

## IMF-World Bank Spring Meetings

# Ministers Resolve to Counter Slowdown, Combat Food Hikes

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IMF Managing Director Dominique Strauss-Kahn told reporters after the International Monetary and Financial Committee (IMFC) meeting on April 12 that "what was obvious was that there is a kind of revival of the multilateral spirit, the idea that we are facing global problems and that to those global problems there must be global answers." IMFC Chairman Tommaso Padoa-Schioppa noted that "the discussion on global economy and financial markets

*(continued on page 50)*



Both World Bank President Robert Zoellick (left) and IMF Managing Director Dominique Strauss-Kahn stressed the need for quick action on food prices.

## Credit Crisis Is Broadening, IMF Warns

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At present, the issuance of most structured credit products—instruments that pool and divide credit risk exposures in various ways—is at a standstill, and many banks are coping with losses and involuntary balance expansions, the April 2008 report said. The report examines this and other forces that could push the current credit crisis into a full credit crunch, as well as offering policy recommendations to mitigate the impact.

"Financial markets remain under considerable stress because of a combination of three factors," said Jaime Caruana, head of the IMF's Monetary and Capital Markets Department. "First, the balance sheets of financial institutions have weakened; second, the deleveraging process continues and asset prices continue to fall;

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## World Economic Outlook

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The credit crisis continues to put stress on financial markets.

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## Ministers Resolve to Counter Slowdown

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reflects what is the mood at this moment, the sense that the chain of bad news may not have come to an end.”

The IMFC—the policymaking committee of the IMF’s Board of Governors—said it was “confident that the key reforms recently agreed by the Fund’s Executive Board, including the strategic refocusing of the Fund on its core mandate based on its comparative advantage, will strengthen the Fund’s role in promoting global financial stability and international monetary cooperation and in serving its universal membership effectively at this critical juncture.”

### A global slowdown

Since its previous meeting in October 2007, the IMFC said, global financial instability has increased, world economic growth has slowed, and growth prospects for 2008 and 2009 have deteriorated. It agreed that “policymakers should continue to respond to the challenge of dealing with the financial crisis and supporting activity, while making sure that inflation is kept under control. While each country’s situation is different, coherent action must be taken, taking due account of cross-border interactions.” As for emerging market and developing countries, it noted that, so far, they have “continued to grow strongly and show resilience in the face of the ongoing financial crisis, though their growth prospects have moderated and inflation risks have increased.”

In this connection, the Group of 24 developing countries called for “decisive” policy actions by rich nations to ensure that the financial turmoil does not spread to them, and it asked the IMF to “urgently” improve its monitoring of advanced economies.

On April 9, the IMF released its latest *World Economic Outlook*, now predicting global growth of 3.7 percent in 2008, down from 4.9 percent in 2007 and with little pickup in 2009—around 3.8 percent. Moreover, there is a 25 percent chance that the growth will be 3 percent or less in 2008 and 2009. The IMF’s chief economist, Simon Johnson, told reporters that on balance, the risks are on the downside, with the principal one coming from the possibility

that financial strains could deepen. Other risks include continuing inflation worries, especially in the wake of increasing commodity prices, large current account surpluses, and the “uneven pattern of exchange rate movement around the world.”

Blaming the twin forces of deteriorating financial market conditions and the continuing correction in the U.S. housing market, the IMF predicts that the United States will slip into a “mild recession” in 2008, from which it will recover only modestly in 2009. The report has marked down sharply its U.S. forecast for 2008 to growth of 0.5 percent—1 percentage point lower than what was forecast in January 2008 and down from 2.2 percent in 2007. The forecast for 2009 is now only 0.6 percent.

On the foreign exchange front, the Group of Seven industrial countries noted that “since our last meeting, there have been at times sharp fluctuations in major currencies, and we are concerned about their possible implications for economic and financial stability. We continue to monitor exchange markets closely, and cooperate as appropriate.” Asked by reporters about this statement, Strauss-Kahn said that the IMF shares this concern. He noted that countries are far from fixing global current account imbalances, and he warned that “new imbalances may have appeared” during the recent financial turmoil.

### Shaky financial markets

The IMFC welcomed “the actions taken by the central banks of the advanced economies to provide liquidity support to ease strains in interbank markets,” and called for “continued vigilance to deal with the financial turmoil.” But it also looked to the private sector, saying that “further prompt actions by large financial institutions to disclose losses and repair balance sheets by raising capital when needed and mobilizing medium-term funding will contribute to restoring confidence.”

