of these initiatives have focused on the spending side of the budget, but a few countries have looked at the revenue side as well.

Australia was the first country to formally incorporate gender budgeting by developing the concept of a women's budget. South Africa followed suit in 1995 as part of its push to eliminate inequalities following the end of apartheid. One tangible result in South Africa was the elimination of gender discrimination from the personal income tax, where some women were taxed more heavily than men with equivalent income. In the European Union, gender equality has long been a priority, with gender-budgeting initiatives under way in a number of countries, including in Scandinavia and Spain. Other initiatives include the Women's Budget Group in the United Kingdom, which comments on the fiscal policies of each annual budget. In India, researchers have assessed the adequacy of budgetary programs to address women's needs and reduce gender disparities. In Mexico, nongovernmental organizations have worked with federal and state governments to combine solid academic analysis with advocacy for gender equality and poverty reduction within the budgetary context. And in Rwanda, a gender-budgeting initiative is used to inform the national debate about policy and allocation of resources.

What is the verdict so far? The answer is mixed. In some cases, such as Australia and South Africa, the initiatives failed to become part of the institutional fabric after an initial burst of activity. These experiences demonstrate the need for gender initiatives to become well integrated within the more general budget processes and to demonstrate their utility. The initiatives also need to gain broad political support to avoid falling victim to a change of government.

As a result, several important lessons may be drawn from the experience to date:

- Gender budgeting should be incorporated into standard budget processes so that it becomes fully institutionalized. Otherwise, even initiatives adopted with enthusiasm may not be sustained. Some elements of gender budgeting, such as an

analysis of benefits or tax incidence, may require periodic special efforts.

- It should address specific goals, such as reducing inequality in educational attainment, that have clear benefits and can be measured even with somewhat crude tools and data (see Table 2).
- It should draw on civil society for support and assistance with the more research-oriented aspects, and should apply to subnational levels of government where relevant.
- It should cover both spending and revenue.
- It should not as a rule set specific goals for spending on women-related objectives (unless budgets are severely constrained and such spending is well below what an unconstrained budget would otherwise choose) because this tends to reduce flexibility, making the budget process less effective.

In sum

Our understanding of gender differences in behavior, and of how public policies have different effects on men and women, has improved in recent years and is influencing macroeconomic policymaking, especially fiscal policy.

Reducing gender disparities can lead to improved macroeconomic performance. The recognition that gender disparities are harmful and that government budgets are not gender neutral implies a need to incorporate gender considerations into the budgeting process. Although gender-budgeting initiatives can take many different forms, their most important purpose is to influence the budgeting process and help policymakers focus on ways that public policies can help reduce gender disparities and improve economic outcomes. ■

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Getting All Girls into School

*Maureen A. Lewis and
Marlaine E. Lockheed*

**New ways
are needed
to educate
“excluded
girls” in
developing
countries**

SINCE 1960, primary school enrollment rates in the developing world have risen steeply for boys and girls, with girls’ participation converging with that of boys in most countries. Yet UNESCO (2006) recently estimated that 43 million school-age girls are not enrolled in school, many more complete fewer than six years of schooling, and a gap between boys and girls remains in some countries. This gap is due overwhelmingly to the lag in schooling of socially excluded groups, often minority groups that are on the margins of society (see box and table) and in which girls are at a distinct disadvantage relative to boys. Indeed, we estimate that approximately 70 percent of these out-of-school girls come from such groups.

Where are these out-of-school girls? By far the greatest number are in sub-Saharan Africa (47 percent) and South Asia (25 percent), followed by East Asia and the Pacific (11 percent); the Middle East and North Africa (9 percent); and Latin America and the Caribbean, Eastern Europe and Central Asia, and North America and Western Europe (all close to 3 percent). However, the Latin American and Caribbean region scores highest when the focus is on the percentage of out-of-school girls coming from excluded groups (see Chart 1).

The educational consequences for the socially excluded—girls in particular—are



Roma women and girls in Romania learn how to read and write.

real. They range from teachers ignoring students in class to the destruction of schools and violence against teachers and communities. Compounding the problem, socially excluded groups are often less likely to send their daughters to school and more likely to allow their daughters than their sons to drop out early.

Over the past decade, much has been learned about how to reach poor children and those from excluded groups. Most of this experience is from developed and middle-income developing countries. Programs have been designed that raise enrollments, sustain attendance, and equalize learning outcomes of excluded children. Similarly, much is known about how to reach girls. But relatively little is known about how to reach excluded girls specifically. This article highlights some of the lessons from our recent Center for Global Development study, which looks at why girls from socially excluded groups are not in school and what can be done about it.

The extent of the problem

To begin with, it is helpful to think of countries as highly homogeneous (like South Korea and Tunisia, which have a single ethnic group with a common language and a shared cultural heritage) or heterogeneous—with multiple ethnic groups that speak different languages and often have distinct cultures. In the latter group,



communities that are “different” from the mainstream society and economy tend to become excluded, and it is the parents in these communities who are likely to keep their children out of school, in contrast to parents in majority communities, who are increasingly sending both boys and girls to school.

Why do minority parents keep children at home? The reasons are complex and many. They include a general resistance

Who's excluded and why?

Socially excluded groups are population subgroups that are prevented by discrimination and indifference in their own countries from receiving the social rights and protection meant for all citizens. These groups—ethnic minorities, isolated clans, and groups in which the majority language is not predominant—are marginalized for various reasons:

- Stigmatization at the hands of the majority population, such as a history of slavery (blacks in Brazil, Cuba, and the United States) or dispossession of a homeland (native peoples of Canada and the United States).
- Differences in ethnic group, language, and religion, such as the hill tribes in Laos and indigenous groups in Latin America.
- Low status, whereby excluded groups are subordinated in the social hierarchy to the majority population, such as the Roma in Europe and lower-caste groups in India and Nepal.
- Involuntary minority status (in contrast to immigrant groups that accept minority status voluntarily in exchange for economic opportunity in the labor market).

Source: Meerman (2005).

to change; a desire to retain a separate ethnic identity; a lack of interest in what schools offer; a worry about discrimination and mistreatment (children might be beaten or simply sidelined); a need for child labor and apprenticeships within the family; the direct costs of fees, books, and uniforms; limited employment opportunities upon graduation; low economic returns to those who have attended school; a lack of accessible and acceptable schools; and concerns for safety (especially for adolescent girls). And minority communities are more likely to educate boys than girls because boys have better labor market opportunities, and girls in many societies are “married away” and join their husband’s family. Moreover, when excluded children do attend school, they are more likely to drop out and less likely to complete primary school.

Although concrete data are available for relatively few countries, the following examples give a sense of the extent and degree of the problem of girls’ exclusion.

- In India, 37 percent of girls aged 7–14 belonging to the lowest castes or tribes do not attend school, compared with 26 percent of majority girls of the same age. School attendance for tribal girls is 9 percentage points below that of tribal boys.
- In Laos, Hill Tribe girls from rural communities complete fewer than two years of school, whereas majority Lao-Tai girls from urban communities complete eight years (see Chart 2).
- In Guatemala, indigenous girls are the least likely to have ever enrolled in primary school (see Chart 3), and only 26 percent of indigenous non-Spanish-speaking girls complete primary school, compared with 62 percent of Spanish-speaking girls.
- In the Slovak Republic, only 9 percent of Roma girls compared with 54 percent of Slovak girls attend secondary school.

But all available evidence suggests that, once in school, excluded girls perform as well as, or even better than, excluded boys at the primary level (although the achievement levels of excluded children as a whole lag behind those of majority children). This difference between girls’ and boys’ performance holds true in industrial countries, where girls outpace boys in schooling completion among the majority population. It also holds true among minority groups—the Maori in New Zealand and African-Americans and indigenous groups

Who they are

Excluded groups differ across regions and countries.

Region	Who they are
Sub-Saharan Africa	Populations other than the dominant tribe
South Asia	India’s dalits, lower castes, and tribes; rural tribes in Pakistan; lower castes in Nepal; rural populations in Afghanistan
Middle East and North Africa	Berbers, rural populations
Latin America and Caribbean	Indigenous and Afro-Latino populations
East Asia and Pacific	Hill Tribes; Muslim minorities; other ethnic minorities
Eastern Europe and Central Asia/Commonwealth of Independent States	Roma; Turkey’s rural populations

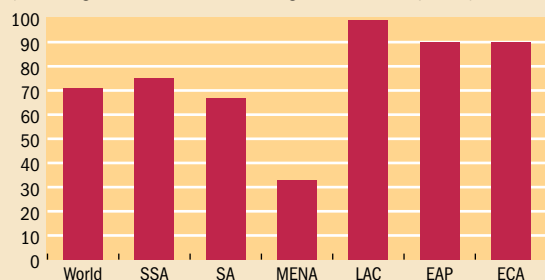
Source: Lewis and Lockheed (2006).

Chart 1

Not even enrolled in school

Most out-of-school girls come from socially excluded groups.

(excluded girls as estimated share of all girls out of school, percent)



Source: Lewis and Lockheed (2006).

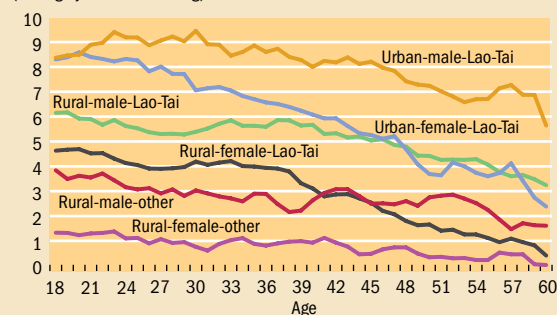
Notes: SSA=Sub-Saharan Africa, SA=South Asia, MENA=Middle East and North Africa, LAC=Latin America and the Caribbean, EAP=East Asia and the Pacific, ECA=Europe and Central Asia.

Chart 2

Less schooling for excluded girls

Rural tribal girls in Laos complete far less schooling than urban majority children.

(average years of schooling)



Source: Lewis and Lockheed (2006).

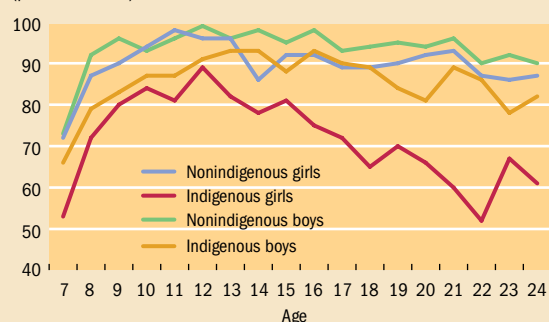
Note: The figures are on a three-age-moving average. The urban non-Lao-Tai are too small a group to include.

Chart 3

Falling through the cracks

Indigenous girls in Guatemala are least likely to have ever been enrolled in school.

(percent enrolled)



Source: Lewis and Lockheed (2006).

in the United States—once concerns about language, culture, and treatment in schools have been addressed and access to quality schools has improved. Most studies in developing and transition countries do not disaggregate achievement results, but some country studies yield encouraging findings on girls' achievement:

- In Peru, the fifth-grade reading and mathematics scores of rural Quechua girls were no different from those of rural Quechua boys, although the performance of Quechua children was substantially lower than that of nonindigenous urban children (see Chart 4).
- In Ecuador, indigenous girls scored higher than indigenous boys on fifth-grade mathematics tests, with scores nearly as high as those of nonindigenous children.

Reaching and teaching excluded girls

We infer from what we have learned about reaching poor and excluded children that getting and keeping excluded girls in school requires different approaches and entails higher costs. Cultural variations, linguistic differences, and girls' special needs (for example, safety and hygiene) drive up costs because they require new methods tailored to each group. Investment on two fronts is essential for enrolling and retaining excluded children in general, and girls in particular.

First, many countries still lack good-quality educational opportunities for all students. Thus, **the first line of attack is to improve the quality of schooling** through three key actions:

Make education policies more fair. Policies that appear fair may be subtly biased against girls from excluded groups. For example, policies requiring use of a majority language in school may be particularly disadvantageous to girls from excluded groups because they often have less exposure than boys to the majority language. Similarly, policies that require either single-sex schools or coeducation may limit girls' opportunities, when, as a result of such policies, only schools for boys are established, as in some areas of Pakistan, or parents restrict older girls' attendance in coeducational schools.

Expand schooling options. Parents' concern for their daughters' safety may mean that nearby community schools and informal alternative schools can attract and retain girls from excluded groups more easily than formal schools located at a distance. For example, in Rajasthan, India, community schools that employed paraprofessional teachers, allowed the community to select and supervise teachers, and hired part-time workers to escort girls from excluded groups to school had higher enrollment, attendance, and test scores than public schools. Preschools can help excluded children transition more easily to formal schools. In Brazil, Turkey, Bolivia, and India, preschool programs involving both mothers and children from excluded groups have reduced primary school dropout rates and boosted achievement. Compensatory programs also help. Brazil, India, and Spain have offered targeted, compensatory in-school or after-school programs to help disadvantaged students stay in school, raising their achievement. In India, where young women were hired to tutor children who were lagging behind, the largest achievement gains were recorded for the most economically disad-

vantaged children. Radio, television, and computers can also expand opportunities for girls, particularly those kept home after primary school.

Improve the physical environment and instructional materials. Girls are less likely than boys to enroll in, and more likely to drop out of, schools that are in poor physical condition (for example, with leaky roofs), whose teachers are often absent, and with inadequate materials. And those who stay in school under these circumstances—especially if only the majority language is taught—tend to perform more poorly. In fact, studies show that school quality matters more for excluded girls than for boys and children from mainstream families because minority parents often have higher standards for the state of the school and the quality—and often gender—of the teachers. What can be done? One solution lies in offering bilingual education. Other solutions encompass targeting additional resources to schools where average performance is low, repairing school buildings, strengthening the curriculum, and hiring knowledgeable teachers, something that cannot be taken for granted.

The **second line of attack is to create incentives for households to send girls to school.** Evidence on what incentives might work is less clear and needs more focused evaluation.

Offer conditional cash transfers. Such transfers help households defray some education costs, tying assistance payments to desirable behaviors. They are often challenging to administer but do motivate families to send children to school. Programs in Bangladesh, Ecuador, and Mexico, among others, have been successful, although their specific impact on excluded groups has not been assessed. A conditional cash transfer program in Ecuador boosted school enrollment overall by 3.7 percentage points but did not benefit girls or minority students in a significant way.

Offer scholarships and stipends for girls. Secondary school scholarship programs offer girls financing and encouragement to stay in school and compensate families for the direct and indirect costs of education. They have been highly effective

in several countries, notably Bangladesh, where scholarships for girls increased their enrollment to twice the national average for females. Stipend programs also compensate parents for the cost of schooling but are tied to such school inputs as uniforms, books, materials, and transportation. Even the opportunity to earn a scholarship has been found to boost student achievement.

Introduce school feeding programs. Various feeding programs are associated with higher enrollment and attendance. In Kenya, free meals raised attendance in program schools 30 percent relative to schools without free meals, and test scores rose substantially. But rigorous evaluations found that the feeding programs benefited boys rather than girls and did little to reduce the gender gap.

How to make it happen

Practical actions to promote education for excluded girls entail tailoring programs that appeal to parents and students, drawing on the kinds of successful efforts discussed above. These are generally expensive alternatives but have been shown to be necessary to bring excluded children, particularly girls, into school and ensure that they remain and graduate. The United States' Head Start program is one such example, and middle-income countries like Chile, Malaysia, and Mexico have pioneered similar programs.

But lower-income countries cannot afford the extra efforts required to reach excluded groups and the out-of-school girls in those communities. For them, external support will be needed. First, bilateral, multilateral, and private donors should direct their support to programs that have demonstrated positive effects for excluded girls. A trust fund could be established to provide the financial basis for expanding successful efforts in reaching, retaining, and teaching excluded girls. Second, a girls' education evaluation fund could help expand the knowledge base about what works, particularly in Africa, where evidence is slim and more than 40 percent of excluded girls reside. Finally, the UNESCO Institute for Statistics should report school participation and achievement data disaggregated by gender and exclusion, which will be essential for monitoring improvements and determining what approaches are most effective. ■

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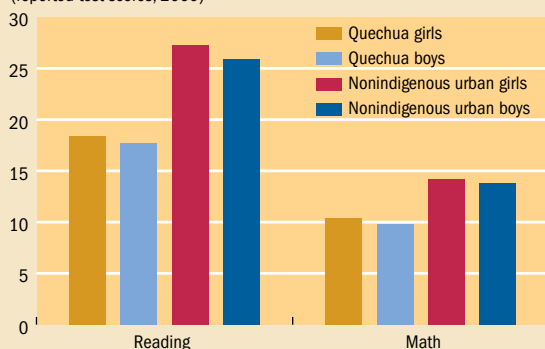
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- Meerman, Jacob, 2005, "Oppressed People: Economic Mobility of the Socially Excluded," *Journal of Socioeconomics*, Vol. 34 (August), pp. 542–67.
- UNESCO, 2006, 2007 Global Monitoring Report: Strong Foundations: Early Childhood Education (Paris).

Chart 4

Lower achievement of the excluded

In Peru, rural Quechua children perform far worse in school than nonindigenous children in urban areas.

(reported test scores, 2000)



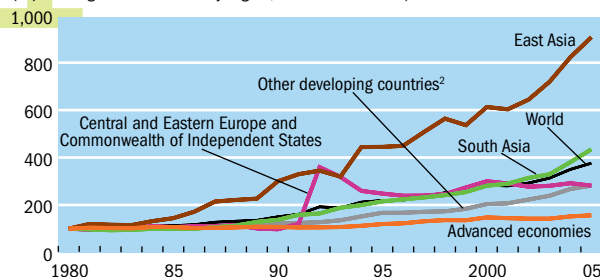
Source: Lewis and Lockheed (2006).

Globalization of Labor

OVER the past two decades, labor has become increasingly globalized. The integration of China, India, and the former Eastern bloc into the world economy, together with population growth, has led to an estimated fourfold increase in the effective global labor force, which could more than double again by 2050.

The global labor supply has shot up since 1980 ...

(export-weighted labor force by region, index 1980 = 100)¹



Sources: United Nations, Population Prospects: The 2004 Revision Population Database; World Bank, World Development Indicators; and IMF staff calculations.

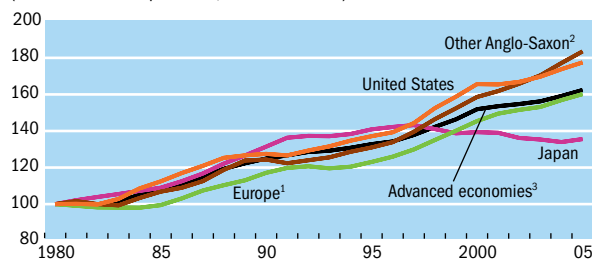
¹National labor forces scaled by export-to-GDP ratios.

²Western Hemisphere, Middle East and North Africa, and sub-Saharan Africa.

Integrating workers from emerging market and developing countries into the global labor force has produced big benefits for advanced economies—where, contrary to fears that globalization is driving down wages, total labor compensation has grown by a cumulative 60 percent on average since 1980. This is in part due to globalization as export opportunities have risen, while productivity and output have benefited from lower input costs and better production efficiencies. The decline in traded goods prices over the past 25 years has generated an estimated 6 percent increase in both output and real labor compensation on average in advanced economies.

Labor compensation has been rising robustly in advanced economies, owing partly to globalization ...

(real total labor compensation; index 1980=100)



Sources: Haver Analytics; International Labor Organization, Labor Statistics Database; OECD, Employment and Labor Market Statistics, National Accounts Statistics, and STAN Industrial Database; United Nations, National Accounts Statistics (2004); and IMF staff calculations.

¹Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Portugal, Spain, and Sweden.

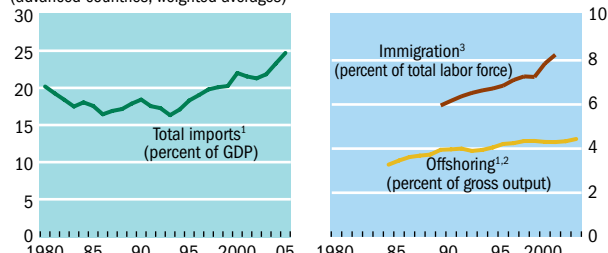
²Australia, Canada, and United Kingdom.

³Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Portugal, Spain, Sweden, United Kingdom, and United States; weighted using series on GDP in current U.S. dollars.

