

# IMF Publication

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## Loan aims to bolster Afghanistan's progress

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On the strength of Afghanistan's performance under a staff-monitored program, the IMF's Executive Board approved a \$119 million loan for the country under the Poverty Reduction and Growth Facility. Despite continued violence in the country, Afghanistan resumed growth and achieved progress on several fronts, including revenue collection and modernization of its central bank. Now the focus will be on sustaining growth at about 10 percent a year, building institutional capacity, and improving health care and education.



ALFRED/SIPA

## China: designing an independent monetary policy

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In the frequently heated debate over the correct valuation of China's exchange rate, what is often lost is the fact that as the economy develops and becomes more market-oriented, a truly independent monetary policy will have an increasingly important role to play in securing stable, non-inflationary growth. That independence—argue Marvin Goodfriend and Eswar Prasad, authors of a new IMF Working Paper—will not be possible without greater exchange rate flexibility.



Claro Contes IV/REUTERS

## Will a resilient Lebanon tackle its debt?

page 200

Lebanon emerged from a devastating civil war in 1991 and, more recently, weathered a high-profile political assassination. Through it all, the economy has proved amazingly resilient, though rebuilding has sharply increased public debt levels. The authorities have laid out measures that add up to a comprehensive reform agenda centered on debt reduction. The challenge going forward will be for the political leadership to adopt the agenda and for the country to embrace it.



Ramez Haidar/AP/Getty Images

## Mining the lessons of experience

page 208

For years, mining and metals companies often took the view that, as long as they did their business responsibly, the host country's broader development was of little concern to them. Now, the International Council on Mining and Metals has launched an initiative to foster sustainable development. It recently briefed IMF economists on findings from four country case studies and efforts to reduce poverty, enhance revenue management, and increase community participation.



Robin Emmott/REUTERS

# What's on

## JULY

**11–12** IMF High-Level Seminar on Crisis Prevention in Emerging Markets, Singapore

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

**20** IMF Economic Forum, "Delivering on the Promise of 2005: The United Kingdom's Development Strategy," Washington, D.C., United States

## AUGUST

**27–September 1** International Disaster Reduction Conference, Davos, Switzerland

## SEPTEMBER

**7–8** 13th Asia Pacific Economic Cooperation Finance Ministers' Meeting, Hanoi, Vietnam

**10–11** IMF High-Level Seminar on Financial Taxation, Singapore

**10–11** China Business Summit 2006, Beijing, China

**14–15** Raffles Forum on Good Governance and the Wealth of Nations, Singapore

**19–20** IMF–World Bank Annual Meetings, Singapore

**19–20** United Nations General Assembly, High-Level Meeting on the Review of the Brussels Program of Action for the Least Developed Countries, New York, United States

**25–26** World Trade Organization Public Forum, "What WTO for the 21st Century?" Geneva, Switzerland

## OCTOBER

**23–27** IMF High-Level Seminar on Current Issues in Monetary and Financial Law, Washington, D.C., United States

## NOVEMBER

**6–7** IMF Symposium on Integrity Supervision of Financial Sector Firms, Washington, D.C., United States

**9–10** Jacques Polak Seventh Annual Research Conference, IMF, Washington, D.C., United States

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

**18–19** 14th Asia Pacific Economic Cooperation Economic Leaders' Meeting, Hanoi, Vietnam

**23–24** World Economic Forum in Turkey, "Connecting Regions—Creating New Opportunities," Istanbul, Turkey

**26–28** World Economic Forum, "India: Meeting New Expectations," New Delhi, India

## JANUARY 2007

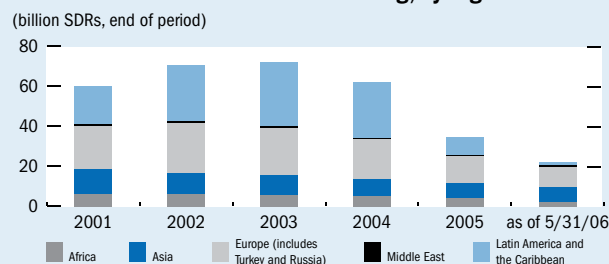
**24–28** World Economic Forum Annual Meeting, Davos, Switzerland

### IMF Executive Board

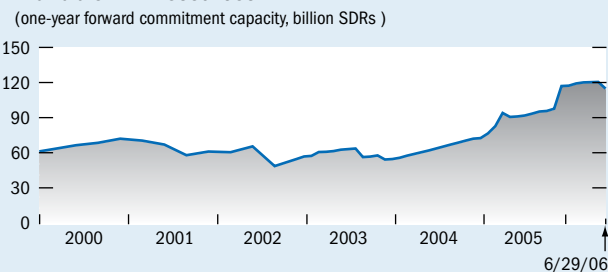
For an up-to-date listing of IMF Executive Board meetings, see [www.imf.org/external/np/sec/bc/eng/index.asp](http://www.imf.org/external/np/sec/bc/eng/index.asp).

# IMF financial data

## Total IMF credit and loans outstanding, by region



## Available IMF resources



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

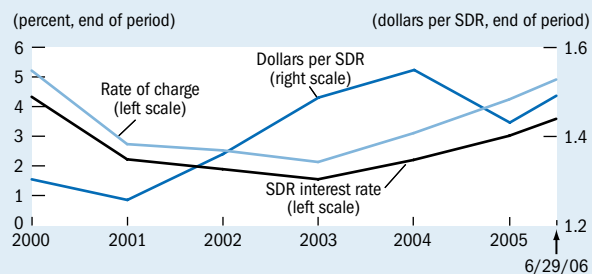
## Largest outstanding loans

(billion SDRs, as of 5/31/06)

Nonconcessional		Concessional	
Turkey	7.87	Pakistan	0.96
Indonesia	5.13	Congo, Dem. Rep. of	0.55
Uruguay	1.26	Bangladesh	0.28
Ukraine	0.73	Yemen, Republic of	0.16
Serbia and Montenegro	0.65	Georgia	0.16

## Related rates

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



serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

## IMF approves \$119 million loan for Afghanistan

The IMF's Executive Board, on June 26, approved a loan of \$119 million for Afghanistan under the Fund's Poverty Reduction and Growth Facility. The Board cited the country's strong economic performance and implementation of key structural reforms under a staff-monitored program, noting that these accomplishments had taken place amid continuing violence and turmoil. The priorities now will be to achieve further progress in boosting capacity, reducing poverty, and creating an investment climate conducive to private sector investment and sustained growth.

The Afghan authorities, with the help of the international community, have made impressive strides toward macro-economic stability since early 2002, when the Transitional Administration took over after more than 20 years of conflict. The authorities initially focused on crisis management and establishing or rebuilding key economic institutions and providing basic government services. The IMF, in early 2002, provided policy advice and technical assistance—notably on introducing a new national currency, preparing central bank and banking laws, improving fiscal management, strengthening revenue policy and administration, and bolstering the statistical database.

### First step

In early 2004, the IMF and the Afghan government reached an agreement on the staff-monitored program, which provided a detailed framework for economic policies whose chief objectives were to maintain macroeconomic stability and build the capacity to implement policies and reforms. Under the staff-monitored program—which Steven Symansky, IMF mission chief, noted was as demanding as many of the Fund's financial programs—the economy grew rapidly, inflation declined, and international reserves strengthened. Despite lingering insecurity, poor infrastructure, and weak institutions, the authorities were able to improve revenue collection, establish a transparent expenditure system with fiduciary standards, and modernize central bank operations.

### More work to do

Reconstruction provided the catalyst for the resumption of broad-based economic activity, including agriculture. But sustained growth, according to Symansky, requires an enabling environment for private sector activity and investment. Other donors are providing support in this area. The IMF is working with the authorities to keep inflation relatively low, follow a prudent fiscal policy, and create a working central bank. Afghanistan has overperformed on revenue but underperformed on expenditure—in part because, Symansky explains,

“they are not able to spend the money.” In other words, the capacity to implement projects is still inadequate.