Work is now taking place in several forums and is meant to draw lessons from the financial turmoil to help strengthen the global financial system and reinforce

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the supervisory and regulatory frameworks. The IMFC welcomed the IMF's work in this area, including the *Global Financial Stability Report*, which recently warned that the widening and deepening fallout from the U.S. subprime mortgage crisis could have profound financial system and macroeconomic implications—with worldwide potential losses of about \$945 billion.

The IMFC also urged the IMF to continue its close collaboration with the Financial Stability Forum (FSF), the Bank for International Settlements, standard-setting bodies, and national authorities. In this context, it called for the “timely implementation” of new FSF recommendations, which center on more vigilant oversight of capital and liquidity at financial institutions. And it emphasized the importance of strengthening the IMF's financial surveillance role, including through the Financial Sector Assessment Program, and its ability to identify risks in the future.

### Soaring food prices

Throughout the weekend, worries kept resurfacing about high fuel and food prices—with oil still above \$100 a barrel and food prices having jumped 48 percent since 2006. Commodity producers and countries that export commodities have done well, with some enjoying windfall gains. But commodity importers and consumers—especially in the poorest areas—are feeling the pinch of higher commodity prices on their purchasing power, resulting in food protests in countries in Africa, Asia, and Latin America and the Caribbean.

In response, World Bank President Robert Zoellick has been urging governments to act quickly to help hungry people by committing emergency aid to the UN World Food Program, which is seeking \$500 million in emergency assistance by May 1. He has also sought backing for a New Deal on Global Food Policy to combat hunger and malnutrition, and at the April 13 meeting of the IMF–World Bank Development Committee, he won that support.

Speaking to reporters after the meeting, he warned that 100 million people could be pushed deeper into poverty if action were not taken. “We can't afford to wait,” he said, adding that “we have to put our money



IMF Photo

The Group of 24, chaired by Jean-Claude Masangu Mulongo of the Democratic Republic of Congo (center), called for “decisive” policy actions by rich nations to ensure that the financial turmoil does not spread to them.

where our mouth is—now—so that we can put food into hungry mouths. It's as stark as that.”

A similar warning came the day before from Strauss-Kahn, who said that “if food prices go on as they are today, then the consequences for the population in a large set of countries, including Africa, but not only Africa, will be terrible.” Moreover, “disruptions may occur in the economic environment, trade balances, and current account, so that at the end of the day most governments, having done well during the last 5 or 10 years, will see what they have done totally destroyed and their legitimacy facing the population destroyed, also.” He underscored after the Development Committee meeting that the food price crisis is “a big concern to the Fund and we are going to devote a lot of resources—time, experts, and financial resources—in the coming weeks.” He noted that this would involve a review of the IMF's financial tool kit for tackling such a crisis.

The latest IMF–World Bank *Global Monitoring Report* warns that most countries will fall short of the UN Millennium Development Goals. Although much of the world is set to cut extreme poverty in half by 2015, prospects are gravest for the goals of reducing child and maternal mortality, with serious shortfalls also likely in primary school completion, nutrition, and sanitation goals.

### Go-ahead on IMF reforms

Another major development over the weekend was solid backing for the IMF's pack-

age of reforms from advanced economies, emerging markets, and low-income countries. The IMFC said it welcomed the recent agreement by the Executive Board on quota and voice reforms “as an important contribution to enhance the Fund's credibility and legitimacy.” It added that it looked forward to the approval of the quota and voice reforms by the Board of Governors by April 28, 2008, as well as the early acceptance by the members of the proposed amendment of the Fund's Articles of Agreement to make the quota and voice reforms effective.

The IMFC also endorsed the recent agreement by the Executive Board for a new income model and a new medium-term budgetary envelope, “which will contribute to placing the Fund on a sustainable financial footing.” It strongly recommended that the Board of Governors give its full support to the new income model by approving the proposed amendment of the Fund's Articles of Agreement by May 5, 2008. And it called on all members to work toward the early completion of the legislative steps required to make the new model effective, including the establishment of an endowment funded by the profits from a strictly limited sale of gold within the agreement of the central banks.

The United States is a key player in the gold sales, and U.S. Treasury Secretary Henry Paulson told the IMFC that “we are committed to seeking congressional authorization for a limited sale of IMF gold to finance an endowment.” ■

Laura Wallace  
IMF External Relations Department

# World Outlook: Amid Serious Market Crisis, IMF Predicts Slower Growth

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Citing the unfolding financial market turmoil as the biggest downside risk to the global economy, the April 2008 report said the IMF expects world growth to slow to 3.7 percent in 2008—0.5 percentage point lower than what was forecast in the January 2008 WEO update.