The bigger labor pool is being accessed by advanced countries through imports of final products, offshoring of the production of intermediates, and immigration. Although offshore outsourcing has received much attention, it is still small in relation to the overall economy. For example, offshored inputs make up only about 5 percent of gross output in advanced countries.

... with advanced countries tapping into it in various ways.

(advanced countries, weighted averages)



Sources: OECD, International Migration Data, Input-Output Tables (1995, 2002, and 2006 editions), and IMF staff calculations.

¹Weighted using series on GDP in current U.S. dollars. Total imports include both imports of final products and intermediate products (offshoring).

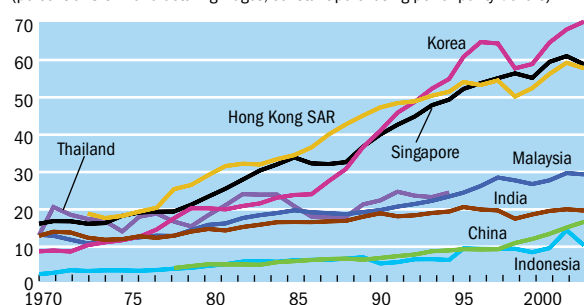
²Offshoring data are limited to select industrial countries.

³Stock of foreign labor force. Weighted using series on total labor force.

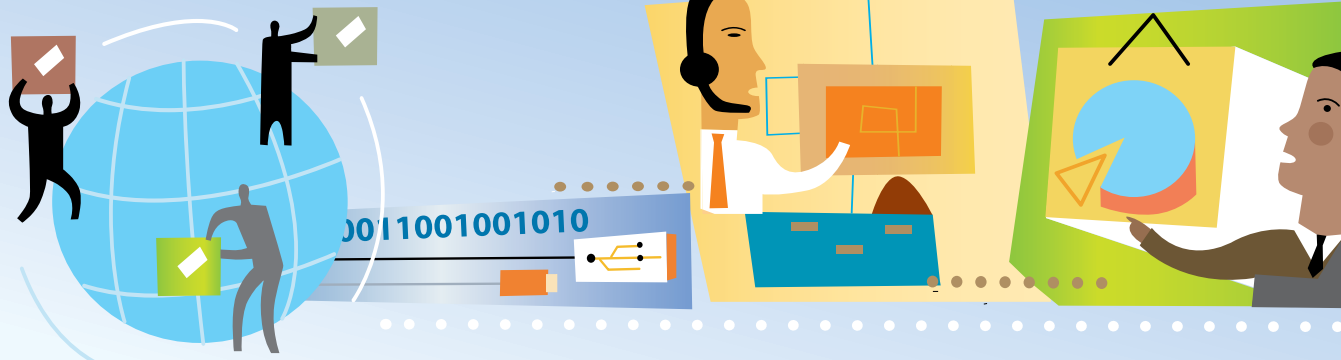
In early Asian developers, such as Korea, Singapore, and Hong Kong SAR, real wages have been converging rapidly toward U.S. levels and are relatively high. Wages in other Asian countries, including China, have been converging at a slower pace, although accelerating in recent years.

... and in emerging markets, especially in Asia, manufacturing wages have also been rising rapidly.

(percent of U.S. manufacturing wages, constant purchasing power parity dollars)



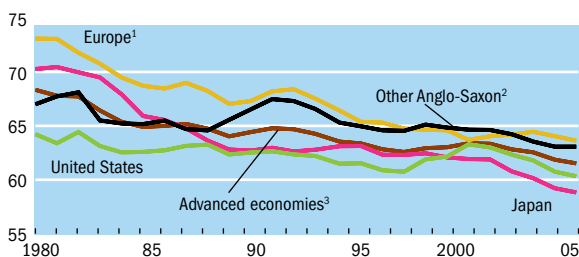
Sources: United Nations Industrial Development Organization, Industrial Statistics Database (2006); Computer and Enterprise Investigations Conference Asia Database; and IMF staff calculations.



Despite these benefits, the share of income accruing to labor (as opposed to capital) in advanced economies has fallen by about 7 percentage points, on average, since the early 1980s, with the drop being largest in Europe and Japan.

The share of income going to labor has declined in advanced countries . . .

(labor share as a percent of GDP)

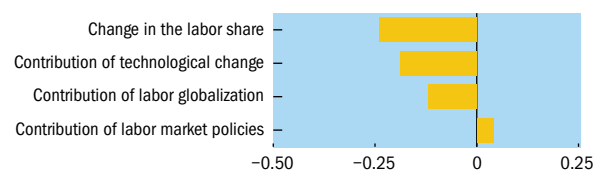


Sources: See Chart 3.
For footnotes, see Chart 3.

Rapid technological change has had the biggest negative impact on labor's income share, followed by labor globalization. Countries adopting reforms to lower the cost of labor to business (by lowering the tax wedge—the difference between the payroll cost to a firm and the net take-home pay of workers) and improve labor market flexibility have generally had a smaller decline in labor share.

. . . with technological progress the main driving force . . .

(annual average, percentage points)

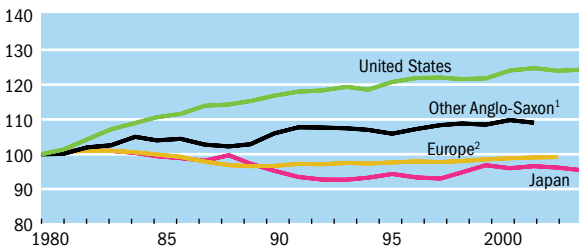


Source: IMF staff calculations.
Note: Data are for 1982–2002 or longest period available, except for Japan, where 1986–2001 was chosen because changes in the relative import price in earlier years reflected the yen's strong appreciation rather than globalization.

Technological change has especially depressed the share of income going to unskilled labor, and growth in total real labor compensation in unskilled sectors has hence been sluggish. In the United States, the United Kingdom, and Canada, this was reflected in very small increases in real labor compensation per worker and a growing earnings gap between skilled and unskilled sectors while unskilled employment held steady. In Europe (excluding the United Kingdom), in contrast, real compensation per worker in unskilled and skilled sectors has grown broadly in line with each other, but employment in unskilled sectors has contracted.

. . . especially in the unskilled sector, leading to a growing earnings gap in Anglo-Saxon countries.

(skilled to unskilled real labor compensation per worker, index 1980=100)



Sources: See Chart 3.

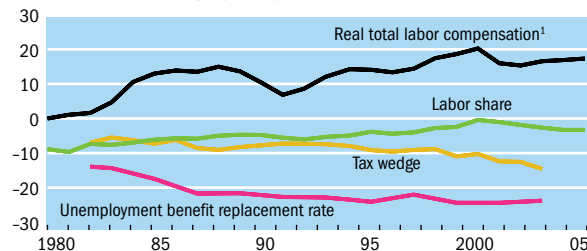
¹For analysis by skill level, other Anglo-Saxon economies include Canada and the United Kingdom.

²For analysis by skill level, Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Italy, Norway, Portugal, and Sweden.

Globalization is a vital force sustaining world growth, but policymakers need to ensure that all people benefit by strengthening access to education and training, adopting adequate social safety nets, and improving the functioning of labor markets. Steps to reduce tax wedges and ensure that unemployment benefit replacement rates do not deter workers from seeking jobs can help protect labor income in the face of the pressures of globalization.

Labor market reforms can help protect income.

(difference in labor market indicators between the United States and Europe, percent)



Source: IMF staff calculations.

¹Difference between labor compensation indices (index 1980=100).



Asia Ten Years After

A decade after the Asian financial crisis, the region is growing rapidly but still has a long to-do list

David Burton and Alessandro Zanello

TEN years ago, the Asian financial crisis of 1997–98 began to unfold. Few countries in the region were left untouched, and the aftereffects reverberated across the globe. A decade later, Asia shines in the global economic landscape, and its vitality stands out as a remarkable achievement. But what lies behind this success, and what are the new challenges for a region that has become a dynamo for the world economy?

A look back

In retrospect, the Asian financial crisis proved to be a temporary setback, despite its enormous economic and social costs. Its hallmark was the sudden reversal of investor sentiment and abrupt withdrawal of international capital. Doubts about the soundness of financial institutions and corporates spread quickly across national borders, creating a vicious circle of capital outflows, plummeting exchange rates, and crippling balance-sheet effects in the crisis-struck countries. Private demand collapsed and output in the most affected economies contracted quickly and sharply. The underdevelopment of social safety nets to protect those most exposed to economic disruptions exacerbated the social and economic impact of the slumps.

The international community stepped in to help as private investors were stampeding for the exits, providing external financing (including IMF assistance), while governments in the region adjusted policies, taking increasingly strong and appropriate action, and steps were taken to coordinate private sector financing. After some adjustments, this combination eventually turned the tide: confidence recovered and capital

started returning. As financial and real sector weaknesses were tackled, output in the hardest-hit countries began expanding again. The most determined reformers were the first to claw back the ground lost and, by 2003, GDP in all crisis countries had surpassed its precrisis level (see Chart 1). GDP per capita took a bit longer to do so.

Fast-forward

Today, Asia is among the star performers in the global economy. The region found strength in no small part by turning crisis into opportunity. The testing times of the late 1990s have rekindled a sense of regional identity and shared economic destiny. Regional policy forums have taken on renewed importance. Policy cooperation is gaining traction, and initiatives like the Chiang Mai network of bilateral swap lines among Asian central banks, which is now being converted into a reserve-pooling arrangement, and the Asian Bond Fund project provide a welcome measure of self-insurance and commonality of purpose. In addition, intraregional trade has grown rapidly, with the development of complex supply chains centered on China.

At the same time, Asia has not turned its back to the outward-looking orientation that propelled its spectacular rise on the world's economic stage. Intraregional commerce is so far complementing—not substituting for—global trade. With deepening financial and trade connections inside and outside the region, Asia's economic vitality 10 years after the crisis stands out. The countries that were most affected by the crisis have made good progress in laying solid foundations for continued growth and their medium-term prospects are bright.

What lies behind their success? The key to today's dynamism has been nimbler macroeconomic policy frameworks and comprehensive reforms in the financial and corporate sectors. More flexible exchange rate regimes have cushioned external shocks and an impressive war chest of official reserves has been built up; inflation targeting has provided a monetary anchor in many cases; and fiscal policies have taken on a longer-term perspective to safeguard debt sustainability. As for structural reforms, measures to deal with the immediate strains in the financial system have been complemented by steps to address the underlying weaknesses. Mechanisms to facilitate financial restructuring are now in place, regulatory and prudential frameworks have been upgraded, and corporate governance has been strengthened. More work lies ahead, but financial institutions and corporates in Southeast Asia have, on the whole, regained a solid footing (see Charts 2 and 3).

While the hardest-hit countries were busy cleaning up the legacies of the crisis, the rest of Asia was not standing still (see table). China and India have made further strides as regional powerhouses, the Philippines has weathered bouts of turbulence and gained considerable resilience, Vietnam has burst onto the global economic scene, and Japan has finally extricated itself from its "lost decade" and entrenched deflation.

The IMF has worked closely with economies in the region on their reform programs throughout the past decade. Increasingly, this has been done as part of the Fund's normal surveillance activities, including under new transparency and financial sector initiatives.

The next 10 years?

So what is ahead for Asia? Much will depend on whether it can tackle a number of issues over the medium term. While priorities differ across countries, a common theme stands out—coping with globalization and harnessing the tremendous upside it could deliver. For instance, the ever-greater participation of China and India in the global economy is opening up new horizons for the rest of the region, but the potential benefits do not come without risks. Nor does the increased fluidity of global capital movements. More broadly, as the pace of world integration quickens, vulnerabilities

and social strains from rapid structural change and external shocks are bound to come to the fore, hand in hand with new opportunities. Governments—in Asia, as elsewhere—need to put in place shock absorbers to mitigate the impact of negative outcomes, as well as adopt policies that help capture the gains from deeper integration.

Although the challenges are many, here we focus on just two of the most important—the need to address worsening income inequality and learning to live with potentially unstable capital flows (for a more comprehensive take on Asia's policy agenda, see "Asia's Winds of Change," *F&D*, June 2006).

Income inequality. Over the past decade, inequality has risen steadily across the region. For example, China displays now a more skewed income distribution than the United States or Russia. Even Japan, once the poster child of a fairly equalitarian society, is today more unequal than the average industrial country. In fact, widely used measures of income dispersion, such as the Gini coefficient and indicators of the size of the middle class, all point in the same direction—a more unequal sharing of income (including along a rural-urban divide) and more polarization for Asian societies (see Chart 4).

The causes of Asia's growing disparities are complex. Several factors may be at play, but skill-biased technical progress in the more advanced economies and the transition from agriculture

Chart 2

Stronger corporates . . .

In the worst-hit countries, once overgeared companies have reduced their debt.

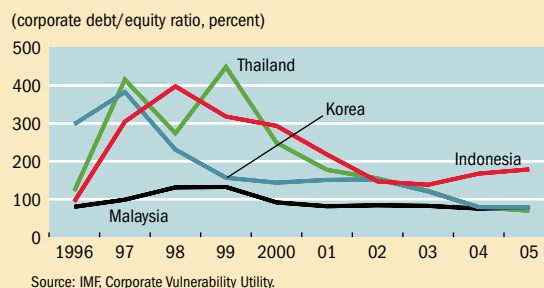


Chart 1

Temporary setback

The Asian crisis resulted in a large initial output contraction, but a recovery started relatively quickly.

(real GDP index, 1997=100)

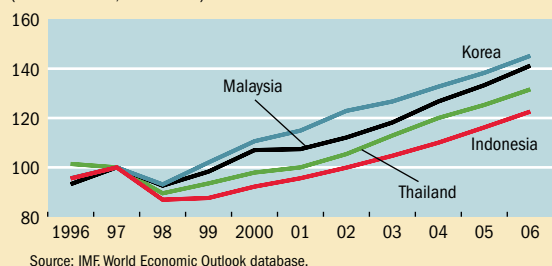
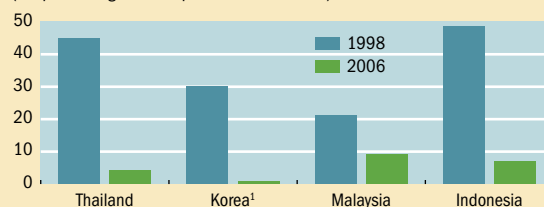


Chart 3

. . . and stronger banks

Through vigorous restructuring, nonperforming loans at banks have been brought down to more manageable levels.

(nonperforming loans as percent of total loans)



to industry in developing ones appear to be the main forces shaping income distribution in the region. Globalization is of course providing the broader context for the changes in technology and patterns of production that are at the root of differential wage and sectoral developments. Besides ethical or social implications, worsening inequality is a concern for economic policymakers. If unattended, growing disparities could strain social cohesion and undermine the support for further engagement in the global economy, in spite of great potential benefits. More broadly, tears in the social fabric could lead to inferior economic outcomes—namely, lower long-term growth, macroeconomic instability, and dwindling room for maneuver when adverse shocks occur.

Asian policymakers are looking for ways to stem the trend. Specific measures depend on individual country circumstances, but in all cases need to be supported by sound macroeconomic management, which is necessary for sustainable growth. Growth holds out the greatest promise for lifting the poor out of poverty and providing better opportunities to the disadvantaged. Policy options to address inequality more directly include greater and more effective spending on education and infrastructure to build human capital and enhance the allocation of resources; labor market reforms that facilitate hiring and improve the employment conditions of nonregular workers; more equal access to financial markets to empower the poor and improve economic efficiency; and regulatory reforms to bolster the investment climate. Because the old tend to be poorer, steps to better absorb the fiscal impact of rapid population aging will also help redress income and geographical disparities in several countries.

Unstable capital flows. The other big challenge facing Asia relates to the ongoing integration of its capital market, both within the region and globally. The region's large current account surplus continues to be the main reason for its overall balance of payments surplus. But, whereas net inflows

to emerging Asia remain close to their long-run average relative to aggregate GDP, gross capital inflows and outflows are at record highs (see Chart 5). Capital is pouring in because of ample global liquidity and an expanded international investor base. It is being attracted by improved fundamentals, favorable interest rate differentials on domestic assets (especially against the yen), and broader and deeper regional financial integration. Savings have also been flowing out of the region as never before. Active official reserve management in some cases, more relaxed restrictions on residents' investment abroad in others, and—throughout the region—better integration of markets and production structures have provided powerful drivers for gross outflows.

Gross flows have also become more volatile in recent years. The increased importance of portfolio and other investments (notably bank lending and derivative transactions) explains the trend and underscores the possibility of financial swings in either direction. Surges in capital movements (at times, in the context of yen carry trades—the practice of borrowing yen to invest in higher-yielding assets denominated in foreign currencies) have become a policy concern (see Chart 6). As the 1997–98 crisis made all too clear, rapid capital inflows carry the dangers of disruptive real appreciations, asset price bubbles, and imprudent domestic lending, on the one hand—and may lead to widespread economic and financial dislocations if they come to a sudden stop or turn into panic outflows, on the other.

No surefire policy tool exists to deal with potentially unstable financial flows, but mutually reinforcing and consistent policies hold the best promise. Greater exchange rate flexibility in the context of sound macroeconomic policies—and, perhaps, intervention to smooth exchange rate movements without undue “leaning against the wind”—may be the least costly approach to absorb surges in capital inflows, after all.

High fliers

Asia includes some of the world's fastest-growing economies.

	2005	2006	2007	2008
			Latest projection	
Industrial Asia	2.0	2.3	2.4	2.1
Japan	1.9	2.2	2.3	1.9
Australia	3.1	2.4	2.6	3.3
New Zealand	2.2	1.5	2.5	2.6
Emerging Asia	8.6	9.0	8.5	8.1
Hong Kong SAR	7.5	6.8	5.5	5.0
Korea	4.2	5.0	4.4	4.4
Singapore	6.6	7.9	5.5	5.7
Taiwan POC	4.0	4.6	4.2	4.3
China	10.4	10.7	10.0	9.5
India	8.7	9.1	8.4	7.8
Indonesia	5.7	5.5	6.0	6.3
Malaysia	5.2	5.9	5.5	5.8
Philippines	5.0	5.4	5.8	5.8
Thailand	4.5	5.0	4.5	4.8
Vietnam	8.4	8.2	8.0	7.8
NIEs ¹	4.7	5.3	4.6	4.6
ASEAN-5 ²	5.5	5.7	5.8	6.0
Asia	7.2	7.6	7.2	6.9

Sources: IMF, World Economic Outlook database; and staff estimates.

¹NIEs = Newly industrializing economies.

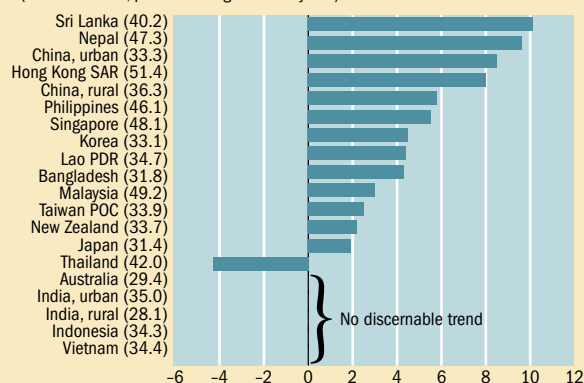
²ASEAN-5 = Indonesia, Malaysia, Philippines, Singapore, and Thailand.

Chart 4

Growing inequality

Over the past 10 years, measures of income dispersion have deteriorated in most Asian countries.

(Gini coefficient, percent change over 10 years)¹



Sources: World Bank, PovCalNet database; WIDER World Income Inequality Database; OECD; Australian and Korean authorities.

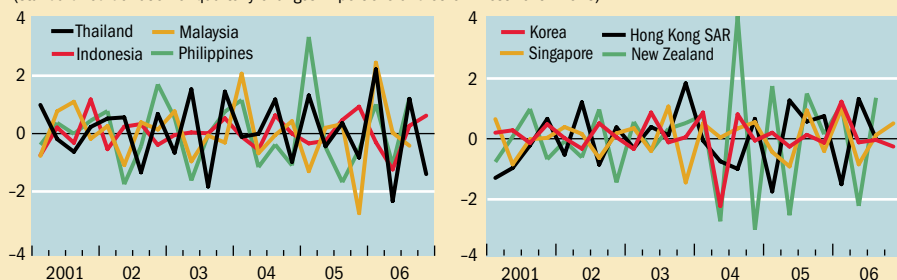
¹The Gini coefficient is a measure of inequality, with the index running from 0 to 100. A low score indicates a more equal income distribution. Values in parentheses give the latest Gini index measure, with the bars showing the change compared with 10 years earlier.