“The donors work very well together and in partnership with the government,” he says. But, at the same time, the government must also learn to manage its citizens' expectations, as “donor pledges do not always translate into tangible results, such as more jobs.” Development often means building better institutions, and that, Symansky notes, takes time. Moreover, the results are not always apparent to the population.

### The road ahead

Despite strong growth, Afghanistan remains one of the world's poorest countries. Alleviating poverty will require well-targeted social programs and substantial investment if the authorities are to reach the announced goal of a per capita GDP of at least \$500 by 2015.

The new economic program is meant to address these needs and help resolve outstanding debt issues, possibly in the context of the Heavily Indebted Poor Countries Initiative. The challenge will be that the program is taking place in an environment of increasing insecurity and weak capacity. Despite these concerns, Symansky is hopeful in light of the country's performance under the staff-monitored program.

Over the next three years, the IMF-supported program will aim to sustain real GDP growth of about 10 percent a year, reduce inflation to about 5 percent, and further strengthen the country's external position. The goal is to boost budgetary revenue to more than 8 percent of GDP while improving the provision of health care and education services.

For fiscal year 2006/07, the program assumes real GDP growth of 12 percent and a decline in year-on-year inflation to 9 percent. The operating budget deficit is targeted to decline to 2.9 percent of GDP through a combination of revenue measures and expenditure restraint. The fiscal program provides some flexibility to accommodate higher development spending if Afghanistan's implementation capacity improves.

The authorities also intend to strengthen the monetary policy framework by developing the central bank's analytical capacity, modernizing monetary policy instruments, and improving monetary statistics. To improve the investment climate, priority will be given to promoting good governance and strengthening the institutional framework, simplifying business regulations, and divesting public sector activities.

Given Afghanistan's large development needs and limited repayment capacity, there will continue to be a need for a prudent external financing strategy, comprehensive debt relief, and continued donor support on highly concessional terms. ■

## African Governors meet with de Rato on voice and representation

On June 23, the Committee of African Governors on Voice and Representation met with IMF Managing Director Rodrigo de Rato in Madrid to exchange views on governance reforms in the Fund and on the role of African countries in the reform process. At the meeting, the Governors indicated that they would like to see action on several fronts that they felt had not been adequately addressed in the IMF's medium-term strategy: protection of Africa's voting power and voice in the Fund, the need for an additional chair to address the heavy workload of the two Executive Directors representing sub-Saharan Africa, and the underrepresentation of Africans at all staffing levels.

The purpose of the meeting, according to Manuel Chang, co-chair and Minister of Finance of Mozambique, was to establish a clear understanding of where the process was and of de Rato's intention to address concerns. The meeting was cordial and constructive, according to Abdoulaye Bio-Tchané, Director of the IMF's African Department.

De Rato emphasized that "he was committed to bringing forward to the Singapore Annual Meetings a package of reforms that could command the broad support of the membership," and he reaffirmed his commitment to ensuring that, as part of the reforms, emerging and low-income member countries have an important role and voice in the governance of the Fund.

### Addressing Africa's concerns

In his opening statement, de Rato stressed that his reform proposals extended beyond rebalancing economic weights, which had been addressed in the past, to include basic votes, which have not been adjusted since the creation of the Fund. The proposals to increase basic votes and rebalance quotas would help protect African's voice in the Fund, he said.

On an additional chair for sub-Saharan Africa, de Rato said he did not see enough of a consensus across the membership to make this a realistic early prospect. But he said he was pre-

pared to explore ways to strengthen the voice and capacity of the existing sub-Saharan African chairs. As for staffing at the IMF, de Rato reiterated the goal of raising the share of African nationals on the staff from 6.3 percent currently to 8 percent. He noted there had been difficulties in achieving the Fund's diversity objectives, which management considered a high priority, and he asked the ministers for help.

As for strengthening Africa's voice and participation in the Fund, de Rato proposed setting up a committee composed of Fund management, Executive Directors representing Africa, and African Governors as a forum in which, twice a year, issues of concern to Africa could be raised. De Rato asked the staff to follow up on this proposal.

Responding to de Rato's opening statement, the ministers reiterated a number of concerns. First, they suggested that an ad hoc increase in quotas, as proposed by the Managing Director, might not benefit Africa and might even erode its voting power further. They thus urged the staff to clarify in a Board document how such an ad hoc increase would affect Africa's voting share. They recognized that IMF members' positions on increasing the number of Executive Board chairs for sub-Saharan Africa were far apart, but several ministers favored launching a debate to consider the proposal. The ministers agreed with de Rato that Africa's representation on the Fund's staff needed to be increased and pledged to support the institution's recruitment efforts.

According to a statement the Governors and de Rato released at a press conference after the meeting, the discussions "emphasized that governance reforms are at the heart of the continued legitimacy and effectiveness of the Fund and that this is a crucial element of the IMF's medium-term strategy. Governance reforms must certainly take into account the need for adequate voice and representation of African countries, where the Fund continues to play an important advisory and financing role." ■

### Public comments sought on IMF-World Bank collaboration

Can the IMF and the World Bank strengthen the ways the two organizations collaborate on joint efforts? An external review committee, appointed in March, would like to hear from the public. Comments should be submitted to [erc@imf.org](mailto:erc@imf.org) by September 15.

The public's input will help the committee weigh the efficiency and effectiveness of current arrangements and contribute to recommendations for improvements. The six-member committee is particularly interested in the public's perspectives on the division of labor between the Fund and the Bank. Among the specific ques-

tions the committee is taking up are whether the division of labor is consistent with the organizations' respective mandates and is actually being implemented; whether Fund-Bank collaboration on country work can be improved and perhaps better tailored to differing circumstances; and whether there is scope to improve collaboration on policy areas, such as financial sector soundness, trade, and poverty reduction.

For more information, please see [www.imf.org/external/np/exr/erc/index.htm](http://www.imf.org/external/np/exr/erc/index.htm).

## Sustained sound policies bode well for New Zealand

Following a vigorous expansion in recent years, a cyclical slowing in New Zealand's economy began in 2005, and growth declined to 2¼ percent, the IMF said in its annual economic review. With the exchange rate reaching a post-float record high in December, the slowdown affected the tradables sector most heavily, and the external current account deficit widened to twice its 20-year average. At the same time, an unexpected revival of the housing market sustained domestic demand, which, along with higher oil prices, pushed inflation slightly above the medium-term target range of 1 to 3 percent.

More recently, domestic demand growth has slowed and the exchange rate has declined. Against this backdrop, growth is likely to be sluggish in 2006 but is expected to recover in 2007, led by exports. With slower growth easing resource pressures, inflation is expected to moderate, allowing for an eventual easing of monetary policy.

The IMF Executive Board commended the authorities on their continued implementation of sound macroeconomic policies during a challenging phase in the business cycle and considered the current policy stance to be supportive of a soft landing for the economy. The Directors endorsed the government's far-sighted conduct of fiscal policy, which has allowed the operating surplus to rise substantially during years of strong growth. They also saw monetary policy as well placed to accommodate the

New Zealand	2002	2003	2004	2005	Proj. 2006
	(annual percent change)				
GDP (production basis)	4.8	3.4	4.4	2.2	0.9
Headline consumer price index (end of period)	2.7	1.6	2.7	3.2	2.9
	(percent of GDP)				
OBERAC <sup>1</sup>	2.2	4.3	4.6	5.6	3.4
External current account balance	-4.0	-4.3	-6.6	-8.8	-8.9
Nominal effective exchange rate <sup>2</sup>	112.3	126.0	132.3	135.9	...

<sup>1</sup>Operating balance excluding revaluations and accounting changes—New Zealand's indicator of current cash flow.  
<sup>2</sup>IMF Information Notice System index (1990=100).  
 Data: New Zealand authorities and IMF staff estimates and projections.

one-off effects on headline inflation of the recent exchange rate depreciation and oil price increases. At the same time, with the labor market remaining tight, they saw little room to cut interest rates in the near term but noted that there was scope to ease monetary policy if the economy slowed more abruptly.