Further, world growth would achieve little pickup in 2009, and there is a 25 percent chance that the global economy will record growth of 3 percent or less in 2008 and 2009, equivalent to a global recession, according to the forecast, released on April 9.

Highlighting high commodity prices as another downside risk, IMF Chief Economist Simon Johnson said that “the effect of the financial turmoil in the United States has been to lower the prospects of growth, but, somewhat paradoxically, it has also increased oil prices, metal prices, and, of course, food prices.”

Johnson pointed out that “the increases in commodity prices create severe inflationary pressures in many countries, and they make it much harder for monetary and fiscal policy to manage this part of the global business cycle.”

## Gloomy prospects

Blaming the twin forces of deteriorating financial market conditions and the continuing correction in the U.S. housing market, the IMF predicts that the United States will slip into a “mild recession” in 2008, from which it will recover only modestly in 2009. This reflects the time it will take for financial institutions and households to resolve their balance sheet problems. The slowing of activity is reflected in weakening employment, consumption, and other indicators.

The report has sharply marked down its U.S. forecast for 2008 to 0.5 percent—1 percentage point lower than what was forecast in January 2008 and down from a 2.2 percent growth rate in 2007 (see table).

The ongoing financial crisis has led to persistent liquidity shortages, pressure on the capital of banks and other financial

institutions, increasing credit risks, and sharply falling prices of mortgage-related and other structured securities, as well as of equities, the report said. The IMF issued a separate report on April 8 on global market conditions, ahead of the spring meetings of the IMF and the World Bank in Washington.

The worsening market conditions and the growth standstill in the United States have affected economic activity in other advanced economies, especially western Europe, where growth is expected to remain sluggish in 2008 and 2009, although Japan has remained more resilient to the downturn (see Chart 1). The slowdown in Western Europe is largely a result of financial strains and trade spillovers. The potential impact of softening house prices in many countries is a source of concern.

The euro area is now estimated to grow at 1.4 percent in 2008—compared with 2.6 percent in 2007—and the United Kingdom at 1.6 percent—compared with 3.1 percent in 2007.

## Diverging, not decoupling

By contrast, the rapidly globalizing emerging economies have so far been less affected by financial market turbulence and have continued to grow at a rapid pace, led by India and China, although economic activity is beginning to moderate in some countries. Nevertheless, according to the IMF, growth across all emerging and developing regions will remain above trend (see Chart 2).

China and India—which grew at 11.4 percent and 9.2 percent in 2007, respectively—are projected to grow at 9.3 percent and 7.9 percent, respectively, in 2008. Other emerging and developing economies, including in Africa and Latin America, are also expected to maintain robust growth rates.

Emerging and developing economies have been more resilient during the current market turmoil than in previous episodes, although countries that had relied

## Growth slower as fallout deepens

Growth forecasts for most advanced economies have been marked down; many emerging economies are also slowing but will maintain above-trend growth.

(annual percent change)

	Current projections			
	2006	2007	2008	2009
World output	5.0	4.9	3.7	3.8
Advanced economies	3.0	2.7	1.3	1.3
United States	2.9	2.2	0.5	0.6
Euro area	2.8	2.6	1.4	1.2
Germany	2.9	2.5	1.4	1.0
France	2.0	1.9	1.4	1.2
Italy	1.8	1.5	0.3	0.3
Spain	3.9	3.8	1.8	1.7
Japan	2.4	2.1	1.4	1.5
United Kingdom	2.9	3.1	1.6	1.6
Canada	2.8	2.7	1.3	1.9
Emerging and developing economies	7.8	7.9	6.7	6.6
Africa	5.9	6.2	6.3	6.4
Sub-Saharan	6.4	6.8	6.6	6.7
Central and eastern Europe	6.6	5.8	4.4	4.3
Russia	7.4	8.1	6.8	6.3
China	11.1	11.4	9.3	9.5
India	9.7	9.2	7.9	8.0
Middle East	5.8	5.8	6.1	6.1
Western Hemisphere	5.5	5.6	4.4	3.6

Source: IMF, *World Economic Outlook*, April 2008.

heavily on short-term cross-border borrowing or have stronger trade ties with the United States remain vulnerable to deleveraging.

Three broad factors are providing the momentum for growth in emerging and developing economies: first, strong productivity gains from the continuing global integration of these economies; second, better terms of trade for commodity producers as prices of commodities such as oil and other raw materials continue to soar; and, third, stronger institutions and macroeconomic policy frameworks.

## Soaring commodities

The ongoing commodity price boom continued in early 2008, notwithstanding the market turmoil and slowing growth in major advanced economies. The IMF commodity price index rose by 44 percent from February 2007 to

February 2008. Prices of many commodities—including crude oil, tin, nickel, soybeans, corn, and wheat—reached record highs in current U.S. dollar terms.