Chart 6

More volatile

Surges in capital movements in either direction have become a policy concern.

(standardized deviation of quarterly changes in portfolio and other investment inflows)



Sources: CEIC Data Company, Ltd.; IMF, *International Financial Statistics* and staff estimates.

A complementary strategy for Asia is to push forward with the development of domestic financial markets, including in the context of intraregional financial integration. Regional financial markets outside Hong Kong SAR, Singapore, and Tokyo are small, especially bond markets, and equity markets are less liquid than those in mature economies. Deeper and broader capital markets will provide a first bulwark against disruptions from unpredictable capital movements and perhaps add a measure of stability by retaining Asian savings within the region. Intraregional financial integration can be spurred

by further steps to strengthen market infrastructure, corporate governance, and risk management at financial institutions, as well as coordinated efforts to harmonize financial regulations and tax treatments. Government-led initiatives in these areas are providing helpful support to a market-driven, bottom-up process in the background. Further liberalization of remaining restrictions on outflows can also support deeper integration and potentially offset swings in capital inflows.

Growing income inequality and potentially erratic capital flows are but two examples of the challenges that globalization presents to Asia. The to-do list for Asia's policymakers is longer. Steps are needed in many cases to encourage household consumption and private investment to reinforce the domestic underpinnings of growth and limit the region's reliance on external demand. Stronger domestic demand will go hand in hand with stronger currencies throughout the region, facilitating a global rebalancing of world growth and an orderly resolution of current account imbalances.

At the same time, protectionism must be resisted as external pressures to open up domestic markets build. By the same token, it will be important to avoid distortions to trade that the proliferation of preferential trade agreements in the region threatens to create. Additional product and labor market reforms may also be necessary to facilitate the development of new areas of comparative advantage as patterns of production and trade shift. Finally, many countries need to put in place welfare systems that cushion, but do not obstruct, structural change, while policy space must be found to deal with the environmental impact of rapid growth.

* * * * *

Ten years after a major financial crisis, Asia is looking at the future with renewed confidence and has good reason to do so. Ground has been regained where it had been lost, and Asia is well positioned to be an ever-greater force in the world economy. Encouragingly, policies are increasingly attuned to the quickening pace of globalization, and the foundations for a sustained expansion are being laid. Although the list of policy issues still to address might seem daunting at first, reforms must be a continuous process in today's fast-paced and interconnected economy, and policies that address any one of these issues are likely to help on the other fronts as well. For its part, the IMF will continue to work closely with economies in the region to help them move forward with this reform process. ■

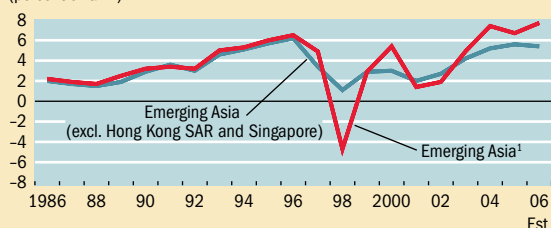
David Burton is the Director and Alessandro Zanello is an Assistant Director of the IMF's Asia and Pacific Department.

Chart 5

Flowing in . . .

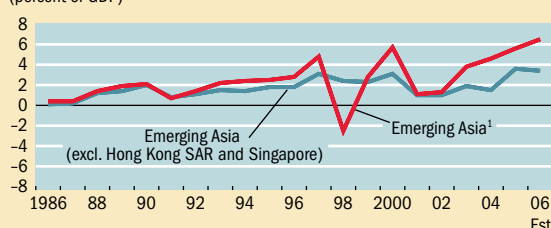
Gross capital inflows to emerging Asia, which dipped abruptly during the crisis, are now higher than precrisis levels.

(percent of GDP)

**. . . and flowing out**

Gross outflows are also at record highs, driven by several factors, including active management of reserves and better integration of markets.

(percent of GDP)



Sources: CEIC Data Company, Ltd.; IMF, *International Financial Statistics*; World Economic Outlook database; and staff estimates.

¹Excludes Hong Kong SAR until 1997.

Asia's Decade of Transformation

Zeti Akhtar Aziz, Governor, Bank Negara Malaysia



IN retrospect, the Asian crisis 10 years ago marked not a halt but the start of a greater role for Asia in the global economy. Since the 1997 crisis, Asian countries have seized the opportunity to undertake significant restructuring and reforms and to strengthen the dynamism and resilience of their economies.

The payoffs from these efforts are visible across the region. Asia is now home to the world's fastest-growing economies, which contribute about 40 percent of global output and one-fourth of world trade and hold nearly two-thirds of the world's international reserves. Most economies in the region have shared in this growth, which has helped to reduce poverty, improve living standards, and expand opportunities for more than half the world's population.

Asia has also deepened its integration with the global economy. Total trade increased from 38 percent of GDP in 1996 to 61 percent of GDP in 2006. Although such a high degree of openness means that Asia is exposed to unfavorable external developments, the region has demonstrated time and again its capacity to rebound from adverse shocks within a short period. Indeed, after the 1997 crisis, most affected economies were able to restore stability and resume growth after just one year.

Renewed dynamism

How did Asia achieve this dramatic transformation from crisis to recovery so fast? Three key elements stand out: enhanced economic flexibility, strengthened fundamentals, and improvements in the financial and corporate sectors.

First, *the greater flexibility of Asian economies* has facilitated adjustment to the changing global and regional environment, resulting in significant changes in Asia's economic structures and a shift to new growth

sectors in response to changing dynamics in global competitiveness.

Greater flexibility, including more labor and capital mobility, has enabled Asian countries to increasingly participate in the globalization of production, particularly in manufacturing, and to expand their technology-related services. At the same time that the North Asian economies have developed increasingly sophisticated products with global brands, the Southeast Asian countries have seen shifts to resource-based products and expansion of the services sector.

There has also been a greater rebalancing of the sources of growth between domestic and external demand. Private domestic consumption has grown. With saving rates remaining high, there is still potential for this trend to be augmented. Consumption demand has been supported by rising incomes, with real GDP per capita about 75 percent higher than before the crisis. In the long term, this trend is expected to be reinforced by the demographic structure of many of the countries in the Asian region that have younger populations.

The private sector is also more involved. Private investment, which was initially slow to recover, has gained momentum. The potential for greater investment is also driven by rising infrastructure requirements throughout the region, estimated at \$1 trillion over the next five years. The investment climate has improved amid the better economic conditions and more efficient functioning of public delivery systems that have been put in place.

Second, *Asia's macroeconomic fundamentals have strengthened*. Current account balances are in surplus, foreign currency reserves are at record highs, and external debt levels are significantly lower and have improved maturity profiles. Governments' budget positions are broadly stronger, and governments are taking measures to ensure greater fiscal sustainability.

Inflation has generally been contained, despite being affected by the recent higher oil prices. More flexible exchange rate regimes are also in place, creating the potential for more efficient adjustments to external shocks.

Third, *financial and corporate reform and restructuring* are having an impact. The payoffs from structural enhancements in the financial sector have been significant. Asia's banking sectors are stronger, as seen in their capitalization, profitability, and asset quality. Corporate governance, risk management, and regulatory and supervisory oversight have improved. Similarly, corporate balance sheets have strengthened considerably, with significantly improved standards for corporate governance. Another major development since the crisis has been the development of the capital markets, particularly the bond market. This has led to greater diversification of sources of financing for the corporate sector as well as expanded asset classes for investors.

Asia's stronger domestic financial sectors have established the preconditions for greater liberalization and deregulation, enhancing not only the range of business opportunities for financial institutions but also their potential to expand beyond domestic borders and build further on regional economic linkages.

More regional integration

The cumulative effect of all the changes since the crisis has been to position Asia as a dynamic and resilient region in the global economy. The diversity in economic structures, income levels, and resource endowments has also helped accelerate the regional integration process. Greater economic regional integration will further unlock Asia's potential.

The region has already begun to reap the benefits of increased intraregional integration on several fronts. Trade within Asia now accounts for more than half of total trade in the region. The emergence of large economies in Asia and the rapidly growing economies in Southeast Asia have created a large and expanding export market, thereby reducing over-concentration in the traditional export markets. The Asian economies have also seen increased cross-border investment undertaken to capitalize on growing opportunities and to leverage the region's diversity of comparative advantages and expertise.

Greater regional financial integration will reinforce and complement expanding trade and investment linkages. It will also play an important role in facilitating the allocation of some part of Asia's surplus funds into productive investments in the region. In addition, more effective and efficient intraregional financial intermediation of the funds will help reduce financing costs, stabilize financial prices, and increase the potential for improved diversification, thus promoting regional financial stability.

While integration is gathering momentum, Asia's ties with other emerging regions have also been enhanced. There is a rising trend of trade and financial linkages between Asia and the Middle East. The "silk road," on which silk and spices were once traded, is now a route on which oil, manufactured goods, and investments flow. Already, more than half the exports from the Gulf states are destined for Asia, and more

than one-fifth of their imports are from Asia. In addition, the emergence of Islamic financial products and services has brought together financial service providers across continents to trade on this new route. Indeed, the new silk road opens up the prospect of increased opportunities for economic progress and prosperity.

The changes since the crisis have positioned Asia as a dynamic and resilient region in the global economy.

Asian integration, both within the region and with other parts of the world, will boost the region's potential to become an important engine of growth in the global economy. This process should contribute to the rebalancing of global growth and to the adjustment of global imbalances.

Strengthening cooperation

During the 1997 crisis, the Asian economies did not come together to contain the crisis and facilitate its resolution collaboratively. The severity of the crisis for the financial markets and, subsequently, for the domestic financial systems and economies was a new phenomenon for the region. The countries had to restore domestic stability prior to formulating a holistic approach to managing the crisis. In addition, there was no authoritative assessment of whether the programs the crisis countries subsequently implemented would produce the desired outcomes.

Ten years on, efforts to strengthen the domestic economies and the financial systems have been reinforced by improved regional surveillance, including of cross-border financial flows, and by putting in place institutional arrangements that could contribute to crisis containment and management. Regional cooperative efforts will continue to be strengthened.

As Asia advances toward increased integration and strengthened cooperation, it is important to recognize the different regional strengths and complementarities, together with those of the multilateral agencies, and the need to maximize synergies and avoid duplication of efforts. Constructive engagement is essential. Efforts in some areas will need to be undertaken by the regional authorities, and some efforts will benefit from regional and greater international cooperation. As part of this process, Asia needs the space to pursue greater regional integration and cooperation. This process would require mutual respect and greater engagement with the region and the multilateral agencies.

Asia's increasing role in the global economy further reinforces the need for it to have a commensurate voice and representation in the international financial community. Asia's perspectives need to be better understood and to be taken into consideration in international discussions and decisions. This would contribute to more comprehensive and effective solutions to address the current global economic and financial challenges. ■

Korea: In Search of a New Compact

Un-Chan Chung, Professor at Seoul National University's School of Economics



BACK in 1997, the Asian financial crisis seemed like it was primarily a liquidity problem—at least in Korea, where the monetary authority had to struggle by the hour to prevent foreign exchange reserves from drying up, until Korea was saved by a huge loan from the IMF. If that's the correct diagnosis, then the affected countries may be said to have learned more than their share of lessons.

First, their foreign exchange reserves are now at much more comfortable levels than before the crisis. For example, since August 2001, when Korea finished paying back the IMF the money it had borrowed during the crisis, it has accumulated foreign exchange reserves of more than \$240 billion—a dramatic improvement from a meager \$7 billion in 1997. Second, the earlier problem of “overinvestment” in Asian countries no longer exists. Investment rates have fallen and net exports have climbed, helped by the drastic depreciation of some Asian currencies during the crisis. Third, the macroeconomic picture in Asia is now bright. Again using Korea as an example, nearly all macroeconomic indicators look quite robust: GDP growth rates fluctuate around 4–5 percent—not bad for a country whose GDP per capita is approaching \$20,000 a year—inflation is below 2.5 percent, and the unemployment rate is below 4 percent.

However, despite what the macro figures imply, it is not very clear whether the Asians who went through the financial crisis are truly better off. In Korea, many people feel that their quality of life is worse now than it was before the crisis. Nor do the nice macroeconomic numbers automatically translate into happiness for ordinary people. This discrepancy raises the question of whether there has been a fundamental change in Korea's economic structure since the crisis. To determine that, we need to look at both the

financial crisis itself and the events before and after as part of a structural problem instead of as a simple liquidity problem.

Looking behind the numbers

Before the financial crisis in Korea, the main players in the country's economy, including financial institutions, large conglomerates, and the government—also known as “Korea, Inc.”—formed a kind of huge risk-sharing system. But it was a system that incorporated fatal problems. Korea's large conglomerates comprised numerous seemingly independent companies that were interlinked through a web of affiliations and cross-payment guarantees. Their profits were often overstated because of the internal transactions taking place among them. And, in the case of financial institutions, the scale of bad loans was underestimated because nonperforming loans excluded substandard loans.

Policymakers refused to admit the difficulties that the Korean economy was facing and, instead, continued to insist that the nation's economic foundation was sound. In such an environment, moral hazard was prevalent among nearly all economic players—including private enterprises, financial institutions, workers, and depositors—mainly because society believed that all of its losses were implicitly guaranteed by the government. Indeed, the government implicitly or explicitly forced financial institutions to guarantee large conglomerates against risky investments, and any burden of loss was covered by the entire nation. It is quite obvious that such behavior was incompatible with the forces of globalization. Admittedly, however, it was also an easy way to create jobs and maintain economic stability.

The problem is that such a risk-sharing system becomes increasingly incompatible as

the economy grows bigger and more complex. This is even truer in a globalized environment. In a sense, such a gap between local and global standards reflected an unwillingness to adapt to globalization. It was only when faced with a crisis that the Korean economy was forced to adapt.

Adopting painful measures

After the IMF and the international community stepped in with big loans, Korea had to adopt painful measures to bring things back under control—including tight monetary policies; stringent government budgets; a free-floating exchange rate system; financial sector restructuring, with nine banks merging to form four successor banks in two years; tightened prudential regulations; and enhanced transparency of financial information.

These policy measures had a powerful impact: the economy not only recovered but underwent a major transformation. For example, banks and big businesses are no longer 100 percent protected, and none of them harbors the deluded perception that it is “too big to fail.” However, this is not a story with an entirely happy ending.

With its sound macroeconomic numbers and more globalized standards, the Korean economy should by now

“A new social compact must be established if the globalized system is to achieve success in Korea—and, perhaps, in other Asian countries as well.”

resemble an advanced one more closely. But instead it suffers from polarization and increased inequality. House prices have gone up dramatically, pricing some people out of the market. In addition, even 10 years on, most self-employed people have been unable to recover their precrisis living standards. In fact, it was these very people, the ones with fewer resources, who bore the brunt of the pain of change and restructuring. This, in turn, hampered the growth potential of the economy, as human capital was eroded in the middle- and lower-income groups.

Therefore, although it is true that the financial crisis is over, the economy is still forced to adjust to internal and external changes, and pain is still felt by those not fortunate enough to share the benefits of recovery.

New compact needed

The heart of the problem in postcrisis Korea lies in the fact that, although the old way of doing things was ostensibly swept away, a new structure has not really evolved to replace it. For example, while Korean companies try to formulate their plans according to global standards, their interactions with one another and with their environment are still rooted in the old ways of doing business in Korea.

Globalization has also brought with it a more hard-nosed attitude by business that has reinforced the sense of polarization in society. For example, since the crisis, a conservative attitude and an emphasis on short-term profit may have raised the soundness of banks, but have also hurt the development of small and medium-sized companies that lack adequate collateral. Understandably, banks feel more comfortable lending against real estate rather than against business plans or the say-so of individuals. This, in turn, has shrunk a potential source of wealth for banks. As a result, the scenario resembles an inferior Nash equilibrium in which, eventually, everyone loses—not what we want from a globalized economy.

How has the Korean economy slipped into this unsatisfactory position? The main reason, it seems to me, is that Korea lacks an effective common understanding about how things should be run in this new era.

As we have seen, before the crisis, Korea had its own unique business culture epitomized by the triangle consisting of the government, financial institutions, and big conglomerates. This overarching structure of Korea, Inc., has been destroyed, in part by the crisis and in part by an inevitable process as the economy grows larger and becomes increasingly exposed to the wave of globalization. However, right now, while the old system no longer works, the Korean economy seems to have no firmly established mechanisms through which individual actions can be coordinated and risks can be managed in a way that is compatible with the global standard.

In my view, a new social compact must be established if the globalized system is to achieve success in Korea—and, perhaps, in other Asian countries as well. In a sense, one can regard an accepted ethos as similar to tacit knowledge. Although global standards that work well in affluent nations can be exported to developing countries, in many cases, the invisible or seemingly unrelated parts that form the basis of well-functioning global standards are neither readily available nor easily transferable. For example, one can easily see that social safety nets that mitigate workers' fear of restructuring, the trust and reputation that facilitate market transactions, and the legal systems that support markets are not easily exported to developing countries.

The potential role of this invisible but important part of human interaction should not be underestimated. The social capital of trust, an accepted long-term view, and shared norms that generate a positive environment for everyone are needed to ensure transparency and to guarantee that market principles work properly. Without accepted norms of operating, the law of the jungle will win out over a regulated market economy, reinforcing the position of economically powerful agents over that of less powerful ones.

Although it will take a long process of trial and error to build a well-balanced economy supported by an overarching set of accepted economic and social norms, political leadership can do a lot to improve things in the meantime, especially in the area of conflict management between the winners and the losers in these changing times. ■



Underutilized Capital

A worker makes harmonica parts at a state-owned factory in Shanghai.

David Dollar and Shang-Jin Wei

If the investment bias toward inefficient state enterprises ended, China could increase living standards substantially without sacrificing growth

CHINA is growing at such a break-neck speed that it may appear superfluous to suggest how to do better. The Chinese growth is in large part driven by capital accumulation and exports. The country's investment-to-GDP ratio has been high and rising in recent years, growing from less than 35 percent a decade ago to more than 40 percent in 2005 (see Chart 1). This is substantially higher than in advanced economies and even most other East Asian countries (which have averaged around 25 percent in recent years). Many China watchers worry that some of the investment, especially that by state-owned enterprises (SOEs), is not efficient because domestic private and foreign firms both have higher returns to capital than SOEs. Private and foreign firms could achieve the same output using less capital, thus freeing resources in China for other uses such as in-

creased consumption. Improved efficiency would also result in higher profitability for the corporate sector and contribute to an improvement in the balance sheet of the banks that fund the firms.

There are several reasons why SOEs may, on balance, be less efficient than domestic private firms:

- They may face more administrative interference, such as restrictions on hiring and laying off workers and on switching product lines in response to changing market conditions.
- SOEs often do not have a compensation scheme that encourages management to maximize economic efficiency and avoid overinvestment and "empire building."
- Some SOEs also have weak corporate governance that may provide opportunities for management to divert firm assets into their private pockets.

- Banks owned mostly by the state, as well as the domestic capital market, favor state-owned firms, directly in the past and mostly indirectly now.

Thus, for these various reasons—weak corporate governance, inappropriate incentives at the SOEs, inappropriate incentives at the state-owned banks, and limited access of private firms to stock equity—there could be a gap in returns to capital across firms of different ownership. Such a return differential would imply that if the distortion to capital allocation were reduced, the massive national investment in China could be reduced without affecting growth outcomes. In this article, we report some new research that quantifies the gap in returns to capital in China and estimates possible gains in consumption that could result from removing the inefficiencies.

Uneven access to finance

The Chinese financial system, dominated by banks largely owned by the state, appears to continue to favor SOEs in spite of steady effort by the authorities over the years to increase the commercial orientation of these banks (see Chart 2). Although SOEs represent a declining share of national output—only about 40 percent in 2005 compared with 53 percent a decade ago and 70 percent in 1985—their borrowing from domestic banks accounts for more than half the total lending by these banks. Moreover, majority state-owned firms account for most of the publicly traded companies on China's two stock exchanges. Some of the bias toward SOEs may be related to the smaller size and higher risk of lending to some private firms. But it is common to hear private firms complaining about the difficulty they face in securing funding for both short-term working capital and long-term investment needs even when they have size and risk profiles comparable to their state-owned peers. In other words, more often than their state-owned counterparts, private firms are likely to have to forgo high-return projects because they cannot obtain funding.

Is there a significant difference in the returns to capital across firms of different ownership or firms in different loca-

tions? Has the country succeeded in removing the bias in its financial sector in favor of SOEs after nearly three decades of economic reforms?