The Directors welcomed recent steps to improve the financial sector regulatory framework and supported efforts to strengthen the monitoring of household debt-service capacity in view of the notable rise in that sector's indebtedness in recent years. They also supported the government's decision to develop a new regulatory framework for nonbank financial institutions. ■

## Libya urged to take up comprehensive reform plan

After the lifting in 2003–04 of international sanctions, which had lasted more than 10 years, Libya decided to undertake structural reforms and accelerate its transition to a market economy. While the authorities have recently made progress in liberalizing the economy, it remains largely state-controlled and nondiversified. Three-fourths of employment is still in the public sector, private investment is minuscule (2 percent of GDP), and the oil sector is dominant.

Libya's macroeconomic performance in 2005 was relatively strong, according to the IMF's annual economic review. Growth was about 3½ percent, inflation was low, the fiscal and external current accounts registered large surpluses, and international reserves increased. Unlike in previous years, the non-oil economy was the primary driver of growth, mainly as a result of increased government spending. Activity grew 7 percent in trade, hotels, and transportation, and 5 percent in construction and services.

Libya	2002	2003	2004	2005
	(annual percent change, unless otherwise noted)			
Real GDP	3.3	9.1	4.6	3.5
Real nonhydrocarbon GDP	4.7	2.2	4.1	4.6
Consumer prices	-9.9	-2.1	-2.2	2.5
Overall fiscal balance (percent of GDP)	5.2	14.2	17.5	32.6
Gross international reserves (billion dollars)	15.0	19.5	25.6	39.3

Data: Libyan authorities and IMF staff estimates.

In 2005, the authorities continued to reform and open up the economy. In particular, they streamlined the tariff schedule; partially liberalized interest rates; and passed laws to reinforce the central bank's independence, allow foreign banks to operate in Libya, and fight money laundering. They also broadened the privatization program and the scope for foreign investments to include downstream activities in the oil, health care, transportation, and insurance sectors; and launched the privatization of a major public bank.

The IMF Executive Board welcomed Libya's strong macroeconomic performance. It commended recent structural reforms and stressed the importance of accelerating the transition to a market economy. Noting the lack of a comprehensive medium-term plan, the Directors urged the authorities to take advantage of Libya's comfortable financial situation to pursue their reform agenda, using as a blueprint the medium-term strategy prepared by IMF staff at the authorities' request. They stressed that successful implementation of reforms would depend on careful prioritization and sequencing and effective coordination among government institutions. The Directors underscored that economic diversification would require a sustained effort, including, in particular, enhancements to the government's privatization strategy and improved conditions for foreign investment. ■

For more information, please refer to IMF Public Information Notices Nos. 06/50 (New Zealand) and 06/38 (Libya) on the IMF's website ([www.imf.org](http://www.imf.org)).

## Designing an independent monetary policy for China

The debate about China's monetary policy has long swirled around one topic—China's exchange rate regime. Many observers have been calling for a revaluation to correct what they see as an unfair competitive advantage that China maintains by keeping its exchange rate undervalued. Whether or not there is merit to calls for a currency appreciation, what China needs is a truly independent monetary policy, which is not possible with a de facto fixed exchange rate, argue Marvin Goodfriend and Eswar Prasad in a new IMF Working Paper. Indeed, that is an important reason the IMF has been calling for greater exchange rate flexibility in China.

As China's economy develops and becomes more market-oriented, and as its integration with the world economy continues, monetary policy will need to shoulder an increasingly large burden in ensuring stable, noninflationary growth. Rising integration, for instance, implies greater vulnerability to external shocks, and monetary policy is typically the first line of defense against many such shocks. Although deeper structural reforms may be the key determinants of long-term growth, monetary policy has an important role to play in creating the stable macroeconomic environment that is essential for those reforms to take root.

In recent years, China's monetary policy has operated under difficult constraints, including a fixed exchange rate regime, an underdeveloped financial system, and numerous institutional weaknesses. While capital controls provide some room for monetary policy to maneuver even in such a regime, this room tends to be quite limited in practice and could result in inadequate control of investment growth and inflationary (or deflationary) pressures. Furthermore, the effectiveness of capital controls inevitably erodes over time as domestic and international investors find channels, including expanding trade, to evade them. Indeed, China's rapid accumulation of foreign reserves in recent years (see chart) is symptomatic of the difficult balancing act that its monetary policymakers face on the domestic and external fronts.

These considerations have led the authorities to move toward a more flexible exchange rate regime. On July 21, 2005, China revalued the renminbi by 2.1 percent relative to the U.S. dollar and announced that the renminbi's value would henceforth be set with reference to a basket of currencies rather than pegged to the dollar. Although the renminbi's value relative to the U.S. dollar has fluctuated only moderately since then, the Chinese authorities have clearly stated their intention to allow for greater flexibility over time.

### Managing inflation expectations

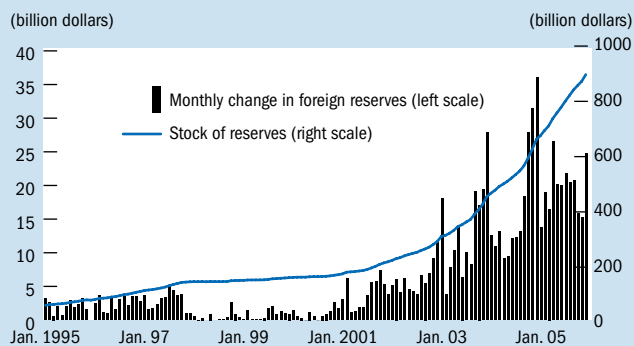
An important consequence of the move toward a flexible exchange rate is the need to adopt a new nominal anchor and strategy for monetary policy. Prominent economists, such as Robert Mundell and Ronald McKinnon, have forcefully argued that the fixed exchange rate has provided a stable nominal anchor and that a flexible exchange rate would deprive the economy of this anchor. They have a valid point: a stable nominal anchor is essential to manage inflation expectations. But McKinnon and Mundell have, the authors argue, the wrong idea about which anchor would work best.

Goodfriend and Prasad make the case that China should adopt a low inflation objective—an explicit or implicit long-run range for the inflation rate and an acknowledgement that low inflation is a priority for monetary policy—as the new nominal anchor. Theory and experience—from both advanced industrial economies and emerging market economies—suggest that adopting such a framework is the most reliable way to enable the People's Bank of China (PBC) to stabilize domestic inflation and protect employment against macroeconomic shocks.

Inflation objectives have emerged in recent years as the leading nominal anchor for monetary policy around the world. An inflation objective can accommodate fluctuations in productivity growth and changing relationships between monetary or credit aggregates and inflation, all of which are relevant considerations for a developing economy. It also has the virtue of easy communicability.

### Stocks and flows

China's foreign exchange reserves have been rising rapidly.



Notes: The flow and stock numbers for foreign exchange reserves include the amounts used for bank recapitalizations: \$45 billion in December 2003, \$15 billion in April 2005, and \$5 billion in September 2005—as well as a \$6 billion foreign exchange swap that the People's Bank of China conducted with domestic banks in November 2005.  
Data: CEIC Data Company Ltd. and authors' calculations.

Can this framework be reconciled with the PBC's broader mandate? The law governing the PBC states that, "under the guidance of the State Council, the PBC formulates and implements monetary policy, prevents and resolves financial risks, and safeguards financial stability." Furthermore, how would a low inflation objective be consistent with promoting sustained high employment growth—a key consideration for Chinese policymakers? In the authors' view, it is precisely by providing a firm and credible nominal anchor through a low inflation objective that the PBC can best contribute to overall macroeconomic stability and best provide for sustained employment growth and financial stability.