Strong demand from emerging economies has accounted for much of the increase in commodity consumption in recent years and has been the driving force in the price run-up. Biofuel-related demand has added to the demand for major food crops, especially corn.

At the same time, supply adjustments to higher prices have not kept up, especially for oil, leading to medium- to long-term low inventory levels in many markets. Also, financial trends—including the effective depreciation of the dollar, falling U.S. policy interest rates, and the emergence of commodities as an alternative asset class—have all contributed to the soaring prices.

### Rising inflation

Inflation continues to be a serious concern throughout the world. According to the IMF, headline inflation (that is, total inflation, including food and energy) has increased across the world, and core inflation (which excludes food and energy prices) is edging up.

Inflation is rising more markedly in many emerging and developing economies, driven by a combination of the continued buoyancy of food and energy prices, strong demand, and credit growth. Rising inflation in these countries also



Simon Johnson (center): “The effect of the financial turmoil in the United States has been to lower the prospects of growth, but, somewhat paradoxically, it has also increased oil prices, metal prices, and, of course, food prices.”

IMF Photo

reflects the greater weight of energy and food in consumption baskets.

### Policy challenges

The WEO underscores that in a multi-polar world—with deepening financial and economic linkages across both advanced and developing economies—policy challenges need to be met broadly. That is, while recognizing differences in countries’ circumstances, policy actions in a globalized world need to fully take into account cross-border interactions.

The advanced economies face the pressing policy challenges of addressing the financial turmoil and responding to

downside risks to growth while simultaneously keeping an eye on inflation and long-term concerns. Emerging and developing economies need to ensure that strong current growth does not lead to inflation buildup while remaining alert to risks from growth slowdown in advanced economies.

In addition to monetary policy, fiscal policy could play a useful stabilizing role in the advanced economies in the event of a continuing downturn in economic activity. In case of a severe global downturn, providing fiscal stimulus across a broad group of countries could prove much more effective than isolated efforts by bolstering confidence and demand, given the inevitable cross-border leakages from added spending in open economies. ■

Subir Lall

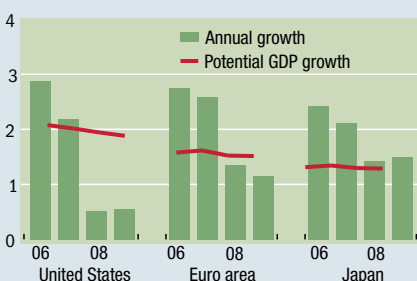
IMF Research Department

Chart 1

### Slowing economies

Growth in advanced economies is being most affected by financial turbulence.

(percent change)



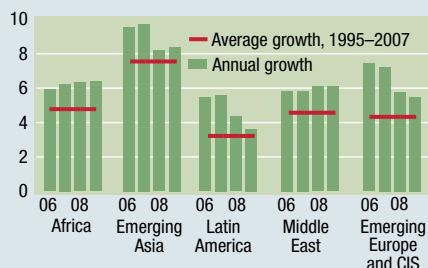
Source: IMF, World Economic Outlook database.

Chart 2

### Resilient economies

Growth in emerging and developing economies is slowing, but it is still above trend.

(percent change)



Source: IMF, World Economic Outlook database.  
Note: CIS = Commonwealth of Independent States.

For WEO analysis on the housing sector and on commodities, see articles on pages 62–64. Both WEO studies—as well as a third one, “Climate Change and the Global Economy”—are available on the IMF’s website at the following address: [www.imf.org/external/pubs/ft/weo/2008/index.htm](http://www.imf.org/external/pubs/ft/weo/2008/index.htm).

# IMFC Stresses Need for Strong Action, Close Cooperation

The International Monetary and Financial Committee held its seventeenth meeting in Washington, D.C. on April 12, 2008, under the Chairmanship of Tommaso Padoa-Schioppa, Minister of Economy and Finance of Italy.

The Committee met at a time of unusual uncertainties surrounding global economic and financial market prospects. It stresses that the challenges facing the world economy are of a global nature, requiring strong action and close cooperation among the membership. The Committee is confident that the key reforms recently agreed by the Fund's Executive Board, including the strategic refocusing of the Fund on its core mandate based on its comparative advantage, will strengthen the Fund's role in promoting global financial stability and international monetary cooperation and in serving its universal membership effectively at this critical juncture.