We investigated these questions using a data set derived from a survey that we designed and carried out in 2005. The survey covered 12,400 manufacturing firms in 120 cities across China. In this stratified, random sample, one-third of the firms are large, one-third medium, and one-third

“More often than their state-owned counterparts, private firms are likely to have to forgo high-return projects because they cannot obtain funding.”

small. The first interesting result is that only 8 percent of the firms are majority state-owned, indicating that the manufacturing sector in China is now largely composed of private firms, both foreign and domestic (see Chart 3). But the state-owned firms tend to be much larger, so that they account for about one-third of all the capital stock covered by the survey (see Chart 4). They also account for about one-third of the ongoing investment, so they remain a significant part of the Chinese economy.

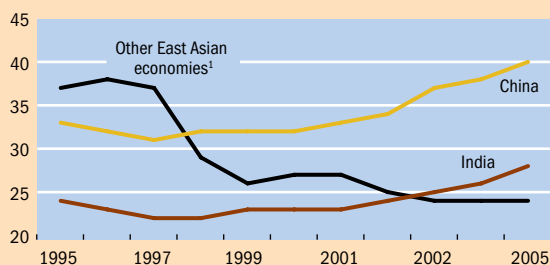
For every firm in a given sector and location, the study computed the return to capital as the value added minus the payment to labor, divided by the stock of capital. Firm-level returns were then regressed on a set of indicator variables representing sector-time pairs and locations, as well as a set of indicator variables representing firm ownership. The sector-year indicators capture the possibility that demand or

Chart 1

Investing a lot

China invests a far higher proportion of its GDP than its neighbors.

(investment-to-GDP ratio, 1995–2005)



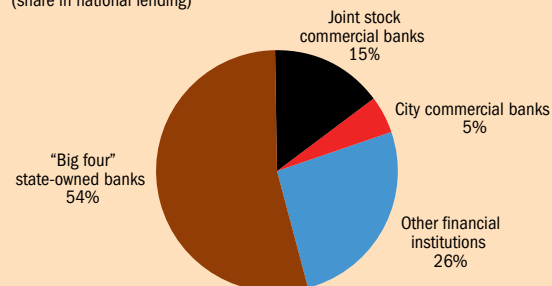
Source: IMF, *International Financial Statistics*.
¹Average for Korea, Thailand, and Singapore.

Chart 2

State-owned banks dominate

The “big four” banks favor state-owned enterprises and account for more than half of total lending.

(share in national lending)



Source: *Almanac of China's Finance and Banking* (2005).

supply shocks in a given sector-year could cause returns in that sector-year to be different from others. The ownership indicators measure the returns of various ownership groups relative to domestic private firms. These ownership groups are defined in a way that is mutually exclusive: wholly state-owned, majority state-owned, minority state-owned, wholly foreign-owned, majority foreign-owned (with no state shares), minority foreign-owned (with no state shares), and collectively owned.

Conceptually, managers would equate a firm's marginal revenue product of capital (MRPK)—the increase in total revenue that results from an additional unit of capital—to the sum of market interest rate, depreciation rate, and distortions in the capital market that the firm faces. If capital is efficiently allocated, then the returns to capital should be equalized across all firms, regardless of sector, location, or ownership. The difference in the returns between two firms in the same sector reflects mostly the difference in the cost of capital. For example, if SOEs receive more favored

treatment than domestic private firms in borrowing from banks or in obtaining government approvals to be listed in the domestic stock market, then the returns for SOEs would tend to be lower than those of private firms, on average (see Chart 5). Using this framework, the study assesses three types of inefficiency, or biases in capital allocation at the level of ownership, location, and sector.

A number of findings emerge:

- Most important, ***largely state-owned firms were found to have lower returns to capital than private or foreign firms.*** The median rate of return for private firms is 63 percent. In contrast, the median values for wholly and majority state-owned firms are 37 percent and 52 percent, respectively. These numbers all appear large because they are computed before tax and depreciation and reflect all other distortions to cost of capital. The key point is that the returns to capital are not equalized across ownership types, and SOEs have substantially lower returns than private firms.

- ***There is a significant location bias in capital allocation in favor of western provinces, even though returns there are the lowest.*** Firms in the eastern section of the country—the Yangtze River Delta region (Shanghai, Jiangsu, and Zhejiang) and Bohai Circle (encompassing Beijing and Tianjin)—have the highest returns to capital, and the remaining regions have intermediate levels of returns. Part of this location bias may reflect deliberate policies to channel funds to poorer regions, but the forgone efficiency costs have not typically been quantified.

- ***There is also an allocation bias at the sector level.*** Many less-efficient sectors, such as printing and copying products and wood processing, tend to receive greater investment than more-efficient sectors, such as black metallurgical refinery and leather and associated products. However, the sector-level bias is not as significant economically and statistically as the biases at the ownership and location levels. Some of the sector-level bias may be justified by environmental concerns or other considerations.

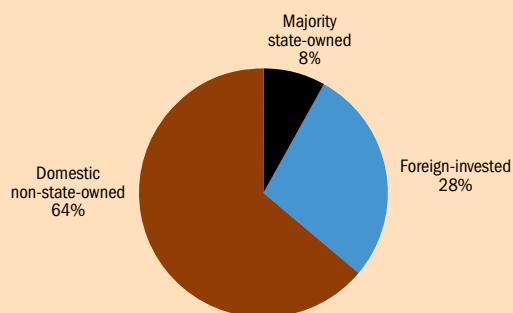
We have also studied the marginal revenue product of labor (MRPL)—the increase in total revenue that results from an additional unit of labor—across firms. The results indicate that wholly state-owned firms have both lower MRPL and lower MRPK than private firms, suggesting that they have lower total factor productivity and easier access to financing. On the other hand, partially state-owned firms have slightly higher MRPL but lower MRPK. This pattern is consistent with the interpretation that their total factor productivity is no lower than that of private firms, on average, but they have easier access to credit than their counterparts in the private sector.

Our findings do indicate that China has made considerable progress in reforming and privatizing state enterprises. The manufacturing sector is now largely in private hands. Many remaining state enterprises are profitable, suggesting that there has been some effective reform of corporate governance. That said, the productivity of capital in majority

Chart 3

Most firms are private . . .

Of 12,400 manufacturing firms in the sample of 120 cities, only 8 percent were majority state-owned.

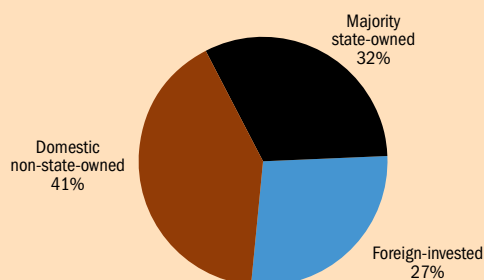


Source: Dollar and Wei (2007).

Chart 4

. . . but state-owned firms are bigger

State-owned companies account for one-third of the manufacturing assets.



Source: Dollar and Wei (2007).

state firms is lower than the return in private firms, both foreign-invested and domestic, suggesting that the reform of the SOEs has not gone far enough.

Policy implications

So what does this mean for policy? On the one hand, the aggregate cost of the inefficient financial allocation, especially the bias at the ownership level, is sizable. For example, if China could raise the returns on the stock of capital currently employed by state firms (for example, by transferring some

“One possible reform would be to require state firms to pay dividends, which could become a general source of revenue for the budget.”

of the capital to private firms or by making further changes in the incentives faced by the managers of SOEs), then the country could reduce its very high investment rate substantially, by approximately 6 percent of GDP, without hurting its growth rate. Such an improvement in investment efficiency could lead to a faster rise in household consumption and living standards by a corresponding amount every year. China has a stated goal of “rebalancing” growth to some extent away from investment and exports and toward domestic consumption, and further reform of the financial system and of corporate governance in state firms would support this objective.

On the other hand, China’s accession to the World Trade Organization has given rise to significant financial sector liberalization (in addition to greater trade openness). The

scope of the liberalization is somewhat constrained by various regulations, such as a relatively large minimum capital requirement for banks. Nonetheless, by increasing competition from foreign-owned financial institutions, the financial sector liberalization may steadily provide the impetus needed to prod domestic banks to rid themselves of inefficient lending practices, especially if the government accompanies the liberalization by moving away from the practice of bailing out failed banks. In the current environment of robust global and Chinese growth, most manufacturing firms are profitable; so lending to the less efficient ones might reduce bank profitability, but it does not necessarily lead to an increase in nonperforming loans. However, if there were any slowdown in the economy, state-owned banks might find their nonperforming loans increasing, and the risk of a financial crisis would increase as well.

Finally, in the current environment, about half of all enterprise investment—whether state or private—comes from retained earnings. Our finding is that state firms tend to reinvest their earnings even though the marginal return is low. These firms pay taxes but do not pay dividends to the owner or its representative, the government. One possible reform would be to require state firms to pay dividends, which could become a general source of revenue for the budget. China could use these funds to help finance its stated goal of improving social services, especially in rural areas. This would both directly and indirectly tend to raise consumption in China.

Many SOEs are taking on social objectives, such as reducing unemployment by overhiring workers. So part of their labor payment might be regarded as a disguised unemployment insurance. To the extent that these noneconomic functions are socially valuable, they should be taken into account in designing reform strategies for SOEs, some might argue. We are sympathetic, but note that decision makers need to calculate properly the social cost of the de facto subsidized financing of SOEs in terms of forgone household consumption. Compared with the alternative strategy of financing the expansion of the more efficient private sector and absorbing excess labor in this way, overfinancing SOEs is likely to be an inferior way to achieve these social objectives.

In summary, structural measures—such as further improving the lending practices of banks, easing access of private firms to the stock market, collecting dividends from state enterprises, and continuing to privatize firms—could help China meet its macroeconomic objective of continuing to grow rapidly, but with less investment and more consumption. ■

David Dollar is the World Bank’s Country Director for China and Mongolia, and Shang-Jin Wei is Assistant Director and Chief of the Trade and Investment Division in the IMF’s Research Department.

Reference:

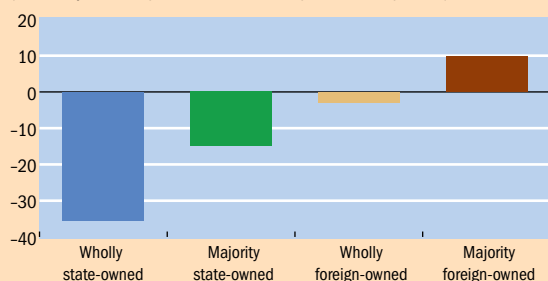
Dollar, David, and Shang-Jin Wei, 2007, “Das (Wasted) Kapital: Firm Ownership and Investment Efficiency in China,” IMF Working Paper No. 07/9 (Washington: International Monetary Fund).

Chart 5

State-owned firms invest less efficiently

Relative to private firms, a given amount of investment by state-owned firms generates much less value added.

(MRPK¹ by ownership relative to domestic private firms, percent)



Source: Dollar and Wei (2007).

¹The marginal revenue product of capital (MRPK) is the increase in value added that results from an increase in one unit of capital, other inputs held constant.

Getting Together

The new partnership between China and Africa for aid and trade

Ulrich Jacoby

CHINA is itself a developing country, but it is also fast becoming a major player in the development of sub-Saharan Africa (SSA). Its brisk growth and resulting hunger for oil and other commodities has propelled trade with resource-rich Africa, and Chinese companies are investing across the continent. Moreover, at a time when Africa is still waiting for the scaling up of aid promised by major industrial countries at the 2005 Gleneagles economic summit, China has already sharply stepped up its aid to SSA and recently pledged to do even more—remarkable from a country that is still among the top 10 recipients of official development assistance.

Huge rise in trade and investment

On the trade front, in 2005, SSA exports to China shot up to \$19 billion, or 15 percent of the region's total exports, from some \$5 billion in 2000 and negligible levels in 1990. This 30 percent annual growth since 2000 accounts for about one-fifth of SSA's total export growth during that period. The emergence of China as an important trade partner for SSA is most pronounced for fuels and raw materials. In 2005, China received one-fourth of SSA's raw materials exports and one-sixth of fuels in 2005; conversely, one-fifth of China's fuel imports came from SSA. Overall, China is now SSA's single largest Asian trading partner and its fastest-growing trading destination (see chart).

SSA imports from China—most of which are manufactured products—also surged, from \$3.5 billion in 2000 to over \$13 billion in 2005, again almost 15 percent of total SSA imports.

On the investment front, Chinese state-owned companies often enter into joint ventures with SSA state-owned companies to secure sources of commodities. In Angola, the Chinese company SINOPEC is investing \$3.5 billion in a partnership with Sonangol to pump oil from recently auctioned offshore blocks and plans to build a \$3 billion refinery. In Gabon, the CMEC/Sinosteel consortium, financed by the Chinese Export-Import Bank, is investing about \$3 billion in exploit-



A Chinese construction worker supervises the building of a road in Ethiopia.

ing iron ore deposits; the plan is to construct a railway, a port, and a hydroelectric power station in return for exclusive rights to develop the mine. And in Equatorial Guinea, a subsidiary of the China National Offshore Oil Corporation (CNOOC) recently signed a production-sharing contract with the National Oil Company of Equatorial Guinea (GEPetrol).

Stepped-up Chinese aid

China has substantially stepped up its aid, which it provides in the forms of technical assistance, with an emphasis on training in Chinese institutions; grants; interest-free loans; preferential loans that have an interest subsidy; and debt relief. But China is not a member of the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD), which reports on members' international aid, and China does not provide details about the level and terms of its own aid to other countries—so data and information in that regard are sketchy.

China's financial assistance to Africa is substantial: as of 2006, existing loans and credit lines are estimated to total about \$19 billion. The beneficiaries of the largest flows are Angola, Equatorial Guinea, Gabon, Republic of Congo, and Nigeria—with Angola and Equatorial Guinea alone having credit lines totaling about \$14 billion. The proportion of grants is small, but China recently cancelled an estimated \$260 million in debt for the Democratic Republic of the Congo, Ethiopia, Mali, Senegal, Togo, Rwanda, Guinea, and Uganda.

The assistance is largely for energy, telecommunications, and transportation projects. Aid is mostly provided in kind, usually by Chinese companies, and tends to be on a turnkey basis, mostly with Chinese inputs, including labor. Projects are concentrated in economic and social infrastructure such as roads and hospitals; the productive sector, notably agriculture; and other construction projects, such as government buildings and sports stadiums. They are often accompanied by deals to develop mining and energy resources.



China prides itself on not attaching political conditions to its aid (other than support for the “one China” policy), and emphasizes that partners are on an equal footing by stressing South-South cooperation. The concessionality of loans varies widely. Some large loans and credit lines have not been fully concessional, although they are on more favorable terms than the market. However, a recent \$2 billion credit line to Equatorial Guinea and numerous smaller loans to SSA countries are concessional. The degree of concessionality of a project also depends on other aspects, such as the requirement that only Chinese companies using Chinese products bid for the projects (70 percent of Chinese credit lines in Angola have been used this way). Also, repayment of loans

has sometimes been tied (as in Angola) to the supply of oil. As for debt relief, China has its own initiative, the terms of which are not necessarily consistent with those of the multilateral enhanced Heavily Indebted Poor Countries Initiative.

Big increases planned

China plans substantially more aid to Africa. At the Beijing Summit of the Forum on China-Africa cooperation in November 2006, President Hu Jintao announced that China would double its 2006 assistance to Africa by 2009. He also said China would provide \$5 billion in preferential credits (of which \$2 billion would be buyers’ credit), establish a \$5 billion development fund to encourage and support investment by Chinese companies in Africa, and cancel all interest-free government loans due at end-2005 owed by the poorest and least developed countries in Africa with diplomatic relations with China. China would also boost trade access for these countries by raising the number of their export items that receive zero-tariff treatment from 190 to over 440; establish three to five trade and economic cooperation zones in Africa; provide assistance in the social and health sectors; and build a conference center for the African Union. During the summit, com-

mercial contracts worth \$1.9 billion were concluded in various sectors, and the intention to more than double bilateral trade to \$100 billion by 2010 was announced.

Policy implications for SSA

Faced with this largesse, how should African countries react? Certainly the continent needs additional resources to make more progress toward the Millennium Development Goals—on which Africa lags behind—and boost living standards. Rising trade and direct investment could create employment opportunities and facilitate the transfer of technology. But in order to make the most of the opportunities provided by China, African countries should also strengthen their own policies relating to both trade and aid use.

Trade. SSA countries should proceed with trade liberalization by encouraging intraregional trade and division of labor. This would help keep costs low and competitiveness high and make the most of access to shipping. Improved regional infrastructure and more effective border and customs procedures would also help. Moving up the value chain based on traditional SSA exports, in particular in agriculture and raw materials, would increase export values and help these countries better exploit preferential access to the European Union and the United States. In doing so, SSA countries would benefit from cooperation with Chinese partners in overcoming market entry hurdles such as technical and quality standards, given their successful experience in entering Western markets. The scope for seeking out partnerships with Chinese firms is significant. However, SSA countries will need to ensure a level playing field for all foreign investors in order to maximize investment from abroad.

Aid. Aid flows from China should be laid out transparently to other donors and development partners, including those that are locally present. This will help not only the harmonization of activities but also the integration with economic policies to underpin macroeconomic stability.

To preserve fiscal and external sustainability, the volume and terms of loans should be compatible with the low-income country debt sustainability framework of the IMF and the World Bank. Assistance should also be aligned with national priorities of the recipient countries, as formulated in their poverty reduction strategies.

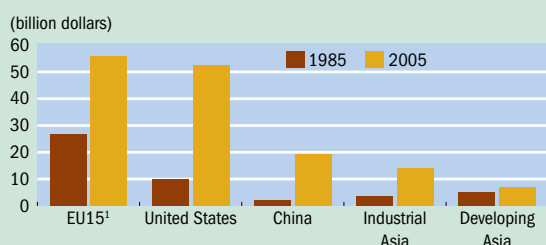
Finally, the provision of turnkey projects using mainly Chinese labor has its pros and cons. It offers particular benefits in countries with short-term limitations to their implementation and absorption capacity and appears to ensure timely delivery of a capital stock that expands the supply response of the domestic economy. However, it likely scores lower in terms of creating local employment, enabling effective technology transfer, and ensuring the sustainability of projects.

In the medium term, to maximize benefits from Chinese projects, SSA countries should strive to provide more local skilled labor, thus raising employment, and move toward forms of cooperation such as joint ventures that better promote technology transfer and sustainability. ■

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Export boom

Africa’s exports—mostly commodities, raw materials, and crude oil—have shot up over the past two decades.



Source: United Nations, Comtrade database.

¹Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.



Connecting Africa and Asia

Improved Asian market access can boost Africa's exports, but Africa needs domestic reforms to fully capture the economic benefits

Harry G. Broadman

THE recent boom in developing country commerce between Africa and Asia epitomizes the explosion of South-South trade. These trade flows are driven by the burgeoning middle classes in Asia's emerging economic giants—China and India—whose appetite for Africa's commodities is growing, and by rising economic growth in sub-Saharan Africa (SSA), which is increasing the demand for Asian manufactured goods.

These trends are fostering trade that is qualitatively different from Africa's traditional North-South commerce with the European Union (EU) and the United States, in which trade flows have been stimulated largely by preferential arrangements. The strengthening South-South complementarities between the two developing regions suggest that the trade we are observing is likely to be sustainable.

As the global marketplace becomes increasingly integrated, much is at stake for the economic welfare of millions of people in SSA. This article explores the evolution of Africa-Asia trade, as well as its developmental, commercial, and policy implications.

Africa in the global context

Over the past decade, many SSA countries have made significant economic progress. During 1996–2005, 34 percent of the continent's population resided in countries where growth was 4.5 percent or higher—and these were non-oil-producing countries. That there is an emerging class of African economic “success stories,” especially outside of the oil producers, is surprisingly little known.

Even so, SSA's trade record remains poor—in no small part because of the continent's numerous small, landlocked countries and high degree

of geographic segmentation (see box). World trade accounted for 16 percent of global output in 1991 and 20 percent in 2004. But Africa's export market shares have fallen continuously over the past six decades (Broadman, 2007).

Since 1999, prices for Africa's leading commodity exports have increased noticeably. The price rise was engendered largely by the rapid growth of Asia's developing countries, notably China and India. At the same time, the desire of these Asian countries' middle classes for manufactured goods has been rising. These demand dynamics create important opportunities for Africa's businesses to increase and diversify

Economic fortunes shaped by geography

Sub-Saharan Africa comprises a heterogeneous group of countries, each having economies, populations, and surface areas of different sizes, and in which GDP per capita ranges from less than \$200 to \$7,000. One-third of the world's resource-dependent economies are in Africa.