The authors stop short of advocating a full-fledged inflation targeting regime. For an economy such as China's that is undergoing marked transitions, there would be numerous impediments to operating such a regime effectively. A low inflation objective is more practical for the foreseeable future and should deliver most of the benefits of formal inflation targeting. In light of the economy's changing structure and weaknesses in the monetary transmission mechanism, the framework could accommodate a continued role for the PBC to monitor and manage monetary (and credit) aggregates. But money may not constitute a good stand-alone nominal anchor because the changes in China's economic and financial structure imply that the rate of money growth consistent with a stable rate of inflation is likely to be highly variable.

### Operational independence for the central bank

Some of the basic requirements of an inflation targeting regime are also important for a low inflation objective. Principal among these is operational independence for the central bank. This means that the PBC should have the authority and the capability to use its monetary policy instruments—bank reserves or an interest rate—to credibly anchor inflation and stabilize the macroeconomy. But it would be important for the Chinese government to explicitly acknowledge its support for a low inflation objective as the nominal anchor for monetary policy.

What would it take to put in place a low inflation objective? Exchange rate flexibility is, of course, a prerequisite for an independent monetary policy. But a move toward greater exchange rate flexibility is hardly the solution by itself. Indeed, enhancing the effectiveness of the monetary transmission mechanism poses difficult challenges independent of the constraints related to the exchange rate regime. The primary one is the reform of the financial system, through which monetary policy must influence economic activity. In China, the state-owned banking system still dominates the financial landscape. For instance, deposits in the banking system now amount to about 160 percent of GDP, with a correspondingly high level of credit to GDP.

### Banking sector reform

Despite recent improvements in the commercial orientation of the banking sector and enhanced banking supervision and regulation, Chinese banks are still far from being robust, commercially driven financial entities. Given the dominance of the banking sector in China's financial landscape, this has important implications for monetary policy transmission.

Thus, China must transform the banking system into one that can direct credit prudently to its most valued uses, given correct interest rate signals. Even in the best of circumstances, it will take years for China to put in place all of the components of a modern, efficient banking system. This is especially so when one recognizes that the transition process must be supervised and regulated with great care to preserve the public's confidence in the banks and guard against the moral hazard problems associated with explicit or implicit deposit insurance provided by the government.

Nevertheless, the authors argue, it is feasible and desirable for China to put in place the financial sector reforms and regulations that would enable it to adopt an independent monetary policy with low inflation as the nominal anchor. The main point would be to ensure that banks could withstand the financial stress that may result from fluctuations in interest rates necessary to stabilize the macroeconomy and maintain stable low inflation. Indeed, significant progress has already been made in strengthening bank balance sheets.

### Extra benefits

Goodfriend and Prasad's proposal has three additional attributes. First, it would allow for continuity in the operational approach to monetary policy. The PBC could gradually adapt its procedures to the pursuit of an independent monetary policy as supporting reforms are put in place. The proposal would entail mainly a shift in strategic focus to a well-defined inflation anchor. Second, under current circumstances, the shift to an inflation anchor would be seamless because it would involve merely locking in the current low rate of inflation. Third, the adoption of an effective independent monetary policy would facilitate various reforms with intrinsic benefits of their own. For instance, the resulting macroeconomic stability would facilitate the modernization of the financial system. In addition, the new policy regime would necessitate improvements in the statistical base that would enhance public sector transparency and encourage better communication about policy intentions. ■

This article is based on IMF Working Paper No. 06/111, "A Framework for Independent Monetary Policy in China," by Marvin Goodfriend and Eswar Prasad. Copies are available for \$15.00 each from IMF Publication Services. Please see page 208 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).



## Lebanon: defying gravity

Imagine an investor who, at the end of 2004, receives information that a country with government debt of 165 percent of GDP (half of it in foreign currency), an external current account deficit of 18 percent of GDP, and a fixed exchange rate faces a major political shock—the assassination of a popular former prime minister, mass street demonstrations, elections, and a protracted political crisis. Likely reaction? An immediate pullout and, possibly, speculation against the currency. The investor would have been wrong, though. The country is, of course, Lebanon. Despite all these adverse events during the first half of 2005, the government and the central bank have managed to restore financial stability, and the country has been able to again attract capital at relatively narrow spreads over international interest rates. Can Lebanon now, finally, tackle its perilously high debt?

Before 1975, the Lebanese economy was one of the most dynamic in the Middle East, and Beirut had established itself as the regional financial hub. But 1975 saw the country plunge into civil war. The war took a heavy human toll and also produced substantial output losses, an extensively damaged infrastructure, and a tremendous loss of human capital as a result of emigration. At no time during the war, however, did Lebanon default on its financial obligations, and the country emerged from civil war in 1991 with a moderate level of debt (about 50 percent of GDP).

GDP subsequently rose in the 1990s, but growth was outpaced by rising debt as the government resorted to large-scale borrowing to rebuild the country (see chart, this page). Faced with dangerous debt dynamics and eager to avert a possible debt and balance of payments crisis, the government developed an ambitious reform agenda in 2002 that received substantial donor support at the Paris II conference. The authorities were able to achieve significant adjustment, although not enough to reverse the debt dynamics—in part because the country was suffering a parallel slowdown in growth. Implementation of the reform agenda also proved difficult, and the reform effort eventually stalled.

### Facing down a crisis

It was against this backdrop that former prime minister Rafik Al-Hariri was assassinated in February 2005, throwing the country into a period of political and financial turbulence. Investors withdrew from Lebanon, and dollarization rose sharply—leading to substantial pressure on international reserves, which declined by about 20 percent over two months (see chart, page 201).

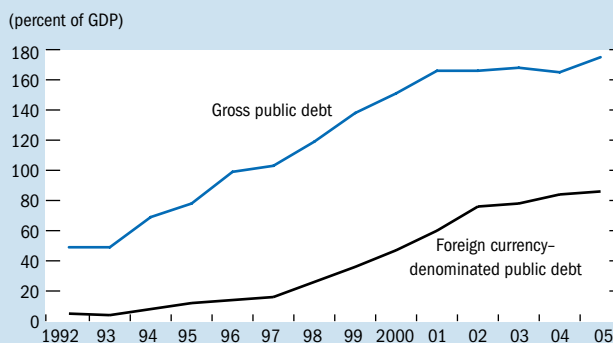
The authorities reacted by raising interest rates and providing additional incentives for commercial banks to extend maturities on government debt and maintain their foreign assets within Lebanon. These steps stabilized the situation until the political crisis waned. Deposit inflows resumed in the second half of 2005, dollarization receded, and international reserves recovered.

The political crisis temporarily interrupted an acceleration of economic growth. A surge in tourism and construction as well as exports raised GDP growth to 6 percent in 2004. But in the wake of the political crisis, public and private demand contracted in the first half of the year. And, although activity recovered toward the end of 2005, real GDP growth was subdued, at 1 percent for the year as a whole. Along with economic activity, foreign direct investment and portfolio inflows picked up again in the second half of 2005, more than offsetting a narrowing current account deficit.

In the absence of an approved budget, fiscal policy remained largely on autopilot during 2005, and public debt rose further. There was a de facto nominal freeze in most expenditure categories, although spending increased in some areas—notably transfers to social security funds and to the state electricity company, whose financial losses were estimated to be at least 3 percent of GDP in 2005. The economic slowdown weakened tax revenues, and a cap on domestic petroleum product prices exacerbated falling revenues, but these factors were mitigated by a decline in interest payments. As a result, the overall fiscal deficit narrowed slightly, but government debt still rose to 175 percent of GDP.

### Rebuilding compounded debt

Government debt—already high—rose sharply during post-civil war reconstruction.



Data: Lebanese authorities and IMF staff calculations.