### The Global Economy and Financial Markets—Outlook, Risks, and Policy Responses

The Committee notes that global financial instability has increased since its last meeting. World economic growth has slowed and growth prospects for 2008 and 2009 have deteriorated. Risks to the outlook come from the still unfolding events in financial markets and from the potential worsening of housing and credit cycles. Inflationary risks—notably from higher food, energy, and other commodity prices—have also risen. The Committee agrees that policymakers should continue to respond to the challenge of dealing with the financial crisis and supporting activity while making sure that inflation is kept under control. While each country's situation is different, coherent action must be taken, taking due account of cross-border interactions.

In the advanced economies, monetary policy should continue to aim at medium-term price stability, while responding flexibly to signs of a more pronounced and prolonged economic downturn. Fiscal policy can also play a useful countercyclical role. In the United States, temporary fiscal easing will help to counter downside risks to growth. Other advanced economies have also experienced financial turbulence and their growth rates have declined; when consistent with medium-term fiscal objectives, automatic stabilizers should be allowed full play. Further progress should also be made on safeguarding medium-term fiscal consoli-



IMF Managing Director Dominique Strauss-Kahn and IMFC Chair Tommaso Padoa-Schioppa confer.

ation in the United States; product and labor-market reforms in Europe; further structural reforms, including fiscal consolidation, in Japan; addressing supply bottlenecks in oil-exporting countries; and reforms to boost domestic consumption in emerging Asia, together with greater exchange rate flexibility in a number of surplus countries.

The Committee welcomes the actions taken by the central banks of the advanced economies to provide liquidity support to ease strains in interbank markets, and calls for continued vigilance to deal with the financial turmoil. Further prompt actions by large financial institutions to disclose losses and repair balance sheets by raising capital when needed and mobilizing medium-term funding will contribute to restoring confidence. The Committee sees the ongoing work in several fora aimed at managing and drawing lessons from the financial turmoil as a key step to strengthen the stability of the global financial system and to reinforce the supervisory and regulatory frameworks. In this context, it welcomes the Fund's work in these areas, notably the *Global Financial Stability Report* and the report prepared by the IMF "The Recent Financial Turmoil-Initial Assessment, Policy Lessons, and Implications for Fund Surveillance." The Committee underscores that continued close Fund collaboration with the Financial Stability Forum (FSF), the Bank for International Settlements, standard-setting bodies, and national authorities will be essential to ensure that the lessons

from the crisis are effectively shared and that agreed policy actions are rapidly implemented. In this context, the Committee welcomes the policy recommendations by the FSF and calls for their timely implementation; it also emphasizes the importance of strengthening the Fund's financial surveillance role, including through the Financial Sector Assessment Program, and its capability to identify risks in the future. The Committee will review further progress on these issues at its next meeting.

Emerging market and developing countries have so far continued to grow strongly and show resilience in the face of the ongoing financial crisis, though their growth prospects have moderated and inflation risks have increased. For many countries, containing inflation and addressing vulnerabilities remain key priorities. Other countries may have room to respond to a further worsening of the external environment by countercyclical monetary and fiscal policies without jeopardizing their stabilization gains. Commodity-exporting countries, exposed to the risk of significant swings in commodity prices, should maintain progress toward economic diversification. The Committee notes that a number of developing countries, especially low-income countries, face a sharp rise in food and energy prices, which have a particularly strong impact on the poorest segments of the population. The Committee urges the Fund to work closely with the World Bank and other partners in an integrated response through policy advice and financial support.

The Committee reiterates its strong support for a prompt and ambitious conclusion of the Doha Development Round of trade negotiations.

The Committee notes that sovereign wealth funds (SWFs) are becoming increasingly important players in the international monetary and financial system, offering various economic and financial benefits, including a stabilizing influence on financial markets, but also posing several challenges for policymakers. The Committee welcomes the IMF's initiative to work, as facilitator and coordinator, with SWFs to develop a set of best practices by the 2008 Annual Meetings. It emphasizes that SWF best practices should be developed on a collaborative and voluntary basis, and go hand in hand with work in the OECD and elsewhere on best practices for countries receiving SWF investments. The Committee looks forward to reviewing the progress made on these fronts at its next meeting.

### IMF Reforms and Policy Agenda

The Committee welcomes the agreement by the Executive Board on the package of quota and voice reforms as an important contribution to enhance the Fund's credibility and legitimacy, in line with the objectives set forth at the Annual Meetings in Singapore in 2006. The Committee looks forward to the approval of the quota and voice reforms by the Governors by April 28, 2008, as well as the early acceptance by the members of the proposed amendment of the Fund's Articles of Agreement to make the quota

and voice reforms effective. The package of reforms is forward looking in requesting that the Executive Board recommend further realignments of members' quota shares in the context of future general quota reviews, which take place every five years, to ensure that members' quota shares adequately reflect their relative positions in the world economy. These realignments are expected to result in increases in the quota shares of dynamic economies, and hence in the share of emerging market and developing countries as a whole. The Committee also looks forward to further work by the Executive Board on elements of the new quota formula that can be improved before the formula is used again.