There are 45 small economies and 2 regional powers (South Africa and Nigeria)—together accounting for 55 percent of the continent's economic activity. Still, 18 countries, accounting for 36 percent of Africa's population, have grown in a sustained manner over the past decade. Another 14 countries, accounting for one-fifth of Africa's population, have experienced little or negative GDP per capita growth over the past decade, and many have been affected by conflict. Among them are Burundi, the Democratic Republic of Congo, and Eritrea.

Africa is also unique in both its physical and its human geography. It has the largest number of countries per square area of any developing region, with each country sharing borders with, on average, four neighbors. A large proportion of Africa's population lives in countries with an unfavorable geographic and economic basis for development. About 40 percent of its population is in landlocked countries, compared with 23 percent in Eastern Europe and the former Soviet Union. Moreover, the low population density is accentuated by high internal transport costs, estimated at nearly twice the levels of other developing regions. The result, except in South Africa and Nigeria, is small and shallow markets. Such conditions make it costly to trade in Africa.

exports. They also create the potential for African entrepreneurs to extract more value locally by further processing commodities before exporting them.

Asia-Africa trade patterns

Over the past 15 years, trade flows between Africa and Asia have increased rapidly, the hallmark of the recent growth of South-South trade.

Shifting shares. During 1990–95, Africa’s exports to Asia grew by 15 percent and, over the past five years, by 20 percent, with Africa’s export growth to Asia surpassing that to all other regions (see Chart 1). Asia is now Africa’s third most important export destination after the EU and the United States. Africa’s imports from Asia have also grown, but less rapidly than exports (see Chart 2).

Emerging complementarities. Manufactured products account for only 20 percent of Africa’s total exports, and the pattern of Africa’s exports to Asia is consistent with this global pattern. Commodities account for 86 percent of SSA’s exports to Asia, and 80 percent of SSA’s imports from Asia are manufactured goods. But there are dynamics at work suggesting growing complementarities between the continents. African countries could supply processed materials to Asian countries, linked to industrial and consumer growth. The growing populations in China and India with higher incomes are spurring purchases from Africa. At the same time, Africa is importing Asian manufactured products for consumption by households and for use as capital goods in the manufacturing sector, in which growth is taking off.

The China-India role. China and India, two of the world’s most dynamic economies, doubled their annual growth rates of Africa’s exports between 1990–94 and 1999–2004 (see Chart 3). These countries’—especially China’s—leading role also applies to Africa’s imports (see Chart 4).

Africa exports mainly petroleum and raw materials to China and non-oil minerals to India. Its exports of oil and natural gas to China account for more than 62 percent of its total exports to that country, followed by ores and metals (17 percent) and agricultural raw materials (7 percent). Africa’s exports to India are also dominated by resource-based products, with ore and metals accounting for 61 percent and agricultural raw materials for 19 percent.

From China and India, Africa imports more value-added commodities—mainly textiles and apparel, electric machinery and equipment, and such consumer products as medicine, cosmetics, and batteries. Manufactured products account for 87 percent of imports from China.

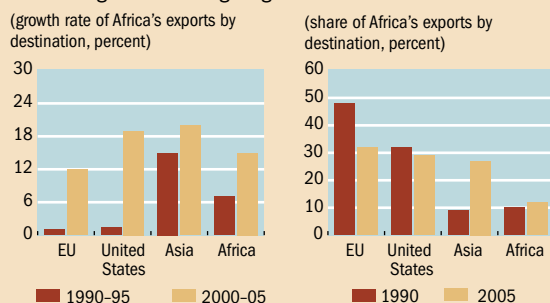
Policies “at the border”

Improved market access for low-income countries has been at the top of the trade agenda in recent years, particularly in the context of the multilateral Doha Round, but also in bilateral and regional forums. The lowering of industrial countries’ multilateral tariff and nontariff barriers on Africa’s products should increase its exports substantially. But African countries also face such barriers in the South, including in Asia’s developing countries. And some African

Chart 1

Asia dominates

Africa’s exports to all destinations have increased, with Asia accounting for the strongest growth.



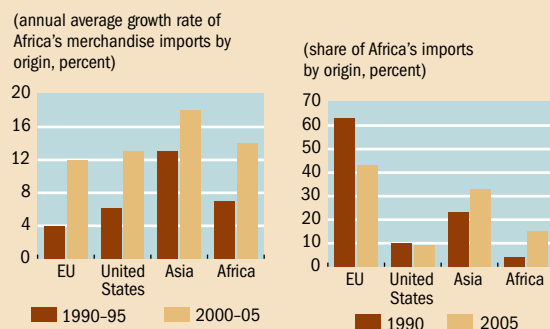
Source: Broadman (2007).

Note: Growth rate is simple average of annual growth rates in each period. Asia includes Afghanistan, Bangladesh, Bhutan, Cambodia, China (including Hong Kong SAR, and Macao), India, Indonesia, Japan, Democratic Republic of Korea, Republic of Korea, Lao PDR, Maldives, Mongolia, Myanmar, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Taiwan Province of China, Thailand, and Vietnam.

Chart 2

Rising share

In the past five years, Africa’s imports from Asia have grown faster than from other regions.



Source: Broadman (2007).

Notes: Growth rate is simple average of annual growth rates in each period. See Chart 1 for Asian countries.

countries also have high tariffs and nontariff barriers that restrict trade flows, in some cases imparting a bias against Africa’s exports.

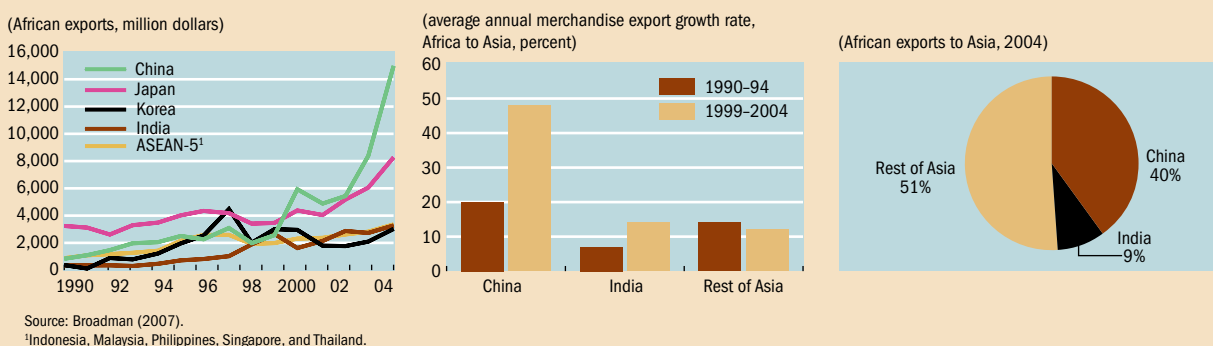
Although Asia’s tariffs on African exports are gradually declining, the trend is weak, especially for Africa’s least developed countries (LDCs). For some specific product groups, Asian tariff rates are *higher* for African LDCs than for non-LDCs. Those groups—inedible crude materials and food and live animals—account for two-thirds of African LDCs’ total exports to Asia.

Recent evidence suggests that, all other things being equal, high Asian tariff rates on some African products may be discouraging their export to Asian countries. High Indian tariffs on agricultural products are of particular concern because they affect products in which African countries have growth potential. China is a relatively liberalized market, with zero or close to zero tariffs on 45 percent of its imports. It plans to

Chart 3

Dynamic duo

Africa's exports to China and India have shot up, with these dynamos accounting for half of Africa's exports to Asia.



further lower its tariffs and bring about lower dispersion in the structure of tariffs by the end of 2007.

The structure of some of Asia's tariffs is particularly problematic for Africa's export prospects to that region. Higher tariffs are imposed on more processed products to retain higher value-added activities in the domestic market, and lower tariffs are applied to locally available raw materials, creating incentives for the domestic industry to access cheap inputs abroad and process them at home. The cascading pattern of tariff rates along the level of processing is called "tariff escalation," which discourages Africa from processing products exported to Asia. A poignant example is an Indian-owned cashew firm in Tanzania that cannot profitably export roasted nuts to India because India imposes higher tariffs on processed nuts than on raw nuts.

In some products, African producers cannot capture the benefit of low tariffs in Asian markets because they lack production capacity. One example is cocoa beans. China is slightly reducing its imports of raw cocoa beans and increasingly importing processed cocoa bean products, such as cocoa powder, cocoa paste, and chocolate. But Africa's exports of cocoa beans to China are overtaking those of cocoa powder and chocolate. China imposes a tariff of only 9 percent on finished chocolate, not very different from its 8 percent duty on cocoa beans. But even with a relatively low tariff on chocolate, Africa has little opportunity to penetrate the Chinese chocolate market because it does not have the supply capacity to produce high-quality chocolate.

Policies "behind the border"

A compelling case can be made for removing escalating (and other) tariff barriers to enable African exporters to access Asia's markets, but such reforms are not substitutes for reforms in Africa's domestic markets. These reforms include reducing domestic barriers to entry and exit and establishing institutions that foster vigorous domestic competition between companies; putting in place effective incentives and discipline to bring about sound governance; and pursuing policies that make domestic labor and capital markets more flexible. Moreover, the removal of tariff barriers will not enhance trade unless African countries are

able to produce goods cost-effectively and identify where demand exists.

Although Africa's exports to Asia as a whole do not exhibit significant product diversification, its factor endowments complement those of China and India. Africa, with its rich resources, has a natural comparative advantage in producing raw materials, including energy resources. China and India, with their rich supply of skilled labor, have a comparative advantage in manufactured products.

But there are three signs that show positive shifts in these complementarities—shifts that can be reinforced by domestic reforms in Africa. The first is the prospect for resource-based value-added manufacturing exports, which China and India are importing. African countries could increase their manufactured exports to China and India based on their existing exports of raw materials. However, growth is always limited by horizontal diversification. African countries do not want to remain a "resource basket" for other economies but instead hope to realize dynamic efficiency gains by extracting values from their endowed resources. Natural resources should allow African countries to launch value-added activities. Although still limited to a few countries, such as Nigeria and South Africa, resource-based manufactured products such as aluminum, iron, and steel figure among Africa's leading exports to China and India.

The second sign is the prospect for broader participation in global value chains. New evidence shows that vertical complementarities along value chains between Africa and China and India are growing. For example, among Africa's top 20 exports and imports with China and India, clear complementarities exist in the cotton-textile-garment value chain. West African countries supply raw material (cotton) to China and India, which supply intermediate materials (fabrics) to apparel producers in Mauritius, Nigeria, South Africa, and other SSA countries. New business case studies show that African producers could participate in global network trade in the apparel sector.

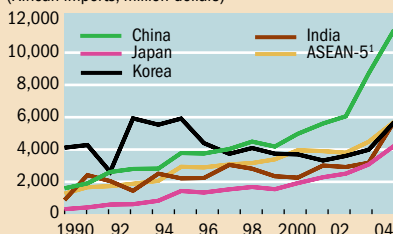
The third sign is the diversity among African countries and potential benefits from regional integration. South Africa has evolved as a regional hub of industrial and commercial

Chart 4

The China card

Africa's imports from China have soared, making it Africa's single biggest supplier of goods.

(African imports, million dollars)

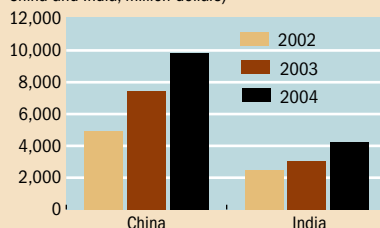
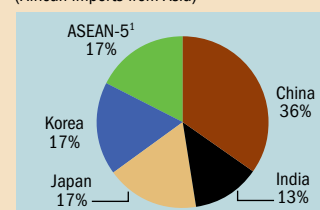


Source: Broadman (2007).

¹Indonesia, Malaysia, Philippines, Singapore, and Thailand.

²Imports are based on partner's export data, except for 2002 data for Thailand, which were based on Africa's export data.

(average merchandise imports from China and India, million dollars)

(African imports from Asia)²

development in SSA and beyond. The technological complementarities between South Africa and China and India provide scope for more intra-industry trade. Through regional integration, the emerging intrasectoral complementarities between Africa's industrial leaders and China and India could lead to wider benefits in the subregional markets through further forward and backward linkages.

Africa can benefit from the rapidly growing markets in China and India to achieve broad-based economic development. To do so, it must determine how to create an enabling environment for engaging more extensively in value-added production in the natural resource and other sectors and how to participate effectively in global supply chains. A key to entering supply chains is attracting foreign direct investment (FDI).

Asian-African FDI patterns

A large proportion of FDI inflows to SSA goes to the oil sector. For the past 15 years, 70 percent of FDI has been invested in five of Africa's seven oil-exporting countries and in South Africa, which has attracted the most dynamic FDI among African countries, including in the financial sector after its mid-1990s liberalization. Still, although 50–80 percent of FDI in most African countries goes to natural resource exploitation, some countries are increasingly able to attract FDI into the telecom, food processing, tourism, construction, electricity, retail trade, light manufacturing, and transportation equipment sectors. This is a recent phenomenon, for which Asian investors, especially the Chinese and Indians, are in the vanguard.

Chinese FDI to Africa represents a small proportion of China's total FDI portfolio, although Africa is second to Asia as the major destination of Chinese FDI. China has had economic and political ties with the region since the cold war era, with an active role in investing in infrastructure projects. Globally, 75 percent of China's FDI is in the tertiary sector, including construction and business activities, although a large proportion has recently gone to oil-rich countries. In 2002, the Chinese authorities allowed 585 Chinese enterprises to invest in Africa, accounting for 8 percent of total approvals. In terms of numbers of investment approvals,

South Africa had 98, valued at \$119 million. Today, about 700 Chinese enterprises are operating in Africa.

India has been present in Africa for decades, with its FDI mostly in the services and manufacturing sectors but also in Africa's natural resources, including the oil sector (for example, Sudan). During 1995–2004, Africa accounted for 16 percent of India's FDI, or \$2.6 billion. Like China, India seeks primarily to secure energy sources and other natural resources from Africa to support its dynamic economic growth. In eastern and southern Africa, Indian immigrants, with business ties to India and a good knowledge of Africa, have played a significant role in attracting new investment to the continent. This is especially true in recent years because India is flush with foreign reserves and the government has lifted regulations and controls, allowing firms to go abroad and removing the \$100 million cap on foreign investment by Indian firms.

An African game plan

Africa's exports to Asia have not yet significantly contributed to sustained, widespread SSA export diversification, of either trading partners or products, including with respect to greater value added through further processing. Even though the boom in natural resource exports to China and India is providing short-term benefits, African countries need strategies to leverage the current export explosion to create opportunities for long-term economic benefits.

Further reforms in at-the-border trade policies—such as reducing Asia's escalating tariffs or harmonizing or consolidating Africa's overlapping regional trade agreements—will surely help facilitate Africa's exports to Asia and elsewhere. But dealing head-on with domestic constraints in Africa is likely to be every bit as, if not more, critical. Indeed, if African countries are to enhance their global economic performance in Asia and beyond, it will take far more than simply liberalizing trade policies to reach that objective. ■

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Making Remittances Work for Africa

Sanjeev Gupta, Catherine Pattillo, and Smita Wagh

If handled well, migrant transfers can reduce poverty and connect small savers to the formal financial sector

REMITTANCES flowing into developing countries are attracting increasing attention because of their rising volume and their impact on recipient countries. In 2005, they totaled \$188 billion—twice the amount of official assistance developing countries received. Moreover, there is evidence that such flows are underreported. Indeed, remittances through informal channels could add at least 50 percent to global recorded flows. Most of the reported flows go to regions other than sub-Saharan Africa (SSA), but SSA has still been part of the overall rising global trend. Between 2000 and 2005, remittances to the region increased by more than 55 percent, to nearly \$7 billion, whereas they increased for developing countries as a group by 81 percent.

Studies relying on household data from different countries in SSA yield some insights into how remittances are used. At their core, remittances are private intrafamily or intra-community income transfers that directly address the single most relevant challenge for SSA countries: poverty. Their long-term development potential is determined by what is left over after basic consumption needs

are met. By contrast, study of the impact of remittances at the aggregate level is confined mostly to Latin America and South Asia, where remittance volumes swamp those going to SSA. This article adds some insights about the role of remittances in SSA and offers suggestions for their more effective use.

A snapshot of remittances

Africa receives just 4 percent of total remittances—by far the smallest share—to developing countries and just 33 percent of those to India, the top recipient. In contrast, countries in Latin America and the Caribbean receive about 25 percent of all remittances, as do countries in the East Asia and Pacific region. Since the 1980s, these flows to countries in Latin America and the Caribbean, and East Asia and the Pacific have grown more rapidly than the average for developing countries. In 2005, the top three recipients—China, India, and Mexico—accounted for more than one-third of the remittances to developing countries. Among the top 25 recipients, only one (Nigeria) was in Africa, but three South Asian countries were on the list (Bangladesh, India, and Pakistan).

Relative to GDP, too, the volume of remittances to SSA is smaller than to other developing countries: about 2.5 percent of GDP on average between 2000 and 2005 compared with almost 5 percent for other developing countries. But Lesotho, Cape Verde, Guinea-Bissau, and Senegal are striking exceptions (see Chart 1), and, in some countries, remittances are an important source of foreign exchange.

Remittances sent to SSA through informal channels, at 45–65 percent of formal flows, are significantly higher than in other regions. In addition, the balance of payments very likely underreports intraregional remittances. Intraregional migration is common in SSA; for example, Botswana and South Africa attract migrant workers from neighboring countries, and strong sociocultural ties in West Africa encourage labor mobility in that subregion.

How do remittances stack up against other flows to SSA? Both official development assistance (ODA) and foreign direct investment (FDI) are considerably higher than remittance receipts but are also more volatile (see Chart 2). The stability of remittances suggests that, through the securitization of future flows, they can potentially ease access to, and lower borrowing costs for, international capital. Some studies have concluded that because remittances are widely dispersed, their Dutch disease effects are relatively contained. However, as with any form of external flows, remittances do carry the risk of real exchange rate appreciation and could hurt export competitiveness in the recipient country—something policymakers must be prepared for.

Remittances, especially those from skilled migrant workers, have been associated with brain drain, a cause for concern in the region. Some analysts attribute the crisis in SSA's health sector to the emigration of skilled health care professionals, who increasingly find employment in the high-demand countries of the Organization for Economic Cooperation and

Development (OECD). By one estimate, almost one-fourth of the new overseas-trained physicians that registered with the U.K. National Health Service between 2002 and 2003 came from SSA. About 80 percent of nurses from Liberia and an equal number of doctors from Mozambique are working in industrial countries. High job vacancy or attrition rates in the public health systems of countries like Ghana, Zambia, and Zimbabwe are all attributed to migration. On average, 20 percent of SSA's population over the age of 15 with a postsecondary education works in OECD countries compared with less than 10 percent in South Asia. For some countries, expatriation rates exceed 50 percent of the educated population.

Some analysts, however, contend that the possibility of higher wages abroad has, in fact, increased the region's supply of health care professionals, even after accounting for emigration. Although the explicit costs of the migration of skilled workers are still being debated, they provide a useful context in which to evaluate the benefits of remittances.

Impact of remittances

How are remittances affecting Africa as a whole? We begin by looking at their *impact on poverty*. Remittances augment recipient households' resources, smooth consumption, provide working capital, and have multiplier effects through increased household spending. Evidence from Ghana indicates that remittances are countercyclical and, over time, help smooth household consumption and welfare, especially for food crop farmers, who are typically the most disadvantaged socioeconomic group. For the most part, remittances are used to finance consumption or invest in education, health care, and nutrition. Studies from a cross-section of developing countries tend to confirm the findings of these localized surveys.

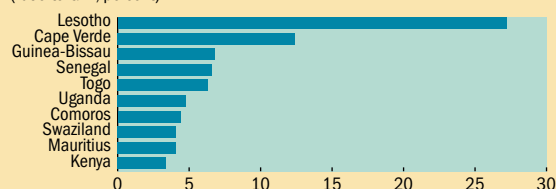
The relationship between remittances and poverty is not unidirectional. Poverty and the accompanying lack of economic opportunities play a role in motivating emigration and incoming remittances. Villages in Senegal sometimes pool resources to pay for the migration expenses of their most skilled young men. Remittances are the return on this joint investment. Poorer households with migrant worker members are also more likely to get a steady income supplement from abroad—another reason that higher poverty might mean more remittances.