## Resilience and risk

The events of 2005 underscored the resilience of the Lebanese economy in the face of shocks but also exposed significant vulnerabilities. The large and growing public debt overhang, the high degree of dollarization, large fiscal and current account deficits, and Lebanon's reliance on short-term inflows to finance these deficits are the core vulnerabilities. The risks associated with these imbalances have been muted by a benign external environment, ample regional liquidity, and the relative stability of the depositor base. Lebanon's resilience has also been bolstered by the liquidity cushion held by banks, its strong reputation for safe banking established over decades, and the authorities' skillful handling of the financial pressures.

Without a doubt, Lebanon has defied the conventional economic wisdom on debt sustainability—and, some say, gravity—for quite a while. As long as the confidence of depositors is not disturbed, this equilibrium may prevail for some time.

But even if a crisis is not imminent, the heavy debt burden severely restricts the fiscal room that authorities have to actively pursue policies to, among other priorities, strengthen growth and raise the standard of living further. In 2005, interest expenses accounted for 34 percent of total government spending and 46 percent of government revenue. This, in itself, is a reason to strive for debt reduction. Not only would lower debt reduce fiscal vulnerabilities, it would also ultimately free up resources for other government priorities. Another reason for concern is that the large debt overhang stifles investment in productive capacity and,

thus, growth. The risk of a major financial crisis severely shortens the investment horizon.

## Reform in the balance

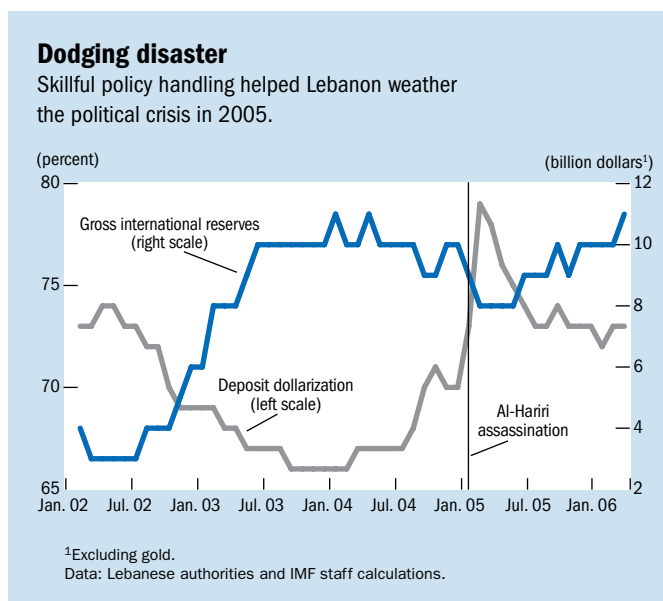
What to do? A well-prepared *mezza* of individual reform measures, including growth-enhancing policies, will work best to balance the short-term costs of adjustment with the long-term benefits of debt reduction. The authorities are committed to pursuing such a comprehensive reform program around a debt-reduction strategy, and they are aware that it will take time to significantly lower Lebanon's debt-to-GDP ratio. Still, up-front fiscal adjustment is needed to reverse debt dynamics and put Lebanon on a downward debt trajectory. Privatization can also lower gross indebtedness.

In its recent report on the Lebanese economy, the IMF staff presented a scenario consistent with the authorities' debt-reduction objectives. In this scenario, government debt would fall below 100 percent of GDP over the next 10 years. If Lebanon could again secure donor assistance, this pace would be accelerated. Of course, the scenario is also subject to uncertainties surrounding possible shocks to interest rates and growth, as well as to the political difficulties of delivering sustained adjustment.

Adoption of a comprehensive reform program is only one of many contentious issues on Lebanon's complex political agenda. There are ongoing political tensions over relations with Syria, the legitimacy of the president, and the United Nations' calls for the disarmament of Hezbollah (one of the government's coalition partners). These issues have proved difficult to solve swiftly in a political system that requires a high degree of consensus among the various communities.

In fact, favorable economic developments since mid-2005 may have lessened the sense of urgency in the wider political arena to pursue a reform program that is likely to include some unpopular measures. But, in a volatile political and financial environment, Lebanon remains highly exposed to the risks of a shock that could trigger a widespread financial crisis. The government's economic team is fully cognizant of these risks and has prepared a credible program to address them. Now it is up to the political leaders and the people of Lebanon to take up the challenge. ■

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Middle East and Central Asia Department



For more information, see *Lebanon: 2006 Article IV Consultation*, IMF Country Report No. 06/201. Copies are available for \$15.00 each from IMF Publication Services. Please see page 208 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## Strong fundamentals and commodity boom help sustain Canada's vigorous performance

The Canadian economy delivered another strong performance in 2005 and maintained its growth momentum during the early part of 2006. In addition to its excellent macroeconomic policy framework, the country has benefited from booming oil and gas exports and rising investment. A flexible labor market has also helped the economy adapt to an appreciating Canadian dollar, which has climbed to heights not seen for the past quarter century. With global competition intensifying, though, there is still more that Canada can do to increase labor market flexibility and bolster the economy's adaptability to meet the challenges ahead.

GDP growth remained close to 3 percent in 2005 as high commodity prices provided a particular stimulus to Canada's resource-rich western provinces (see chart, this page). Much of the rest of the country did well, too. As in recent years, increases in domestic demand provided the primary impetus for growth. Household spending was boosted by a rise in personal wealth, including some acceleration in house prices. In the corporate sector, strong earnings, low interest rates, and falling prices for imported capital goods facilitated business investment. Stepped-up development of Canada's natural gas and oil resources—in response to rising energy prices—added significantly to investment demand.

### Adapting to challenges

On the external side, the Canadian dollar has strengthened, particularly against the U.S. dollar, reaching levels not seen

since the late 1970s. The appreciating exchange rate—which reflects, in part, a sharp improvement in the terms of trade in recent years—has dampened net exports, which continued to be a drag on economic activity in 2005. Nevertheless, rising revenues from commodity exports—notably oil and gas—have helped maintain Canada's nominal current account surplus at 2¼ percent of GDP.

Canada's economic performance has benefited from a highly flexible labor market that has permitted it to reallocate productive resources in response to shifts in the terms of trade and the exchange rate appreciation. With labor demand shifting from manufacturing toward the natural resource sector and services, as well as from the eastern to the western part of the country, employment expanded by almost 1½ percent in the first five months of 2006, and the unemployment rate has fallen to a 31-year low of 6.1 percent. Productivity growth has also accelerated since mid-2005, following several years of lackluster performance.

### Prudent macroeconomic policies

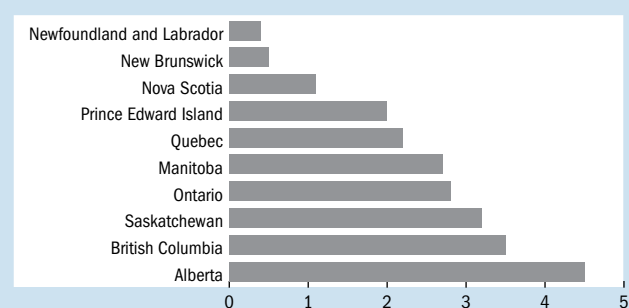
Despite higher energy prices and robust growth, inflation has remained subdued. Headline inflation stayed well within the Bank of Canada's 1 to 3 percent target band, except in September 2005, when a spike in energy prices in the aftermath of Hurricane Katrina caused it to overshoot temporarily. Core inflation (which excludes particularly volatile components, such as energy and food prices) has not exceeded 2 percent since early 2004, with the strong currency and global competition keeping prices of imported goods low, and well-anchored inflation expectations helping to contain the spillover of energy price shocks to other prices.

The change in government following the January general election has not affected Canada's commitment to budget discipline. The FY2006/07 budget has centered on the new government's objective to reduce the federal debt by C\$3 billion a year. The government also took advantage of the FY2005/06 surplus (the ninth consecutive federal budget surplus; see chart, facing page) to advance the target of lowering the ratio of federal debt to GDP to 25 percent by one year to FY2013/14. The budget also aimed to contain expenditure growth and lower the tax burden, including through a 1 percentage point reduction in the goods and services tax and other measures designed to boost incentives to work, save, and invest.