The Committee endorses the agreement by the Executive Board on a new income model and a new medium-term budgetary envelope, which will contribute to placing the Fund on a sustainable financial footing. The new budgetary framework, which reduces net spending by 13½ percent in real terms over the next three years, and the new income model provide for a strengthened, inte-

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**“Policymakers should continue to respond to the challenge of dealing with the financial crisis and supporting activity, while making sure that inflation is kept under control.”**

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grated budget process to ensure lasting budget discipline and an allocation of resources reflecting the Fund's refocused strategic priorities. The Committee strongly recommends that the Governors give their full support to the new income model by approving the proposed amendment of the Fund's Articles by May 5, 2008. It calls on all members to work toward the early completion of the legislative steps required for making the new model effective, including the establishment of an endowment funded by the profits from a strictly limited sale of gold within the agreement of the central banks. By relying on broader and more sustainable income sources, the new model appropriately recognizes that many Fund activities provide a public good. The Committee endorses the safeguards adopted to ensure that the reimbursement of the Fund for the administrative expenses of the PRGF-ESF Trust does not result in insufficient concessional lending capacity of the Trust. The Committee looks forward to the introduction of comprehensive cost accounting of Fund activities. It encourages further work by the Executive Board on the design of investment policies under the Fund's expanded investment authority, with a passive investment approach that closely tracks widely used benchmark indices; the operationalization of the new framework for setting the basic rate of charge; the review of the role and adequacy of precautionary balances; the need for a dividend policy; and the completion of the review of charges and maturities on Fund facilities by the time of the 2008 Annual Meetings.

The Committee agrees that the principle of comparative advantage should underpin the refocusing and repositioning of the Fund's activities in all areas of its mandate.



Consistent with the 2007 Surveillance Decision, bilateral surveillance will remain at the core of the Fund's work and an essential input into multilateral and regional surveillance. The Committee supports the efforts under way to sharpen the analysis of the financial sector, macro-financial linkages, exchange rates, and spillovers; deepen work on identifying and addressing risks to financial stability in close cooperation with other institutions; extend the Fund's vulnerability exercise to advanced economies; and better integrate global and cross-country perspectives into bilateral surveillance. It looks forward to steps to make surveillance outputs better focused and more timely, while ensuring that the quality of bilateral surveillance is preserved. Key operational aspects in implementing the 2007 Surveillance Decision will be clarified at the Executive Board, and the upcoming Triennial Surveillance Review will address strategic issues related to refocusing surveillance. The Committee encourages the Executive Board to consider a first statement of surveillance objectives and priorities prior to the next Annual Meetings.

The IMF's closer interaction with emerging market economies will focus on the specific challenges that they face from global financial integration, cross-border linkages, and volatile capital flows. Recognizing that the emerging market and developing countries are not immune to a broadening of the problems in financial markets, the Committee encourages the Executive Board to consider increasing the level of normal access to Fund resources and to continue its work on an appropriate crisis prevention financial line. It notes the Managing Director's decision to bring these matters

promptly to the Executive Board's attention. The Committee looks forward to reviewing the progress achieved at its next meeting.

The Committee supports continued close engagement by the Fund with its low-income members. This will be achieved by focusing the Fund's work on macroeconomic and financial stability issues and helping low-income countries tackle the challenges of debt sustainability, capital inflows, and commodity price swings. Work will also continue on possible improvements in the Fund's engagement with countries suffering from shocks affecting their balance of payments, including through the Exogenous Shocks Facility and other existing facilities; in

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**“The IMF's closer interaction with emerging market economies will focus on the specific challenges that they face from global financial integration, cross-border linkages, and volatile capital flows.”**

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fragile situations; and emerging from conflict. Efficiency gains will come from closer and more efficient cooperation and a clear delineation of responsibilities between the Fund and the World Bank, as well as from a streamlining of operations and procedures. The Committee calls on the Fund to provide a structured way of approaching donors regarding funding requests and encourages members to provide additional financial contributions to ensure that the Fund can continue to subsidize emergency assistance and capacity building to its low-income members.

The Committee agrees that Fund technical assistance and training should continue to play a key role in supporting members' capacity-building efforts in the areas of the Fund's core mandate. It looks forward to steps that will increase the effectiveness of technical assistance in a resource-constrained environment with greater prioritization and a stronger result-focus, including through consideration of a system of graduated charges. The Committee also supports initiatives to promote external financing for the provision of Fund technical assistance and training.