Chart 1

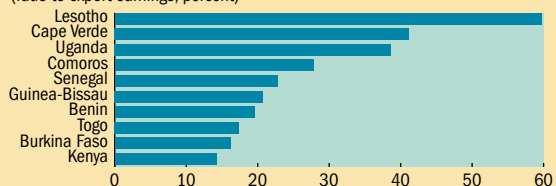
Top African destinations

Lesotho and Cape Verde receive the largest remittance flows relative to their size.

(ratio to GDP, percent)



(ratio to export earnings, percent)



Sources: IMF, *Balance of Payments Yearbook* (2006); IMF, *World Economic Outlook* database (2006); and World Bank staff estimates.

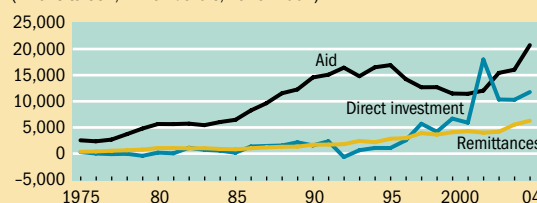
Note: Rankings are based on average remittance inflows for 2000–05.

Chart 2

Lower but steadier

Remittances are not as high as other flows but are less volatile.

(inflows to SSA; million dollars, 1975–2004)



Sources: IMF, *Balance of Payments Yearbook* (2006); IMF African Department database (2006); and OECD Development Assistance Committee database (2006).

Our empirical analysis—using data from 233 poverty surveys in 76 developing countries, including 24 in SSA—confirms the poverty-reducing effect of remittances: a 10 percent rise in the remittances-to-GDP ratio is associated with a fall of a little more than 1 percent in the percentage of people living on less than \$1 a day and the poverty gap (which measures how far below the poverty line the average poor person's income is). Further, we find that even taking into account the impact of poverty on remittances, in a model in which both poverty and remittances are simultaneously and endogenously determined, the poverty-reducing effect of remittances remains. However, the average remittance-inducing effect is slightly greater.

How about the **impact of remittances on long-term growth potential**? The direct impact depends on how households use the remittances, how migration affects the domestic labor supply and output, how recipient households respond to this steady transfer, and whether remittances promote financial deepening. Studies that focus on the labor supply response of recipient households find that remittances lower growth. But studies that link remittances to the investment channel, whereby remittances either substitute for or improve financial access, tend to conclude that remittances stimulate growth.

We looked at an indirect consequence of cross-border money transfers: **their impact on financial development**. Because migrant transfers entail cross-border flows of relatively modest sums of money, they enable low-income households to access formal financial services, starting, most likely, with savings products. But the growing interest of micro-finance institutions in this segment of the market raises the possibility of remittances serving as collateral for small business start-up capital for individuals previously excluded from the formal sector. For SSA in particular, a lack of access to formal financial services impedes financial deepening.

We investigated the impact of remittances on financial development in 44 African countries over six time periods, composed of five-year averages from 1975 to 2004. Our findings confirm that remittances promote financial deepening in the region, after controlling for macroeconomic and institutional variables that are commonly used to explain financial development in low-income countries. These results hold even after accounting for the possibility that reported remittances are likely to be higher in better-developed financial markets. Although SSA receives only a small portion of the remittances going to developing countries, their estimated effect on financial development in our study compares favorably with other studies that use a larger sample of developing countries.

Making formal money transfers affordable

Although remittances can facilitate the entry of households into formal financial markets, only a fraction of them find their way into the formal system. The high fees formal providers charge deter poor migrants, who want to send small sums of money home. Even if a migrant has access to banks, the recipient may not. As a result, many migrants rely more on import-export operators, retail shops, and currency dealers, which do not keep records of their transactions.

Informal money transfer systems modeled on the hawala system in the Middle East dominate the remittance market in several African countries. Informal providers offer such client-friendly features as anonymity, minimal paperwork, and speed. But the lack of supervision of these markets makes it a risky proposition for the recipients of small remittances to continue to rely on these channels.

The cost of formally transferring funds to SSA, especially small sums, is high. A survey of U.K. money transfer operators (MTOs) found that the fee on money transfers was lower between the United Kingdom and India, where volume is high, than between the United Kingdom and Africa (see Chart 3). The market in money transfers between SSA countries is especially underserved by formal institutions, and the prohibitive fees they charge severely depress their use. A study in South Africa found that the comparative cost of an international transfer of 250 rand was the lowest when it went through a friend or a taxi driver and the highest when it went through a bank. Although cross-border post office transfers are competitively priced, they are slower and less secure.

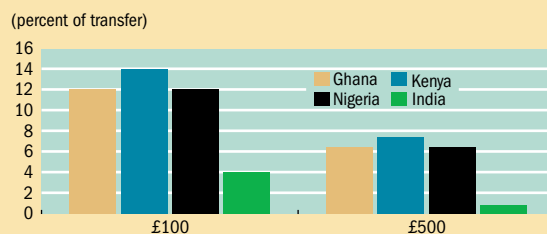
The underdeveloped financial infrastructure is another deterrent. The absence in South Africa of a major MTO like Western Union further limits competition among the players in the formal market and increases the likelihood that migrant workers will use informal channels to send money home. Since September 11, 2001, scrutiny of international money transfers has increased, and many banks are imposing more identification requirements on both individuals and small MTOs. In South Africa, only authorized dealers, who must have a banking license and have invested in an expensive exchange control reporting system, can remit funds. By further increasing the effective cost, the rules discourage remittances through formal channels. Although these costs are unavoidable for preventing money laundering and terrorist financing, there is some leeway in the extent to which they are passed on to clients.

Moreover, given excess liquidity in most SSA banks, there is little interest in the small remittances market. Most analysts see significant, untapped opportunities for banks to reduce

Chart 3

Prohibitive fees

Because of high fees on money transfers from the United Kingdom, migrants prefer informal channels to Western Union.



Source: United Kingdom, Department for International Development (2006).

Note: Fees can change as a result of exchange rate changes, so the numbers should be interpreted as indicative rather than precise.

the transaction costs on remittances, especially small remittances sent by poor migrants. Financial sector reforms that address any or all of the structural problems in the recipient and sending countries are also likely to lower the cost of remittances. In Uganda, measures permitting residents to open foreign currency accounts led to a dramatic surge in private transfers in the early 1990s. Cross-border uniformity in the regulations related to remittances and regulatory interventions where fees are prohibitive have been proposed as other cost-reducing measures.

The growing demand for remittance services in well-developed financial markets like the United States has captured the attention of major commercial banks, such as Citizens Bank and Wells Fargo. These banks see remittance services as a way to draw the attention of a significant unbanked population to their more mainstream financial products. In an arrangement with two banks in Cape Verde, Citizens Bank offers Cape Verdean migrants a remittance facility that is less expensive than Western Union. In three years of operation, this program has made more than 1,000 formerly unbanked migrants customers of Citizens Bank. However, most such programs require that the migrant open a bank account and are thus unlikely to appeal to undocumented workers.

Among formal providers, it is the smaller banks and micro-finance institutions that have gauged the untapped potential of this market. Microfinance institutions are well suited to meet the needs of the typical remittance-receiving household. At the same time, these institutions view remittances as a timely capital infusion to overcome the operational problems that currently plague the sector. In countries with a long history of migration, some small banks have adapted to the needs of the migrant community. For instance, Theba Bank, a miners' bank, offers low-cost transfers from South Africa to families that have bank accounts in Mozambique and Swaziland. The International Remittance Network—about 200 credit unions that offer low-cost remittance services in 40 countries in Asia, Africa, Europe, and Latin America—does not require that the recipient family have an account.

New technologies are also lowering the cost of transferring funds. Recent strides in cell phone encryption technology have facilitated fast, low-cost money transfers between OECD countries and recipient countries as diverse as the Philippines and Zambia, allowing customers to avoid the higher fees and longer waiting periods associated with MTOs and banks. Recently, telephone operators with networks in more than 100 countries announced that they would allow clients to send money home simply as text messages. If households at the receiving end do not have a bank account, the remitted sum can be converted to a prepaid debit card that can be used directly to make purchases. Financial institutions can make these technological innovations work to their advantage most effectively in areas in which retail banking networks are weakest. Recently, South Africa's First Rand Bank bought Celpay, a cell phone banking service provider operating in Zambia and the Democratic Republic of the Congo.

Getting more out of remittances

Bringing recipient households into the formal financial sector is only the first step in using remittances more effectively. Country surveys indicate that, although households typically spend a large proportion of their remittances, their propensity to save can be as high as 40 percent. For policymakers, the challenge is to channel these savings into productive uses.

Most studies indicate that a large proportion of remittances is used for human capital development, whose long-term benefits are apparent, or consumption. The construction of large houses for migrant workers in West Africa has spurred local economic activity through multiplier effects. In Mexico, the Sociedad Hipotecaria Federal, a government financial institution, provides long-term financing and partial mortgage insurance to Mexican mortgage providers that extend peso-denominated loans to emigrants for housing construction in Mexico. The scheme simultaneously encourages remittances and their productive use. Because of Africa's inadequate financial infrastructure, similar schemes can be more challenging to launch there, but they can spur a sustained housing boom with positive spillovers on the real and financial sectors of the economy.

SSA banks can promote investment from remittances by bundling financial services like savings products and entrepreneurial loans for households that receive remittances. The market is currently dominated by specialized MTOs like Western Union that are less likely to offer their clients ancillary financial products. Banks could also consider using the flow of remittances as collateral for small business loans.

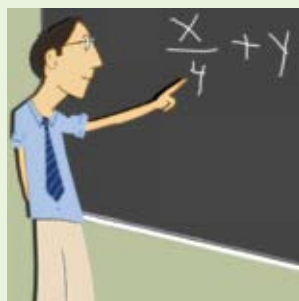
The bottom line is that remittances cannot be a substitute for a sustained, domestically engineered development effort. Moreover, large-scale migration may hurt domestic labor markets in specific sectors, particularly when those leaving are mostly skilled workers. High and rising remittance flows also require policymakers to remain alert to possible Dutch disease effects on the real exchange rate. Nevertheless, migrant transfers can help ease the immediate budget constraints of recipient households. For developing countries as a whole, they are a larger transfer of resources than all development assistance and have a more direct impact on poverty. And the vast, untapped market in money transfers is an opportunity for small savers to gain a foothold in the formal financial sector. ■

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Reference:

Clemens, Michael, 2007, "Do Visas Kill? Health Effects of African Health Professional Emigration," CGD Working Paper No. 114 (Washington: Center for Global Development).



Microfinance: Banking for the Poor

Ina Kota

MUFIYA Khatoon—a poor, illiterate young woman in rural Bangladesh—used to spend her days begging for a few ounces of rice to feed her children. She desperately wanted a livelihood, but lacked the funds to start a small business, and there was nowhere she could borrow on terms she could afford. That is, until she discovered Grameen Bank, one of the first microfinance institutions (MFIs), which set up shop in rural Bangladesh in the wake of the 1976 famine. In 1979, Grameen made Mufiya a one-year loan of 500 taka (about \$22), enough to start a bamboo business. To qualify, she had to form a group with four others in similar circumstances. She paid an interest rate of 20 percent, with repayments of 2 percent of the loan each week. Stiff terms perhaps, but better than the 150 percent interest rate a local money lender would have demanded. Mufiya was able to start her bamboo products business and, one year later, she repaid her loan. She is better off materially and more in control of her own destiny.

Microfinance gave Mufiya—as it did to millions of other poor people with no credit history, collateral, or steady income—access to basic financial services. Half of the world's population, nearly three billion poor people, lack such access. Most mainstream banks have considered the poor high-risk and hard to serve because they often live scattered across remote areas and because the small loans they need are costly to make and maintain. But microfinance, which specializes in providing small loans and other financial services even to the world's most destitute, challenges those traditional assumptions.

In the past three decades, microfinance has mushroomed from Grameen's tiny nonprofit experiment in Bangladesh to a global industry. Grameen Bank and its founder Muhammad Yunus won the 2006 Nobel Peace Prize for pioneering efforts to provide financial services to the poorest of the poor. Many enthusiasts believe microfinance is an important tool in the effort to end world poverty. Whether they are right is still open to question.

The current landscape

Today, microfinance players include governments, philanthropists, social investors, and commercial banks, such as Citicorp and ING, that are attracted by the potential for profit and corpo-

rate social responsibility. Customers can still go to a Grameen-type bank, but they can also go to microfinance credit unions, public sector and commercial banks, and, relatively recently, Islamic banks (which apply Islamic financial principles, such as risk sharing). Besides tiny business loans, MFIs offer deposit, savings, pension, and insurance products. Microinsurance is growing because borrowers need to insure assets such as farming equipment that they purchase with microcredit. In fact, MFIs are as important in providing savings vehicles and transaction services as they are in lending.

Microfinance customers live in both rural and urban areas—the rural poor borrow for cattle fattening, dairy farming, bamboo making, or weaving, whereas the urban poor borrow to become street vendors, rickshaw drivers, or seamstresses. Moreover, microfinance has moved well beyond its roots in developing countries—some MFIs now serve poor people in industrial countries.

Still, reliable data are hard to come by. The number of MFIs operating today is estimated to range anywhere from 300 to 25,000, depending on the definition. The Microfinance Information eXchange (MIX), known as the “Bloomberg” of microfinance, reports on nearly 1,000 microfinance institutions worldwide, nearly half of which are self-sustainable. The number of borrowers is hard to pin down, with estimates ranging from 30 to 500 million. The Washington D.C.-based advocacy group Microcredit Summit Campaign verified

Big business

The Microcredit Summit Campaign says microfinance has shot up globally in just the past six years.

Year	Number of institutions verified	Number of poorest clients verified
2000	78	9,274,385
2001	138	12,752,645
2002	211	21,771,448
2003	234	35,837,356
2004	286	47,458,191
2005	330	58,450,926
2006	420	64,062,221

Source: *State of the Microcredit Summit Campaign Report* (2006).

more than 64 million worldwide in 2006, up from more than 9 million borrowers in 2000 (see table). Many more millions of poor people have their savings in MFIs.

How it works

MFIs assume that their clients are clever enough to handle their own affairs, but do not assume that all the poor will be reliable borrowers. They have adopted two basic approaches:

“It will be challenging to achieve sustainability while reaching the remote rural poor, especially those at the bottom of the income ladder.”

Group lending. Grameen Bank is considered the pioneer of the group lending model, which has now been adopted in many countries. Individual borrowers are required to form a group and take responsibility for each other's loans. Grameen Bank depends primarily on peer pressure to guarantee repayment. Moreover, it limits risk by targeting female borrowers, who are considered more reliable because of family-based community ties. In early 2007, Grameen Bank reported almost 7 million borrowers—96 percent of them poor, illiterate women from remote villages. And since 1976, it says, \$6 billion has been lent, with a repayment rate of 98 percent.

Individual lending. These loans are bigger and are made to individuals without a collective guarantee and on more flexible terms. Typical borrowers are not the very poor seeking to start businesses, but the self-employed poor who are skilled business people. In some cases, the borrower has a small amount of collateral. Accion, a leading MFI that operates in Latin America and the Caribbean, Africa, and Asia, has adopted individual lending in the form of small, short-term loans of \$100 to \$500 at interest rates that it says reflect the cost of lending. Loan officers look not only at a borrower's financial wherewithal but also at references from customers and neighbors. Incentives such as the possibility of borrowing progressively larger amounts and the opportunity to get business and vocational training encourage repayment. In countries like Bolivia, credit bureaus have been set up to enforce repayment.

The road ahead

Although microfinance appears to be a promising way to provide financial services to the poor, there is considerable debate about its future.

Is microfinance sustainable? If microfinance can achieve commercial success, it can move beyond relying on subsidies, which today total hundreds of millions of dollars. MFIs are expected to increase their reach among the urban poor—who, because they are concentrated, are easier to serve. But it will be challenging to achieve sustainability while reaching the remote rural poor, especially those at the bottom of the income ladder, because of the high costs and risks involved.

Should microfinance be sustainable? A microfinance movement that becomes mainly commercial might shift its focus from the poorest borrowers to relatively better off, more conventionally safe customers. Thus, MFIs may evolve into direct competitors with conventional banks, and the special benefit for the poorest may be lost in the search for commercial sustainability. Yet in some locations, heavily subsidized MFIs may be crowding out sustainable MFIs, and the subsidies may therefore be of little additional benefit. One may also ask whether MFIs should concentrate on the poorest borrowers, or are other mechanisms better, given constraints on aid budgets?

Why are interest rates so high? The interest rates on microloans range from 20 percent to 35 percent (even after adjusting for inflation). MFIs are subject to significantly higher costs than commercial banks, because of lending and administrative costs (for example, identifying and screening clients). For some MFIs, interest rates cover the cost of doing business, whereas others add a premium for risk. Some say that despite the high interest rates, the loans still provide positive welfare benefits for borrowers and that costs will fall as the infrastructure of the industry grows. There is a broad consensus that increased competition is the key to driving down interest rates.

What regulatory and legal framework is necessary? The regulatory and legal approach used for large-scale commercial financial institutions may not be appropriate for microfinance. Countries such as Morocco and Kenya have developed legal frameworks to regulate MFIs. Key challenges are how best to protect depositors and borrowers while promoting the MFI sector, how to limit the costs of MFI supervision, and how to prevent regulation from restricting innovation and competition. What, for example, is the balance between consumer protection, the regulatory burden, and sustainability and development?

Going digital

Technology may provide some answers. Today, “branchless banking” is active in the Philippines, South Africa, and Colombia. Commercial players are using point-of-sale devices and mobile phones to connect with the rural poor, licensing local merchants and shop owners to make cash transactions on their behalf. The availability of such transfer services is especially important in areas where families rely on remittances from relatives working in economic centers or abroad. Technology will likely reduce transaction costs, allowing MFIs to grow and reach more customers.

The latest innovation is the digital microfinance marketplace, where Web-based MFIs like Kiva.org team up with local credit providers to match low-income borrowers with higher-income social investors—individual lenders who make electronic loans for amounts as small as \$25. One potential borrower, Zemfira Bayramova of Azerbaijan, can advertise her need for \$1,000 to buy three calves. Once \$1,000 has been received, the funds are sent to a local partner, Komak Credit Union, which disburses the funds to Zemfira. Kiva.org claims to have processed nearly \$5 million in loans in April 2007, up from \$400,00 in October 2006. ■

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A Government's Net Worth

Bob Traa and Alina Carare

A new tool in surveillance, the public sector balance sheet, can help diagnose vulnerabilities that are not immediately visible in the budget

WITH the economic crises of the 1990s, economists were reminded that they could no longer rely solely on a country's so-called flow variables (among them revenues, expenditures, imports, exports, and borrowing) as a guide to economic vulnerabilities. Financial health turns out to be more complicated than the relationship between income and outgo—the flow analysis of macroeconomics that has been the workhorse of fiscal policy since John Maynard Keynes provided a structure to analyze its impact on growth, inflation, and employment. Studying the accumulated stocks of assets and liabilities of a country (public, private, and external), and mismatches among them, can be a supplemental guide to uncover distress.

What holds for the country holds for the public sector as well. Many vulnerabilities do not show up in the budget, but become apparent when a public sector balance sheet reflecting all assets and liabilities is constructed. Analyzing the government's net worth and what causes it

to change can lead to understanding the need for better policies. For example:

- Ecuador's oil production contributes large revenues to the budget, but is gradually depleting the state-owned oil reserves (assets). Its revenue flows may look healthy even as its balance sheet (a stock concept) suggests that net worth is declining.

- When the present value of future social security claims is recognized as a liability in the balance sheet, the fiscal position in Germany and Switzerland, among other advanced countries, suddenly looks more challenging.

Shocks to stock variables can ruin countries. In many recent financial crises—Korea, Thailand, Indonesia, Argentina, Uruguay, and Ecuador—the root cause was not a simple flow imbalance (for example, a public or private sector deficit), but rather a sudden loss of investor confidence that affected prices of financial assets or an exchange rate crisis that led to a collapse in net worth as debt denominated in foreign currency increased while there were losses on assets. Private or public

entities do not succumb easily to pressures from a budget deficit, even when it continues for a few years, because flow imbalances, such as deficits, can be relatively quickly corrected once the political will to do so materializes. But correcting a stock imbalance can require efforts that stretch a decade.