### The west is booming

Strong demand for oil and gas exports has boosted growth rates in Canada's western provinces.

(growth rate; percent)



Data: Haver Analytics.

## Looking ahead

The IMF's Executive Board agreed with the staff's assessment that Canada's near-term macroeconomic outlook appears broadly favorable. Growth is expected to remain around 3 percent through 2007—close to most estimates of Canada's potential growth rate. The estimates reflect the continued support that high commodity prices are likely to provide to incomes and domestic demand.

This outlook is subject to risks, however, including the potential for a rapid adjustment of global imbalances—which could lead to, among other things, further exchange rate appreciation—and the low household saving rate. Against this background, and in light of increased global competition and intensifying demographic pressures, it will be important for Canada to maintain prudent fiscal and monetary policies and further improve the economy's flexibility.

On the monetary side, the Bank of Canada has appropriately withdrawn monetary stimulus in recent months. With the economy operating near its potential, further policy decisions will need to balance the support that favorable terms of trade are providing to economic activity against the drag from an appreciated exchange rate, whose strength has continued to largely reflect fundamentals. Canada's inflation targeting framework has kept inflation and inflation expectations low, and the Bank of Canada has established a commendable record of transparency.

The Executive Board welcomed the new government's commitment to lowering the tax burden, maintaining fiscal surpluses, and continuing debt reduction. It also viewed the authorities' emphasis on limiting the growth of spending, the planned reductions in corporate rates, and the early

elimination of the federal capital tax (given the relatively high level of Canada's marginal effective corporate tax rates) as appropriate. The Board said, however, that in its view, Canada could have provided greater incentives to save and invest by reducing marginal personal income tax rates and promoting tax-deferred saving rather than by cutting the goods and services tax rate.

The Directors supported the new government's prudent fiscal framework, which has benefited from steps to strengthen fiscal transparency. Both the medium-term debt anchor and the planned establishment of a Parliamentary Budget Office could help support the social consensus for prudent fiscal policies. Going forward, the Board cautioned that the authorities would have to be alert to the fiscal challenges presented to all levels of government by the rapid increase in provincial and territorial expenditures on health care. They will also need to ensure that the boom in oil and gas prices does not exacerbate regional disparities in fiscal capacity.

Canada's financial sector has enjoyed strong profitability in recent years, and strong balance sheets and low default rates suggest that the sector is well placed to support continued economic growth. There is still room, however, to further strengthen the system's efficiency and resilience, particularly with global competition intensifying in the financial services market.

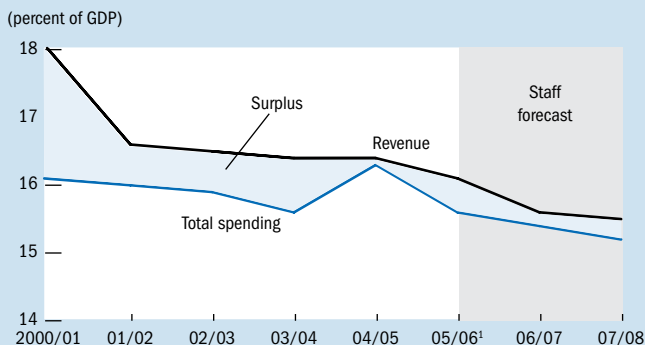
Finally, although Canada has been among the fastest-growing industrial countries in recent years, there is still scope to boost productivity through labor and product market reform. In particular, continuing to reduce welfare walls—that is, spikes in the marginal tax rate at income levels where targeted tax preferences and social benefits are cut off—could increase labor participation among low-income groups.

On other fronts, amending the immigration process could help address skills shortages, and simplifying the recognition of occupational qualifications across provinces would also increase labor market flexibility. Consideration could also be given to funding the employment insurance system's social benefits through general revenues rather than through the payroll tax. This would further reduce price distortions in the labor market. ■

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### In the black

Canada's federal budget remained in surplus for fiscal year 2005/06—the ninth consecutive year it has done so.



<sup>1</sup>May change once final accounts are published.  
Data: Haver Analytics, Finance Canada, and IMF staff calculations.

This article is based on IMF Country Report No. 06/230, *Canada: 2006 Article IV Consultation*. Copies are available for \$15.00 each from IMF Publication Services. Please see page 208 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## A case for creating “Gulfstat”—a regional statistical system

The six member states of the Gulf Cooperation Council (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates—have laid out a path to a common market by 2007 and monetary union by 2010. To monitor this convergence process and support economic and monetary policy, the member countries must be able to provide comparable economic data. What is the most efficient way to produce these data? A new IMF Working Paper surveys the statistical institutions in the GCC countries and presents the case for creating “Gulfstat”—a regional statistical agency. Such an agency could draw valuable lessons from regional statistical organizations in Africa and the European Union (EU).

The GCC’s overall aim is to bring about the economic integration of its member states. Progress toward this end can be measured against a set of convergence criteria in areas such as macroeconomic indicators, trade patterns, and social trends. Member states have agreed on criteria similar to those adopted by the EU under the 1992 Maastricht Treaty: inflation, interest rates, foreign exchange reserves, fiscal deficit, and debt relative to GDP.

Creation of a regional statistical agency could aid the GCC countries as they move toward a common market and monetary union. With GCC national statistical offices still evolving, it is critically important that the six countries develop a common methodology for collecting and processing certain data and agree on a program of data dissemination. Special consideration should be given to the potential role that Gulfstat could play as compiler of statistics. In her opening address at the 15th GCC Ministerial Planning and Development Committees meeting in Abu Dhabi in June, Shaikha Lubna al Qassimi emphasized the importance of establishing GulfStat in light of the 2010 GCC census and other statistical activities.

### Building blocks

These six states have, for some time, been coordinating statistical activity to achieve cross-country comparability. The heads of the national statistical offices meet regularly and, in May 2004, adopted a set of measures to consolidate and further develop joint statistical work that would unify statistics laws, adopt a common methodology in building a data warehouse, conduct regionally coordinated demographic surveys to fill gaps in population statistics, coordinate efforts to develop data on foreign direct investment, and implement the International Comparison Program—a global statistical program that produces internationally comparable price levels, expenditure values, and purchasing power parity estimates.

It also coordinates gender statistics, which would, among other purposes, monitor implementation of the Millennium Development Goals.

One important step in fostering collaboration across GCC statistical agencies would be to assign clear responsibilities for producing official statistics at the national level, which is not currently done in all countries. For monetary and balance of payments statistics, central banks have the lead responsibility in all GCC countries except one, making coordination in these areas relatively straightforward. For all other statistics, however, the institutional framework is far more complex. Legal action may be required to allow the agencies to enter into an agreement with one another and with the proposed future regional agency, Gulfstat. A clear legal mandate is especially needed in cases where the national statistical agency is housed in a ministry.

It would also be essential to clarify legal responsibility for compiling and disseminating government finance statistics—a key element in monitoring convergence toward monetary union. In many industrial countries, ministries of finance produce many of the source data for government finance statistics, but national statistical agencies are generally responsible for compiling and disseminating these data. A similar approach might be considered for the GCC countries.

To be effective and to produce credible data, Gulfstat should be endowed with a strong governance structure. It should be an independent agency with the necessary legal foundation to support professionalism and engender public trust and confidence in the statistics it publishes.

### Learning from Afristat and Eurostat

To achieve these goals, Gulfstat could look to two models—Afristat and Eurostat. Afristat is a regional statistical agency open to all sub-Saharan African countries. Created in 1996 in response to a decline of national statistical systems in the 1980s, it focuses on building capacity in compiling consistent, comparable, and reliable economic and social data.

Eurostat was established in 1953 to meet the requirements of the European Coal and Steel Community. Its task broadened with the creation of the European Community in 1957. It now supplies the Economic Commission and other European institutions with data that allow them to define, implement, and analyze Community policies. Since the start of European Economic and Monetary Union, the European Central Bank has also been an important user of statistics produced by Eurostat.