### Other Issues

The Committee recommends members' acceptance of the amendment of the Articles of Agreement for a special one-time allocation of SDRs.

The next meeting of the IMFC will be held in Washington, D.C. on October 11, 2008. ■



IMF Photo

The IMFC voiced its support for recent IMF reforms at the spring meetings.

# IMF Warns of Broadening Credit Crisis

(continued from page 49)

and, finally, the macroeconomic environment is more challenging because of the weakening global growth.”

## Growing systemic risks

The crisis has weakened the capital and funding of large systemically important financial institutions, raising systemic risks. Such financial institutions need to raise capital or cut back assets to cope with the strains, the report said. The continued stress increases the downside risks for global financial stability and potentially forces institutions to further curtail credit, it added, noting that the macroeconomic effects could be severe.

But Caruana pointed out that “the recent Fed [U.S. Federal Reserve] actions in solving the Bear Stearns case and also in providing liquidity to a broader range of counterparties have reduced the probability of a tail event in the financial system, although there are still funding pressures that continue.”

## Financial-macroeconomic linkages

Credit deterioration, which was first evident in the U.S. subprime market, is now showing up in higher-quality residential mortgages, U.S. commercial real estate, and the corporate debt markets, according to the GFSR. These concerns are further exacerbated by a drop in valuations of structured credit products and a dramatic drying up of market liquidity.

Uncertainty about the size and distribution of bank losses, reduced capital buffers, and the normal reduction in credit as the cycle turns are also likely to weigh heavily on household borrowing, business investment, and asset prices. This, in turn, would affect employment, output growth, and balance sheets—thereby creating worrying macroeconomic feedback effects.

This feedback dynamic is potentially more severe than in earlier credit cycles, because it was fueled by a proliferation of new credit products that allowed more people to obtain credit, the report said. “Thus, it is now clear that the current tur-

moil is more than simply a liquidity event, reflecting deep-seated balance sheet fragilities, which means its effects are likely to be broader, deeper, and more protracted,” it added.

## Spreading concerns

Even though the United States remains at the epicenter, financial institutions in



Jaime Caruana: The continued stress increases the downside risks for global financial stability.

other countries have also been affected by the current market crisis—“reflecting the same overly benign global financial conditions, an inattention to appropriate risk management systems, and lapses in prudential supervision.”

And there are also signs that house prices in mature markets other than the United States could fall. Therefore, countries in which house prices have been more inflated or corporate or household balance sheets have been more stretched are particularly at risk, the report pointed out.

Emerging markets have so far been relatively insulated from the effects in mature markets, but the earlier benign financial conditions and low-interest-rate environment have also meant that risk taking was higher in some of these countries. The countries—most notably in emerging Europe—that have experienced rapid credit growth, some of which also have

large current account deficits financed by private debt or portfolio flows, may be particularly vulnerable.

## Policy considerations

The first policy priority is to limit the spread of dislocations to other markets and to repair banks’ balance sheets. Systemically important financial institutions need to move quickly to raise equity and medium-term funding, even if it is more costly to do so now, in order to boost confidence and avoid further undermining of credit channels. Although various investors, including sovereign wealth funds, have recently made capital infusions into banks, more such funding will likely be needed to recapitalize institutions.

Further, more rapid and informative disclosure of financial institutions is needed, and national authorities should seek to quell misperceptions by providing timely and accurate aggregate information.

The GFSR proposes that central banks and other relevant regulators issue special financial stability reports that could act to calm markets. Restoring counterparty confidence is a key element to reducing volatility and the knock-on effects to the real economy.

It is now widely acknowledged that public measures are needed in a number of areas. In particular, there may be a need to shore up the prices of various types of securities to prevent fire sales. Plans that use public money, however, should attempt to ensure that shareholders accept the first losses. Also, measures will need to carefully weigh the legitimate issues of consumer protection and the legal rights of contract holders.

The IMF, as a member of the Financial Stability Forum (FSF) working group evaluating the crisis, continues to work closely with the FSF, along with other international forums, to formulate policy recommendations. ■

Laura Kodres  
IMF Monetary and Capital Markets Department

## Directors Back Reforms to Overhaul IMF Quotas and Voice

In a key step toward reforming the IMF, the Executive Board backed a resolution that would achieve a significant shift in the representation of dynamic economies, many of which are emerging market countries, and give poorer countries a greater say in running the multilateral institution.

### Objectives of the reform

Acknowledging the underlying shift taking place in the world economy, with emerging market economies playing an increasingly important role, the IMF reform process aims to better align quota and voting shares in the Fund with member countries' weight and role in the global economy. Equally important, the reform aims to enhance the participation and voice of low-income countries.