In recent years, the IMF has increasingly incorporated analysis of stock variables in its monitoring of countries' economies and the global economy—what is known as the balance sheet approach in surveillance (Allen and others, 2002 and 2007; Rosenberg and others, 2005). This methodology uses linkages within and between the balance

Oil workers upgrade a production facility in Ecuador.



sheets of the private and public sectors and the external position of the economy to reveal stress affecting different sectors, and how valuation changes or other shocks can cause an abrupt unwinding of these imbalances. It often includes a partial balance sheet for the public sector, focusing on financial assets and liabilities (excluding nonfinancial or intertemporal information). This goes beyond the more narrowly defined public debt but is incomplete because it leaves out much vital information. An approach that focuses on the net worth of the public sector by itself is gradually finding its way into surveillance.

Indeed, the IMF Statistics Department and the Fiscal Affairs Department presented a blueprint for linking public sector flow accounts (budget reporting) and stock accounts (balance sheet reporting) in the *Government Finance Statistics Manual* (IMF, 2001). It reflects government activities in a statement of the operations of government covering transactions in revenues, expense, the net acquisition of nonfinancial assets, and financing; a gross cash flow statement; and a balance sheet that explains changes in the stock positions in assets and liabilities at the beginning and the end of the accounting period by transactions in revenues and expense that affect net worth and other economic flows, including valuation and volume changes (IMF, 2005; Da Costa and Juan-Ramon, 2006). Countries are implementing these guidelines but because data requirements are demanding, progress has been gradual. Meanwhile, the staff has been exploring available balance sheet material to see if it can shed light on risks and broader sustainability issues in fiscal analysis.

Totting up assets and liabilities

The basic concept of a public sector balance sheet is clear: add up all financial and nonfinancial assets accumulated over the years on one side, and all debt and other liabilities on the other—the difference is the public sector net worth (see Table 1). By recording both assets (nonfinancial and financial) and liabilities, the balance sheet enables analysts to assess the impact of fiscal policies on net worth and to evaluate trends in net worth over time as a basis for determining the sustainability of fiscal policies.

But reality is not that straightforward. Many governments do not know what assets they have acquired over the years, what they owe, or who holds title (for instance with contingent or certain future liabilities). Moreover, the prices at which assets and liabilities need to be entered into the balance sheet (market or nominal book values) make an important difference.

Examples of how even a simple stand-alone balance sheet can suggest vulnerabilities in fiscal analysis include:

Exchange rates. Many private and public sectors carry some foreign currency-denominated or indexed debt on their balance sheet, which can accumulate to a point where even a small exchange rate change can become costly. This could affect the government finances in two ways. First, the exchange rate change can directly increase the cost of the public debt on the government's books. Second, it can force the government to absorb private sector debts if bankruptcies among households and businesses with debts in foreign currencies push lenders

Table 1

What a public sector balance sheet shows

It totals assets and liabilities to find a government's net worth.

Conceptual public sector balance sheet	
(percent of GDP)	
Assets	120
Financial assets	30
Cash	5
Deposits	25
Nonfinancial assets	90
Net capital stock	55
Public enterprises	35
Liabilities	120
Gross debt	70
Other liabilities ¹	35
Net worth	15

¹Could include contingent and/or implicit liabilities.

such as banks into insolvency. To prevent further damage, the public sector sometimes has no choice but to socialize part of the costs of the private defaulted debt through deposit insurance or bailouts. None of the risks from currency mismatches can be observed directly in flow accounts and, without a comprehensive balance sheet analysis, they tend to go undetected for too long. For example, vulnerability to exchange rate risks was important in Argentina and Uruguay leading up to the crises in the early 2000s.

Public enterprises. Voters generally know about the public debt but are less aware of their ownership in and the performance of state assets and enterprises. Take Uruguay in 2001. State enterprises were returning relatively little to the taxpayers and, as a group, their net worth was lagging, especially the state banks. At the same time, Uruguay was rapidly accumulating debt, much of it in foreign currency. Preliminary staff calculations suggested that the value of the enterprises was still enough until 2000 or so that they could have been sold and the proceeds used to extinguish or sharply reduce the debt, in turn reducing or ending the foreign currency mismatch on the public balance sheet (see Table 2). Uruguay had already engaged in a substantial discussion about whether to divest the enterprises but in the end opted against it, perhaps because the public did not fully realize that the enterprises were not generating a sufficient return. In contrast, Australia has shown that it helps to garner political support for better management or divestment if the authorities inform the public about their asset holdings and systematically disclose their return.

Resource depletion. For some countries, oil reserves are the most important asset on the public sector balance sheet, and they feel well-off if they can sell the oil for use in (current) spending. But from a balance sheet perspective, the country is using a nonrenewable resource and consuming its assets. The sovereign's net worth is declining. This goes undetected when no public sector balance sheet is produced (see Table 3). The IMF and Ecuador discussed resource depletion in 2003, and the IMF staff recommended placing oil receipts in the financing statement (instead of the budget) and focusing policies on developing the non-oil economy for a soft landing when the oil runs out. There are cases where countries have developed wealth management funds with the proceeds from oil

or other commodities—to smooth out over time the consumption of these important state assets—including Norway, Russia, and Chile (copper).

The environment. For years, it seemed that pollution could be absorbed by the environment without difficulty, but pollution pressure has grown so large that symptoms of distress are surfacing. One problem is that clean air and water, or diffuse concepts such as biodiversity, have no well-defined price and are difficult to value in economic modeling. But if a good is a public good with social benefits, it makes sense to try to value it on the public sector balance sheet, and for it to be managed with either appropriate regulation or revenue-generating licensing. Slowly, the value of “goods” such as CO₂ capture and biodiversity, as well as “bads” such as carbon emissions, is being priced in market systems to become tradable goods that yield cash flow.

Table 2

Accounting for public firms

A balance sheet would have enhanced awareness of the trade-off between low-yielding public firms and growing high-interest debt.

Uruguay—Preliminary public sector balance sheet						
(million dollars)						
	1995	1996	1997	1998	1999	2000
Assets	11,497	11,448	11,259	11,987	12,023	10,887
Central bank net worth	1	-29	-140	-13	-6	-123
Public enterprises	6,160	6,362	6,468	6,860	6,862	5,662
Capital, net	4,925	4,704	4,520	4,730	4,756	4,937
Other, net	411	411	411	410	411	411
Liabilities	11,497	11,448	11,259	11,987	12,023	10,887
Debt	5,199	5,441	5,779	6,368	6,621	7,232
Net worth	6,298	6,007	5,480	5,619	5,402	3,655

Source: IMF Country Report No. 01/185, October 2001.

Table 3

Accounting for oil use and the environment

It is hard to value ecological assets, but the IMF tried to do so in Ecuador, plus calculated the declining value of oil and gas reserves.

Ecuador—Public sector balance sheet					
(million dollars)					
	1970	1980	1990	2000	Prel. 2002
Assets	7,818	258,724	131,082	140,400	116,489
Deposits	54	494	359	1,228	1,282
Central bank net worth	35	327	237	1,343	1,037
Public enterprises	586	5,404	3,927	4,430	5,389
Capital stock, net	606	3,777	7,445	11,204	12,819
Oil and gas reserves	6,134	245,000	116,410	118,093	89,694
Biodiversity and carbon capture	403	3,722	2,704	4,102	6,268
Liabilities	7,818	258,724	131,082	140,400	116,489
Shortfall in insurance funds	395	3,645	2,648	4,017	6,138
Debt	563	5,132	8,554	13,227	13,730
Arrears	0	0	3,033	1,331	789
Net worth	6,860	249,947	116,847	121,825	95,832
With oil and gas at 2001 prices	139,303	133,486	114,280	96,374	94,139

Source: IMF Country Report No. 03/91, April 2003.

Take Ecuador, which has one of the world’s richest natural environments. In 2002–03, when IMF staff met with the authorities for the annual country consultation, they agreed to include environmental data in the public sector balance sheet (see Table 3). Although the Fund has no standard for environmental accounting, the staff consulted experts in Ecuador who had used formulas from the Kyoto Treaty to value biodiversity and the capacity of forests to act as carbon sinks to calculate a notional economic value for ecological wealth in their country. Environmental trade-offs at that time were particularly acute, because the country had issued permits for a new oil pipeline that opened the interior Amazon rain forest and carried the oil through ecologically sensitive areas. The idea of the exercise was not to provide a new cost-benefit analysis of the oil pipeline project but rather to encourage a discussion on trade-offs that need to be made when pitting economic growth against environmental sustainability.

Intertemporal accounting and fiscal sustainability. Fiscal sustainability is often analyzed in terms of how well debt can be managed. But debt is only one of the liabilities on the public sector balance sheet. It is difficult to see the so-called intertemporal liabilities—including the future unfunded social security claims that are now attracting attention as baby boomers near retirement.

In recent talks with Germany and Switzerland, the IMF staff has developed preliminary intertemporal public sector balance sheets that include the net present value of future unfunded liabilities (see Table 4). These liabilities reflect prospective fiscal deficits, essentially driven by aging costs in the social security system (such as pensions, health care, and long-term care) under current policies (a baseline scenario) over a rolling 50-year horizon. These liabilities are sometimes much larger than the existing debt, and including them in the balance sheet turns public sector net worth from positive to negative.

At present, international convention, including IMF methodology, does not consider unfunded pensions a government liability, but this interpretation is likely to change. Standard and Poor’s rating agency has warned that with unchanged policies, the Group of Seven industrial countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) could lose their investment credit rating over the next two decades based on the deleterious effects on the public finances of these emerging aging costs (Kraemer, Chambers, and Merino, 2005). It is no surprise, therefore, that Germany, Switzerland, and many other countries are engaging in adjustment and structural reforms to prepare their economies for the coming wave of retirements and other aging costs.

Moreover, intertemporal public sector balance sheets can provide valuable information that can point out the benefits of stronger economic policies. Structural reforms, for example, are notoriously difficult to approve and implement because in the short run the public does not see clearly the (flow) benefits. Instead, an intertemporal approach can allow voters to better understand the trade-off between doing something now or waiting. Running different scenarios through the balance sheet can show that doing nothing often leads to the need for more severe action later on, because the country is

Table 4

When costs rise in the future

After the present value of future welfare liabilities such as social security are taken into account, Germany's and Switzerland's positive net worth disappears.

Germany—Preliminary public sector balance sheet (percent of GDP)					Switzerland—Preliminary public sector balance sheet (percent of GDP)				
	2003	2004	2005	2006 ¹		2003	2004	2005	2006 ¹
Financial net worth	-46	-49	-51	-53	Financial net worth	-23	-24	-22	-21
Gross debt	-63	-65	-66	-68	Gross debt	-54	-53	-52	-48
Other	17	16	15	15	Other	31	29	30	27
Nonfinancial net worth	56	55	55	54	Nonfinancial net worth	72	71	73	70
Net capital stock	51	50	50	49	Net capital stock	56	55	55	53
Other	5	5	5	5	Other	16	16	18	17
Current net worth	10	6	4	1	Current net worth	49	47	51	49
NPV of implicit future liabilities	-191	-150	-114	-30	NPV of implicit future liabilities	-153	-152	-152	-103
Intertemporal net worth	-181	-145	-111	-28	Intertemporal net worth	-104	-105	-101	-54

Source: IMF Country Report No. 06/438.

¹Assumes that the fiscal balance will be zero in 2010; and that incremental aging costs are 4 percent of GDP by 2050.

Source: Forthcoming IMF Country Report 2007.

¹Assumes that incremental aging costs are 6.3 percent of GDP by 2050.

then confronted with a further-deteriorated public sector net worth. Conversely, if reforms are implemented that improve long-run growth and reduce aging costs, the intertemporal position of the state will strengthen, and the public can see that this bolsters the sustainability of the welfare state.

Indeed, in 2003–04, Germany initiated important reforms to reduce future aging costs. Then in 2006–07, the coalition government took further important measures (including a hike in the value-added tax) to strengthen the fiscal balance. Similarly, Switzerland has been strengthening its underlying fiscal accounts with the help of the debt brake fiscal rule, and has also made important progress with structural reforms that, in the view of the IMF, have improved potential output growth. The benefits from these policies are again visible in stronger intertemporal balance sheets in Germany and Switzerland.

Further steps

More work is needed to implement public sector balance sheets and learn how to integrate stock analysis with traditional macroeconomic flow analysis. The first step might be to complete as much as possible a first rendering of the public sector balance sheet in all countries at book value (the cost of acquisition less depreciation). The next step could be to value selected assets and liabilities at market prices, as appropriate; many governments already report their registered debt on a market-to-market basis. An even more sophisticated approach would be to prepare “stochastic balance sheets.” These recognize that standard balance sheets are snapshots of assets and liabilities at a point in time. The stochastic balance sheet deals with risk assessment, allowing policymakers and voters to recognize the probability at which the value of assets and liabilities will fluctuate over time as conditions change. They are gradually being applied to public sector balance sheets (Gapen and others, 2005; Barnhill and Kopits, 2003).

In principle, the complete stand-alone public sector balance sheet should be integrated into the sectoral balance sheet analysis of surveillance. This would bring out connections

between important public and private actors in the economy, and between different economies, to highlight policy spillovers. For example, issues surrounding global imbalances can be illuminated with public balance sheet analysis because some countries are reacting relatively early to aging, thereby boosting their domestic savings, whereas others have hardly started, tending to lower savings. When some countries bolster their net savings to anticipate aging, while others do not, global imbalances will emerge.

Publishing even preliminary balance sheets as part of the annual budget document would help bring them into the policy discussions. ■

Bob Traa is a Division Chief and Alina Carare an Economist in the IMF's European Department.

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Getting Spending Right

The 4,000-foot President Juscelino Kubitschek Bridge spans Paranoá Lake in Brasília, Brazil.

Benedict Clements, Christopher Faircloth, and Marijn Verhoeven

Latin America needs to reform public spending to make it more efficient, better help the poor, and address infrastructure bottlenecks

LATIN America's recent economic performance has been strong. The region is in the midst of its most vigorous expansion since the 1970s, with average growth of more than 5 percent over the past three years. Inflation has also declined to an average of about 5 percent in 2006, and the IMF projects external current account balances to be in surplus in 2007 for the fifth consecutive year. Stronger growth has also helped reduce poverty rates.

Still, there is widespread recognition that more needs to be done to raise growth—which continues to lag the average for developing countries as a whole—and reduce macroeconomic vulnerabilities, including high levels of public debt. Fiscal positions have improved because of rising government revenues, mostly derived from commodity-based receipts. But public debt remains high at 52 percent of GDP (as a weighted average at the end of 2006). As such, a key challenge will be reducing the growth of government spending, which has risen rapidly in recent

years and precluded an even deeper reduction in public debt burdens. At the same time, the region suffers from the low quality of its infrastructure and high levels of income inequality. If governments in the region are to reduce spending while improving infrastructure and providing a greater level of services, including to the poor, they must improve the efficiency and equity of public spending.

Recent trends in public spending

Public outlays in Latin America (net of interest payments) have drifted upward since the mid-1990s (see Chart 1). Spending increases have not been continuous, however. Increases were well contained in the early phases of the region's ongoing economic expansion, especially in 2003–04. Since then, however, they have resumed their upward trend, rising in 11 of 17 countries between 2004 and 2006. Real spending grew an average of 7½ percent a year over the past two years but, as a percentage of GDP, grew a moderate 1 percentage point because GDP grew rapidly too.

Expenditure increases since the mid-1990s have been driven by current spending. Capital outlays have declined in relation to aggregate output and total spending, while social spending has become more prominent in government budgets, especially for education and social insurance. Between 1995 and 2004, for example, social spending rose by an average of about 2 percentage points of GDP, roughly equal to the increase in total primary (that is, noninterest) outlays during the period.

Expenditure reform will be essential if the countries are to reduce public spending while maintaining public services at existing—and preferably higher—levels. Much of the region's spending is inefficient—a higher level of public services could be provided with the same level of public outlays. Improving the composition of spending across different categories and programs could also help catalyze faster growth and poverty reduction. Some key priorities include the following:

Reforming the stop-and-go pattern of government spending. Government spending has tended to surge in good times, only to be curtailed sharply during economic downturns (see Chart 2). Akitoby and others (2006) found that in about two-thirds of Latin American countries, there is a statistically significant short-term relationship between shocks to real output and real primary expenditure, with spending and output moving procyclically—that is, in the same direction. The share of countries in which spending is procyclical is higher in Latin America than for developing countries as a whole. Capital expenditures appear to be the most sensitive to macroeconomic developments, reflecting the tendency in the region to cut these outlays sharply during recessions.

The surge in spending over the past two years raises to the fore the challenge of ensuring that spending growth is consistent with a sustainable fiscal position over the longer term. Toward this end, fiscal rules that limit spending growth could be useful, although such rules will need to be backed by an effective system of monitoring and sanctions to ensure that they are effective.

Improving the efficiency of public investment. Rates of public investment have declined in the region, dropping from 5.8 percent of GDP in 1995–99 to 5.1 percent since 2000, but this has been partially compensated for by higher private spending for infrastructure. Inefficiencies in public investment spending are contributing to infrastructure shortfalls. The value-for-money from these outlays, as measured by the relationship between public investment and improvements in infrastructure indicators, varies markedly across countries. This suggests that there is scope for improvement, in particular by following the best practices in the region in project selection, evaluation, and monitoring (IMF, 2005). Countries should also implement stable multiyear budgets for public investment and strengthen staff capacity (Aldunate, 2007).

Improving the effectiveness of the civil service. Public sector wage bills, at about 7 percent of GDP, are close to the averages prevailing in other regions. The quality of government services, however, is lower than in many fast-growing regions of the world, and has not improved since the late 1990s. A recent assessment (Echebarría and Cortázar, 2006) indicates that in more than half of the countries of the region, civil

service systems are inadequate to attract qualified staff and ensure the efficient performance of employees.

As in many countries, there has been no correlation, over the past decade, between increases in the wage bill and improvements in the quality of government services. This suggests that there is room to achieve better value-for-money on the wage bill and that higher compensation alone is unlikely to bring about better public services. Instead, the focus of reform efforts should be on making bureaucracies more merit-based and addressing the core weaknesses of administrations in the region. These weaknesses include patronage in hiring and promotions; the absence of performance evaluation; and internal inequities in remuneration, such as different pay for similar jobs (Echebarría and Cortázar, 2006).

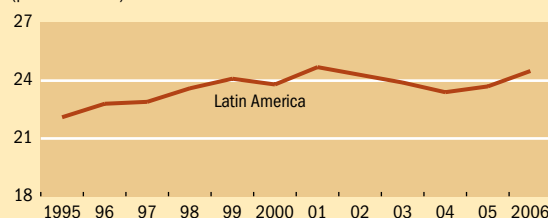
Improving the efficiency and targeting of social spending. Outlays for health care, education, social protection, and housing are substantial, at about 13 percent of GDP (roughly half of government noninterest spending). But they have produced mixed results on social indicators. Education attainment and health indicators are broadly in line with the region's level of development (ECLAC, 2006), and health and education indicators such as school enrollment rates, access

Chart 1

Higher outlays

Primary public spending¹ in Latin America has been rising.

(percent of GDP)



Source: Authors' calculations.

Note: Unweighted average of 17 countries.

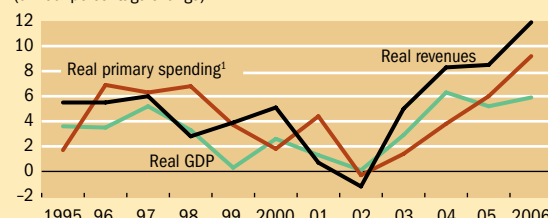
¹Total government spending less interest payments, based on the broadest definition of government available.

Chart 2

Spending has been stop and go

Government spending in Latin America tends to go up rapidly in good years and decline in bad times.

(annual percentage change)



Source: Authors' calculations.

Note: Unweighted average of 17 countries.

¹Total government spending less interest payments, based on the broadest definition of government available.

to clean water, and immunization rates all climbed in the 1990s. But there are significant lags in human capital relative to the industrial countries and fast-growing regions of the world. The quality of education—for example, as measured by performance in international examinations in reading, science, and mathematics—is also low. Although poor quality can reflect a number of factors, the large share of education spending allocated to wages, as opposed to nonwage inputs such as teaching materials, may be a contributing factor, as well as weak incentives for good performance (De Ferranti and others, 2003).

Social spending has had a limited effect in reducing poverty and in shrinking the large gap between rich and poor. On average, the poor receive a less-than-proportionate share of social spending benefits, but their share varies markedly by spending program (see table). A large share of the outlays on higher education and social insurance goes to upper-income groups; primary education and social assistance largely benefit the poor (De Ferranti and others, 2004; ECLAC, 2006; Lindert, Skoufias, and Shapiro, 2006).