Both Afristat and Eurostat coordinate activities of national statistical agencies, promote harmonization of statistical processes and methodologies, and, more generally, encourage

dialogue among the statistical agencies. These are basic features that Gulfstat could use while tailoring the agency to the unique environment of GCC regional statistical integration.

Among Gulfstat's likely top priorities would be to intensify the collaboration among statistical agencies, develop common work programs, and coordinate data collection procedures. Eurostat collaborates with member countries through active advisory groups within the European System of Statistics (ESS). These advisory groups play a crucial role in bringing member countries' statistical practices closer together. Firm agreements among ESS members about dissemination requirements support Eurostat's work. Such contractual relationships contain useful lessons for the GCC countries.

Afristat provides technical assistance to its member institutions. Eurostat does not have such a function within the ESS, but many of its staff members are experts seconded from member statistical agencies, providing valuable opportunities for statisticians to learn from other countries. Gulfstat may want to employ a mix of these arrangements—combining some international experts and some staff members from regional statistical agencies while also organizing training courses for the national statistical agencies and acting as a focal point for collaboration with international agencies.

### Promoting integration and comparability

The heads of national statistical agencies in the GCC countries have already agreed on a coordinated household survey and a population census, and Gulfstat could provide the institutional setting for these activities. In the EU, data collection is in the hands of national statistical agencies, but, in practice, Eurostat is an active partner in this process. Gulfstat could, similarly, play an active role in compiling regional data.

Afristat's and Eurostat's constituencies are broad economic areas including, but not limited to, monetary unions. This may offer another lesson—namely, that Gulfstat would have its own merits in supporting the development of statistics in the region and thus fostering economic integration of the six Middle Eastern states. It would also suggest that a regional statistical agency could proceed at a different pace from the common market and monetary union agendas.

Under the common statistical work that the GCC Secretariat envisages for Gulfstat, consistency, timeliness, and comparability would be high priorities. Work is under way to adopt a common methodology for preparing national accounts estimates. In this regard, the GCC's Statistical Committee is currently preparing a detailed time frame to implement the 1993

System of National Accounts. Efforts are also under way to finalize unification of statistical definitions, concepts, and classifications. Moreover, a methodology for compiling intra-GCC trade statistics is under review, with close coordination between statistical offices and customs departments.

Eurostat's work implicitly benefits from the fact that most of its constituency already subscribes to the IMF's Special Data Dissemination Standard (SDDS)—a set of standards for countries having, or seeking, access to international capital markets that entails commitment to timely data dissemination in line with international standards. Similarly, Afristat's work benefits from its members' participation in the General Data Dissemination System (GDDS)—a set of recommended standards coupled with a strategic action plan to build up the national statistical system. Universal participation of GCC countries in the GDDS, with a view to moving toward SDDS subscription over time, would lend support to the effectiveness of regional statistics and a regional statistical agency.

**Among Gulfstat's likely top priorities would be to intensify the collaboration among statistical agencies, develop common work programs, and coordinate data collection procedures.**

### Required resources

If Gulfstat is to aid regional integration, what kind of resources would it require? Ultimately, that decision would have to be made in line with the new central agency's functions. The experiences of Afristat and Eurostat, though both serve much larger constituencies, can provide guidance. Afristat grew out of the need to pool members' scarce financial resources. The GCC countries do not face such constraints, but Afristat exemplifies how a lean organization—staffed with only 12 professionals—can serve the diverse needs of its members. Afristat's role in supporting the development of national statistical agencies is also comparable to the situation of the GCC states.

Eurostat evolved during a time when national statistical agencies in the region were already well developed. In this environment, its main role as coordinator of statistical activity was a natural outgrowth. Gulfstat's environment would be different. The GCC national statistical agencies are still developing, which would afford Gulfstat an important role in leading this process. ■

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This article is based on IMF Working Paper No. 06/38, "Providing Official Statistics for the Common Market and Monetary Union in the Gulf Cooperation Council (GCC) Countries—A Case for Gulfstat." See page 208 for ordering details. The full text is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

## Forecasting European Central Bank monetary policy

Various aspects of economic behavior are known to be affected by geographic dimensions. For instance, firms in the same industry tend to cluster in geographic areas, indicating a productivity-enhancing role of proximity to other firms. The financial sector is no exception, as is evident from the existence of financial centers. Furthermore, geography plays a role in the performance of investors: local investments tend to be more profitable than remote investments. Do these findings expand into the area of monetary policy? Are there geographic heterogeneities across forecasters of monetary policy decisions? Systematic geographical differences, for instance, could arise in larger currency areas such as the United States or European Economic and Monetary Union, which encompass large and possibly quite diverse geographical regions.

A new IMF Working Paper addresses this question for the case of the European Central Bank (ECB) and finds that the accuracy of analysts' forecasts of ECB monetary policy decisions varies considerably. In particular, there is evidence of agglomeration effects in euro area financial markets, as forecasters in financial centers outperform others. Moreover, ongoing research suggests that the ECB may not be the only central bank faced with heterogeneous expectations.

To better understand this range of forecasting results and the reasons for it, the study analyzed a novel database of monetary policy expectations by professional financial analysts from 120 institutions in 24 countries between 1999 and 2005. The database, surveyed by Reuters, found substantial differences in forecast accuracy (see chart). The top 10 percent of all institutions participating in the survey have a forecast error that is, on average, 8 basis points smaller than the error made by the

worst 10 percent of performers. These differences are significant in economic terms: the best-to-worse difference of 8 basis points is about one-third the typical ECB policy rate change of 25 basis points during the sample period.

### Explaining the variability

What explains this heterogeneity in anticipating ECB monetary policy decisions? The analysis found that geography matters for forecast accuracy. There is a surprising amount of cross-country variance in expectations about ECB policy rates—especially in the first years of the sample period. But forecast accuracy depends more on presence in a financial hub than on nationality. In fact, the best forecasters tend to be located in the financial centers of London or Frankfurt. Accuracy tends to be lower with large geographical distance from Frankfurt. In essence, agents in or near a financial hub seem to have a clear advantage over more distant observers.

Another factor driving accuracy of these forecasts is *history*. Analysts in countries with a history of relatively high central bank independence tend to make better forecasts of ECB behavior than others. National *macroeconomic conditions* also tend to influence forecast accuracy, as the predictions of ECB policies become less precise if the forecaster is located in a country where inflation or unemployment rates deviate from the euro area average.

Is the observed variation in forecasting ability systematic, rather than based on differences in “gut feeling” among analysts? The Working Paper finds that, while some systematic differences between analysts are persistent, others have been transitional and are, thus, indicative of learning.

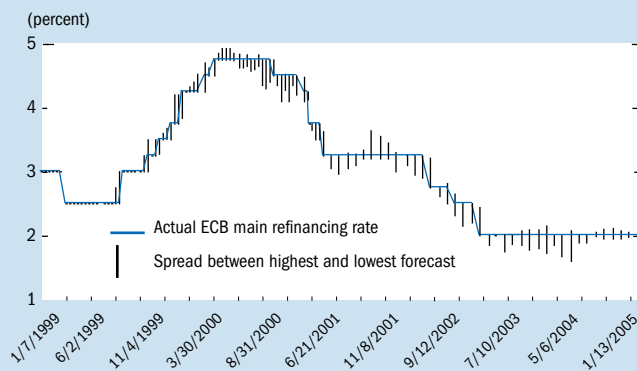
Ongoing research by the authors indicates that these challenges may not be unique to the ECB: the U.S. Federal Reserve also faces some significant regional heterogeneity in forecasting quality among its central bank watchers. Being able to draw on a richer database for the Federal Reserve forecasts, the research suggests that the above-average performance in financial hubs is partly explained by the superior pool of economists available in these locations, suggesting that better forecasts are also at least partly related to the skills of the individual analysts. ■

Helge Berger, Free University of Berlin

Michael Ehrmann and Marcel Fratzscher, European Central Bank

### A range of expectations

The ability of analysts to accurately forecast the European Central Bank's monetary policy decisions varies considerably.