One bright area for the region has been the success of conditional cash transfer programs, which have proved to be effective in channeling resources to the poor and reducing poverty. These programs often make cash assistance dependent on self-help steps by recipients, such as sending family members to school, that improve the prospects for escaping poverty on a long-term basis. In most countries, spending on these and other social assistance programs averages about 1–1½ percent of GDP and comprises a small share of social spending.

A road map for reform

To make spending more efficient, governments must reduce the tendency of expenditures to rise sharply in good times, only to collapse during downturns. Effective fiscal rules that help contain spending during economic upswings would be useful. Governments should also step up their capacity to evaluate and manage investment projects. The efficiency of spending would be assisted by implementing merit-based systems of employment and compensation.

Helping the better off

Social spending in Latin America benefits those at the top of the income ladder more than those at the bottom.

(distribution of benefits from social spending, percent)		
	Poorest quintile	Richest quintile
Education	20.2	20.4
Primary	29.0	7.9
Secondary	13.2	18.3
Tertiary	1.9	52.1
Health	20.6	17.6
Social security	5.6	51.2
Total social spending	15.0	30.4
Share of quintiles in primary income	3.6	56.4

Source: Authors' calculations.

Note: Unweighted average. Country coverage varies by category. For total social spending, education, health, and social security spending, the number of countries covered is 8, 13, 14, and 9, respectively.

The region's recent experience provides useful lessons for forging a more pro-poor pattern of outlays. Steps in this direction could include continuing reform of public pension systems to reduce their generosity and place them on an actuarially sound footing; increasing user fees for higher education, combined with subsidies for low-income families; improving the quality of secondary education; and expanding targeted social

“Social spending has had a limited effect in reducing poverty and in shrinking the large gap between rich and poor.”

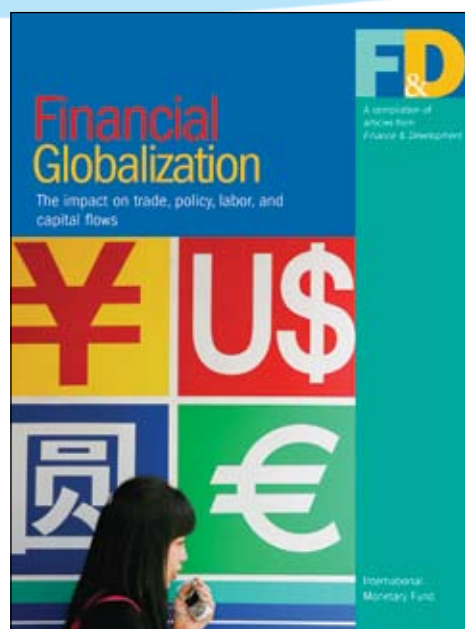
assistance programs. Restructuring social spending—most of which bypasses the poor—will be politically challenging, but is essential if the state is to fulfill its role in building a more equitable society. ■

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This article is based on IMF Working Paper No. 07/21, “Public Expenditure in Latin America: Trends and Key Issues.”

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Financial Globalization: The Impact on Trade, Policy, Labor, and Capital Flows

A compilation of articles from Finance & Development

The IMF's quarterly magazine *Finance & Development* regularly tracks the trends and consequences of globalization and discusses the policy options and challenges faced by governments in an era when many national decisions transcend borders. This compilation of articles published over the past eight years examines the economic implications of, and responses to, globalization. As the title suggests, many of the articles focus on financial globalization, including the policy implications of the huge growth in cross-border capital flows, but other articles also look at the expansion of world trade, explore the impact of globalization on jobs, taxation, and the poor, and examine the digital divide between developed and some developing countries.

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Integrating Europe's Financial Markets

Interaction between financial integration and financial stability—a global model?

Edited by Jörg Decressin, Hamid Faruquee, and Wim Fonteyne

By and large, EU financial integration has been a success story. This book tracks the EU's journey along the path to a single financial market and identifies the challenges and priorities that remain ahead. The study takes an IMF perspective, focusing on two main imperatives: growth and economic integration, on the one hand, and financial stability, on the other. It follows the EU as it stepped up efforts to integrate its financial markets in the 1980s, aiming to develop a single modern financial market for the EU. The book looks at economic growth performance and progress in other areas toward the Treaty of Rome's single market objective. Particular attention is paid to the interaction between integration and stability. This interaction presents the EU with a challenge, but also with the opportunity to play a pioneering role in developing a regional approach to financial stability that could become a model for the rest of the world.

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Harnessing the market



José A. Gómez-Ibáñez

Regulating Infrastructure Monopoly, Contracts, and Discretion

Harvard University Press, Cambridge,
Massachusetts, 2006, 448 pp.,
\$26.95 (paper).

Network utilities—such as electricity, telephones, transport, and gas—have undergone wide-ranging reforms over the past decade, with many governments restructuring, and sometimes

even privatizing, entire infrastructure industries. The reforms have aimed at securing private participation in industries that have traditionally been dominated by the public sector. These changes have been accompanied by the creation of regulatory agencies and supervisory frameworks to manage the provision and quality of services and pricing policies. Sector performance has thus become intrinsically linked to the effectiveness of the regulatory framework and to contract design. Using a combination of theory and practice, José Gómez-Ibáñez evaluates the impact of these changes.

In the first part of the book, the author describes the relationships between the government, regulators, firms, and users and analyzes how these often complex dynamics shape the regulatory frameworks and the behavior of the participants. Using case studies, he assesses the effect of regulatory capture (when state laws give rise to monopolistic behavior), contractual problems, and asset expropriation

on prices, quality, and investment. In one example, he recounts how uncertainty over contracts led to a series of renegotiations in the privatization of Argentina's railroad industry, resulting in serious delays—and in some cases even cancellation—of vital investments. He also discusses how the threat of expropriation may deter private sector investment, using examples of both direct and indirect expropriation in Latin America's electricity industry to illustrate this set of problems.

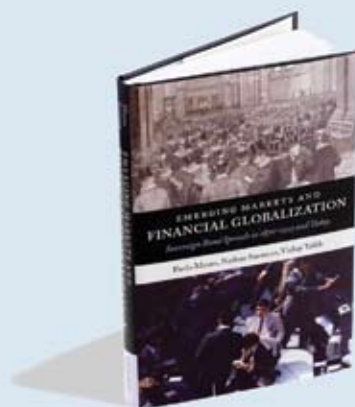
In the second part, Gómez-Ibáñez examines the circumstances under which three principal regulatory strategies—concession contracts, private contracts, and discretionary regulation—are likely to be successful. He also explores the circumstances under which private contracts might substitute for government regulation, concluding that private contracts can be an effective—even superior—substitute for government regulation in certain circumstances.

The last section of *Regulating Infrastructure* studies the consequences of network unbundling—forcing a

How news affects sovereign spreads

What can emerging market countries do to lower their cost of borrowing in international capital markets? In this timely book on the determinants of emerging market spreads, economists Paolo Mauro, Nathan Sussman, and Yishay Yafeh attempt to answer this important question.

The analysis in the book is based on a comparison of two historical periods characterized by unusually lively trading in emerging market sovereign bonds. The first period is 1870–1913, sometimes called the first era of financial globalization because government bonds from all over the world were traded on the large bond market in London. The second period covers the early 1990s, when the market in Brady bonds took off.



Paolo Mauro, Nathan Sussman,
and Yishay Yafeh

Emerging Markets and Financial Globalization Sovereign Bond Spreads in 1870–1913 and Today

Oxford University Press, Oxford, 2006,
200 pp., \$74 (cloth).

Comparing sovereign spreads from two so obviously different historical periods is not, of course, without its problems. For example, there are differences in the way bonds were issued (in terms of maturity length and redemption clauses) and how bond yields were, and should be, calculated. However, these problems do not diminish the merits of attempting a comparison in the first place. In my opinion, the comparison is a truly original and innovative methodological contribution and makes this book stand out among other books on the same topic.

The authors set out to uncover the most important factors driving emerging market spreads in 1870 and today. They do so by linking significant shifts in bond spreads to different types of news as covered by the media. By classifying news into different categories such as “wars,” “bad economic news,” “reform,” and “debt-related news,” the

Camilla Andersen is Book Review Editor.

supplier to give competitors access to its infrastructure—and the related trade-off between competition and coordination. Here, Gómez-Ibáñez uses the examples of the British railroad industry and Argentina's electricity sector to demonstrate that competition can lead to better service and lower prices. However, he also notes that market power may remain an issue even after unbundling has taken place. One challenge in this respect is to establish a mechanism for dealing with access charges and network congestion.

This clearly written book by one of the most distinguished economists in the field describes the roles played by the different stakeholders in utility reform and evaluates their impact on the efficient regulation of natural monopolies. The author's use of examples from the real world, combined with a modern microeconomic approach to transactional cost and incentive regulation, makes this a book any serious thinker or practitioner in the field of utilities regulation must read.

Daniel A. Benitez
Economist, World Bank

A wakeup call for Europe



Alberto Alesina and Francesco Giavazzi

The Future of Europe

Reform or Decline

MIT Press, Cambridge, Massachusetts, 2006,
186 pp., \$24.95 (cloth).

“**A** wakeup call.” The title of the last chapter captures the thrust of this very readable book on Europe’s need for

reform. In the book, Alberto Alesina and Francesco Giavazzi cast aside the academic genre—though not their academic grounding—to better convey a sense of urgency. They focus on a short list of core issues and in each case identify the broad direction of reform. Their tone is incisive, even militant, and the book proceeds at a brisk pace with many original insights.

Some of the problems have received a lot of attention elsewhere. The continuing decline in working hours belies the increasing old-age dependency ratio. The labor markets in many European countries protect insiders at the expense of the unemployed. Monopolies and other forms of protection reflect the large rents enjoyed by existing firms and the weakness of independent regulatory agencies. And the judicial system fails to provide for the cost-effective enforcement of contracts.

The authors look at other important issues as well. They rightly

authors are able to get a precise picture of the kind of information driving the spreads. Of course, one may question whether findings based on news about wars can be generalized into findings about actual wars.

Using panel data regressions on the full sample of countries, the authors successfully show that news about wars and instability does, in fact, have a much larger impact on spreads than any other type of news. In contrast, news about institutional reforms, whether good or bad, has almost no measurable effect on spreads. Although this finding could simply be because many reforms become effective only over longer periods of time, it serves as a useful reminder that institutional reform alone cannot solve acute public finance-related problems in the developing world.

The authors also find evidence suggesting that markets for emerging market bonds have become more

prone to contagion. First, the overall impact of news on spreads has diminished considerably over time, which could indicate that investors are more

“The authors argue that a systemic problem underlies institutional investor behavior today, increasing the risk of international contagion.”

likely to treat emerging markets as a homogeneous group today than they were at the turn of the nineteenth century. Second, movements of emerging market spreads are much more correlated today than in the past. Even if economic fundamentals

are also more closely correlated today than they were 130 years ago, this does not explain the entire increase in correlation. Based on these two findings, the authors argue that a systemic problem underlies institutional investor behavior today, increasing the risk of international contagion and exposing countries whose finances are basically sound to contamination from financial crises in other countries.

Emerging Markets and Financial Globalization is an impressive empirical achievement. It provides both new statistical evidence and insightful analysis of the workings of emerging sovereign debt markets. It deserves to become required reading for all economists with an interest in financial history and sovereign bond markets for many years to come.

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recognize immigration as “one of the important questions for Europe in the next decade, if not the most important issue.” While mindful of the social problems associated with ethnic and racial diversity, they advocate a selective immigration policy, attuned to the needs of the labor market in each country.

They also roundly denounce conflicts of interest in the financial system and, interestingly, trace them to the resistance of national central banks to their loss of power following the introduction of the euro. And they convincingly argue that the main cause of the decline in the quality of advanced education and research is not a lack of resources but a lack of competition.

But the book’s most original contribution is its focus on the role of European institutions. The authors argue that policy coordination is beneficial when government activities present significant economies of scale, which is the case in areas such as the European Union’s (EU’s) single market, its common foreign policy, and its fledgling common defense policy. But policy coordination can also lead to excessive intervention when it pointlessly tries to override country-specific preferences, for

instance in the fields of social policy or even fiscal policy (the authors suspect that the EU’s “stability and growth pact,” which sets rules for the conduct of fiscal policy, has gone too far in that direction). Failure to properly allocate the prerogatives of “Brussels” and of individual member states may sharply undermine the effectiveness of European institutions in promoting badly needed reforms.

This is a useful and even enjoyable book, though it is frustrating that the authors—like others in this field—do not address the key question of why the rigidities they denounce are so prevalent in Europe. A deeper understanding of their social function would surely help in designing reform strategies. It is also unfortunate that the authors pin the differences in social models between Europe and the United States on different attitudes toward inequality.

Rather, different attitudes toward the role of government in the economy stand out as a general thread across the diverse reform areas discussed in the book. In each case, the need for reform arises because insiders have captured the authority of government to prevent competition—what is known among

economists as “regulatory capture” is, unfortunately, a common occurrence in Europe. The proliferation

“It is frustrating that the authors—like others in this field—do not address the key question of why the rigidities they denounce are so prevalent in Europe.”

of public and semi-public enterprises, curiously not discussed in the book, is an important manifestation of this phenomenon. The authors could have noted its rollback in the past two decades as a welcome development, but plenty remains to be done.

Pierre Dhonte

The IMF’s former Special Representative to the EU

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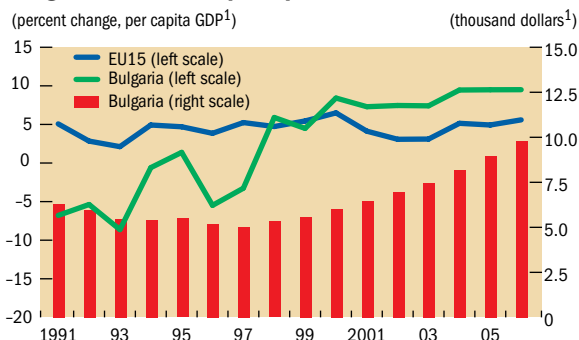
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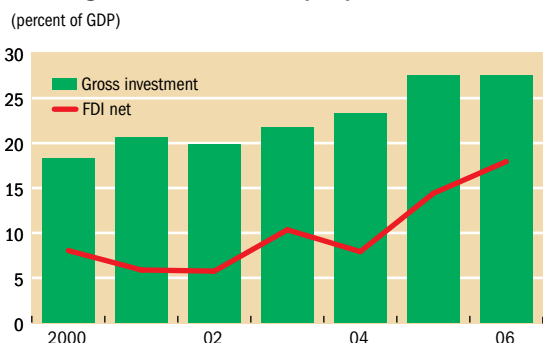


Having joined the European Union (EU) in January 2007, Bulgaria is off to a promising start in its marathon to catch up with the living standards of its new European partners. But the challenge ahead will be to improve productivity.

Since a crisis in 1996–97, progress has been made in closing the large gap in living standards between Bulgaria and its European partners . . .

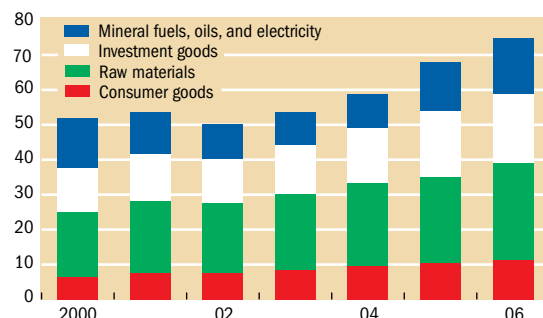


In the run-up to EU membership, strong investor confidence led to high investment and large inflows of foreign direct investment (FDI) . . .



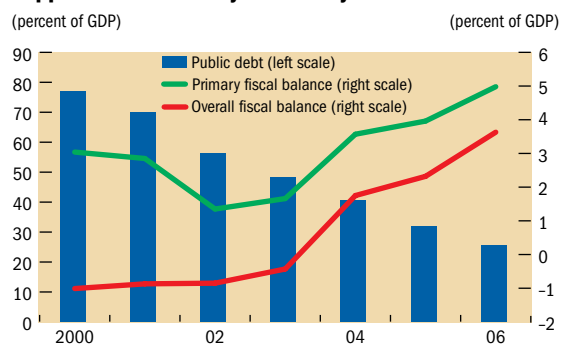
The current account deficit mainly reflects growing imports of investment goods and raw materials, holding the promise of boosting future output.

(composition of imports as a percent of GDP)

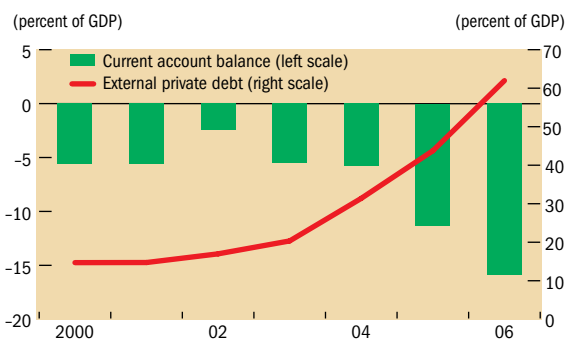


Sources: IMF Staff Report No. 07/127, Bulgaria's National Statistical Office, and Eurostat.
¹Calculated using purchasing power parity exchange rates.

. . . thanks in large part to sound fiscal policies in support of the country's currency board.

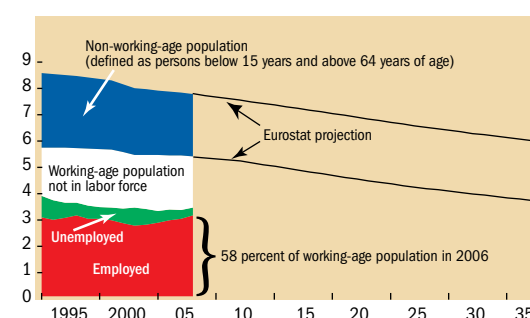


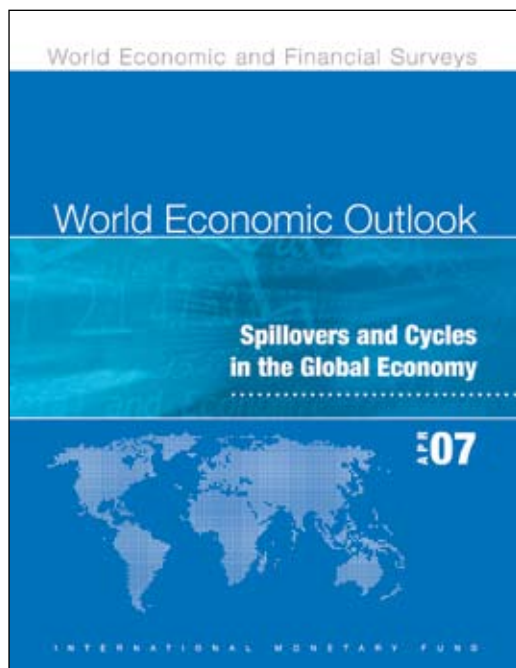
. . . but private external debt has also risen significantly, signaling the need to manage vulnerabilities.



But with the population declining and aging problems looming, sustaining growth hinges on higher productivity growth and employment.

(millions)

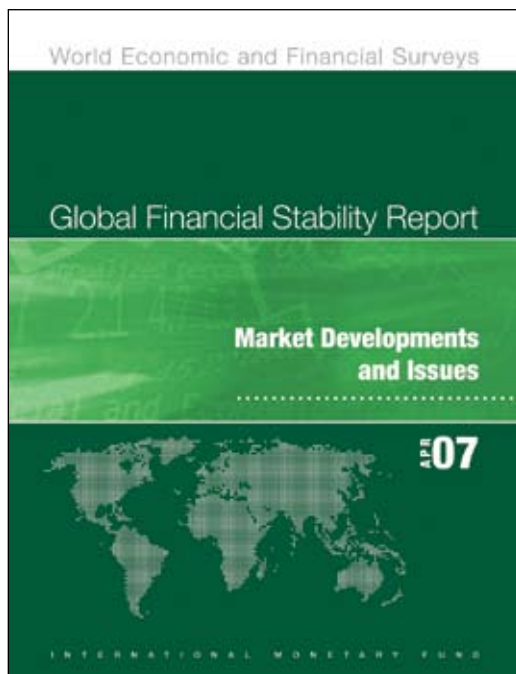




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