Data: Reuters survey of 120 institutions in 24 countries between 1999 and 2005.

Copies of IMF Working Paper No. 06/41, “Forecasting ECB Monetary Policy: Accuracy Is (Still) a Matter of Geography,” are available for \$15.00 each from IMF Publication Services. See page 208 for ordering details. The full text is also available on the IMF’s website ([www.imf.org](http://www.imf.org)).

## The WAEMU urged to advance on regional convergence

Growth in the West African Economic and Monetary Union (WAEMU) was moderate in 2004 and 2005 as the region grappled with the real appreciation of the CFA franc and falling prices for its core commodity exports. Per capita income growth was positive but below the sub-Saharan African average, according to the IMF's recent economic review. WAEMU countries also contended with domestic problems, including food shortages in some, weak fiscal performance, sociopolitical crises, and financial sector difficulties. In this environment, the WAEMU had difficulty implementing regional policies and made slow progress in complying with the convergence criteria for the monetary union.

Inflation was less than 1 percent in 2004, largely because of successful agricultural production in most countries and the strong CFA franc. But inflation rose in 2005, partly because of oil price increases, food shortages, and a pickup in domestic demand. With excess liquidity, banks in some member countries were able to significantly increase lending, contributing to higher domestic credit in some countries, which also contributed to higher inflation.

WAEMU members' fiscal positions continued to weaken, but much of the increase in deficits was due to poverty-related spending. Although the share of capital expenditures has increased, fiscal flexibility is still limited by the high share of current expenditures, particularly wages. Efforts to raise revenues have been hampered by problems in tax administration.

External sector developments in 2004–05 were mixed. At least some of the exchange rate–based competitiveness gains from the 50 percent 1994 devaluation persist: the regionwide real effective exchange rate currently stands at 76 percent of its predevaluation level. With exports dominated by limited primary commodities, the WAEMU is vulnerable to changes in the terms of trade, which deteriorated by more than 20 percent during 2000–05. However, the terms of trade impact of the 2004–05 oil price increase was softened by Côte d'Ivoire's oil exports, representing about half of the WAEMU's oil imports.

Macroeconomic prospects are good but subject to risks. Price projections for the region's main export commodities are stable

or set to increase, which should help improve fiscal and external current accounts. Debt relief for some countries and related flows, as well as any increased aid under the Multilateral Debt Relief Initiative, will also spur growth. Given Côte d'Ivoire's economic importance, a faster regional expansion will hinge on improved socioeconomic conditions in this country. Other risks include possible further exchange rate– and oil price–induced shocks and domestic financial sector weaknesses.

The IMF Executive Board noted that prospects for strengthened economic performance would depend on developments in the external environment, the strength of macroeconomic and structural policy implementation, and the resolution of Côte d'Ivoire's conflict. The Directors called on the member authorities to make progress on already agreed-upon regional policies, particularly on trade.

Stressing that future exchange rate and terms of trade developments should be monitored carefully, the Directors called for more domestic price and wage flexibility to alleviate past losses in price competitiveness. They also underscored the importance of prudent fiscal policies, including the containment of wage increases, in underpinning the exchange rate regime.

The Directors welcomed the regional central bank's ability to maintain sufficient international reserves. The rapid credit and monetary expansion, however, is a source of concern. In light of increasing inflationary pressures, they called on the Central Bank of West African States to reactivate its market-based instruments to manage liquidity at the regional level.

The Directors regretted the region's failure to date to reach macroeconomic convergence and welcomed ongoing efforts to redefine the convergence criteria. Members need to renew their commitment to common macroeconomic targets and to promote more integrated regional markets. In this context, the Directors noted that the emergence of a regional treasury bill market—while a positive step—reinforces the importance of improved regional fiscal policy coordination. They encouraged the authorities to promote the use of existing regional guidelines on public accounting, statistics, and budgetary processes.

The Directors urged the authorities to improve the soundness of the financial sector and enforce prudential regulations. They underscored the importance of preserving confidence in the regional banking system. The Directors welcomed the dynamic development of the microfinance sector in the region but called for a consistent regulatory framework and effective oversight. ■

WAEMU	2002	2003	2004	2005	Proj. 2006
	(annual percent change)				
Real GDP	2.0	3.9	3.2	4.0	4.1
Consumer prices (average)	3.0	0.8	0.2	4.5	1.9
(percent of GDP)					
Overall fiscal balance (including grants)	-2.3	-2.1	-2.4	-2.6	-2.9
Exports of goods and services	30.3	28.2	28.7	28.0	31.4

Data: IMF, African Department database, *World Economic Outlook*, and staff estimates.

For more information, please refer to IMF Public Information Notice No. 06/53 on the IMF's website ([www.imf.org](http://www.imf.org)).



## Helping countries avoid the “resource curse”

**H**ow can the mining and metals sector contribute to sustainable progress in the developing world? The International Council on Mining and Metals (ICMM) seeks to help answer this question with its Resource Endowment Initiative, a project launched two years ago with the help of the United Nations Conference on Trade and Development (UNCTAD) and the World Bank. On June 30, Kathryn McPhail (Principal, ICMM) and John Groom (Head of Safety, Health, and Environment, Anglo American plc) presented the initiative’s initial findings to a group of IMF staff.

The initiative set out to explore why the “resource curse”—the paradox that countries with abundant natural resources often have lower economic growth than countries without comparable resource endowments—was not a universal phenomenon. With the help of expert consultants and an independent advisory group, the ICMM conducted four case studies in countries with long histories of mining activity—Chile, Ghana, Peru, and Tanzania. To ensure greater comparability in macroeconomic policies, the case studies focused on periods following the implementation of economic reform programs supported by the IMF and the World Bank.

Foreign direct investment registered a marked increase in each of these countries, with exports also rising, and mining contributed to higher GDP growth. This phenomenon was most striking in Ghana, whose per capita GDP had registered positive growth since 1987. In addition to higher growth, Groom explained, the study showed significant reductions in poverty in Chile and Ghana, at both the national level and in the mining regions. For Tanzania, the data were incomplete, while for Peru, no meaningful poverty reduction was in evidence. All four countries also registered a slight improvement in governance from 1996 to 2004, though McPhail observed that only in Chile did governance reach a level where it could be considered good in absolute terms.



John Groom and Kathryn McPhail discuss project findings.

Eugene Shtazar/IMF

In addition to problems of governance, taxation and royalty issues were seen as critical to tapping the full potential of mining sectors. The study identified problems with the allocation of mining revenues between different levels of government, as well as with the capacity of regional and local authorities to manage mining revenues. In the lively question-and-answer session that followed the presentation, staff economists stressed the need for equitable sharing of both risks and rewards between companies and host governments. More generally, staff noted that fiscal policy should be used to help save windfall gains and thereby cushion the effects of commodity price volatility.

### What’s next

In the initiative’s next phase, the ICMM will work with donor agencies, civil society organizations, international organizations, and host governments to derive more

specific lessons on ways to reduce poverty, enhance revenue management, and increase local inputs into mining projects in host countries.

Moderator Scott Brown (Assistant Director, IMF Policy Development and Review Department) observed that, although much of the initiative’s work falls outside the IMF’s mandate, the organization provides considerable related policy advice and technical assistance in the areas of tax policy, public sector financial management, and fiscal transparency and has recently released the *Guide on Resource Revenue Transparency*. Brown hoped the two organizations would maintain a continuing dialogue and that it might prove possible for Fund staff to participate in seminars in the field to discuss the lessons from the case studies.

*Maureen Burke*  
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For more information on the Resource Endowment Initiative, please visit the ICMM’s website at [www.icmm.com/project.php?rcd=16](http://www.icmm.com/project.php?rcd=16)

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