The Board proposal is part of a two-year reform program approved at the 2006 Annual Meetings in Singapore, when initial ad hoc increases in quotas were agreed for China, Korea, Mexico, and Turkey. A country's quota at the IMF largely determines its voting power in the 185-member institution.

### Reform package

The main reform elements are the following:

- **A more transparent quota formula.** The reform is based on a simpler, more transparent quota formula (see box).
- **A second round of ad hoc quota increases.** Together with the 2006 ad hoc adjustments, the cumulative increase in quotas for dynamic countries is 11.5 percent. All underrepresented members under the current formula are eligible for a quota increase under the reform. Three onetime elements are also included:
  - *Some advanced economies forgo increases.* To reinforce the objectives of the reform, several underrepresented advanced countries have agreed to forgo

## 135 countries will see an increase in their voting share

part of the quota increases for which they are eligible: the United States, Germany, Italy, Japan, Ireland, and Luxembourg.

- *Boost for members underrepresented based on global PPP GDP.* Emerging market and developing economies with actual quota shares substantially below their share in global GDP in terms of purchasing power parity (PPP) will receive a minimum nominal quota increase of 40 percent under the reform.

- *Further increases for the Singapore-4.* Recognizing that the four members that received quota increases at the Singapore Annual Meetings remain underrepresented, these members will receive a minimum nominal increase of 15 percent.

- **Five-year reviews.** To ensure that quota and voting shares continue to reflect developments in the weights of member economies, the proposal recommends further realignments of quota shares in the context of future general quota reviews, which occur every five years.

- **Improved voice for low-income countries.** The proposal enhances the voice and participation of low-income coun-

tries through two measures, requiring an amendment to the IMF's Articles of Agreement:

- *A tripling of the basic votes of all members*—the first such rise since the Fund's inception in 1945. A mechanism is also to be established that would protect the share of basic votes to total votes going forward. All countries receive an equal number of basic votes, designed to protect the voice of smaller members.

- *Additional Alternate Executive Director for African chairs*—this would further enhance the capacity of the two Executive Director offices representing African constituencies.

The reform brings quota shares closer to members' evolving position in the world economy. As a result, 54 countries will get an increase in nominal quotas ranging from 12 to 106 percent. The combined increase in quota shares for these 54 countries is 4.9 percentage points.

In total, 135 countries will see an increase in voting share of 5.4 percentage points owing to the combined effects of the increase in quotas and basic votes. Among countries that will see the biggest increase in voting share in the two rounds combined are China, Korea, India, Brazil, and Mexico.

The Governors, who represent the highest decision-making body in the Fund, are requested to vote on the proposal within the next 30 days. The resolution will come into force when it is accepted by members having at least 85 percent of total voting power. IMF officials say that governance reform at the Fund is an ongoing process, and completion of the reform agenda approved in Singapore will open the door for further reforms in the future. ■

### New Quota Formula

The new quota formula contains four variables expressed in shares—GDP, openness, variability, and reserves—with weights of 50 percent, 30 percent, 15 percent, and 5 percent, respectively. The GDP variable is a blend of 60 percent of GDP at market exchange rates and 40 percent of GDP at purchasing parity power (PPP) rates. In addition, some of the variables in the new quota formula have been updated and modernized from those in the existing five formulas.

## New Income Model to Set IMF on Firmer Footing

On April 7, the IMF's Executive Board endorsed a new package of measures to set the institution's finances on a sound long-term footing, ending the IMF's overreliance on income from lending operations to finance its work.

The package picked up on many measures that had been proposed in early 2007 by the Committee of Eminent Persons—which was headed by Andrew Crockett (President, JPMorgan Chase International) and created to help the IMF design a new income model.

Speaking with the *IMF Survey*, IMF Finance Department Director Michael Kuhn discusses the new income model and explains how it fits in with the broader effort to refocus the IMF's operations.

**IMF Survey:** Will the new income model that you've developed—together with the planned expenditure cuts—help solve the IMF's income problem?

**Kuhn:** Yes. The package just endorsed is a major achievement—it puts the Fund on an entirely different financial footing. We're moving away from relying almost entirely on income from lending to a more diversified income base that is more robust, stable, and sustainable. It's the first major change in the way we generate our income since the IMF was founded.

**IMF Survey:** What are the new income model's main elements?

**Kuhn:** The first element is the expansion of the IMF's investment authority, allowing it to generate higher returns. The Fund currently has a very restrictive investment authority. The change requires an amendment of the IMF's Articles of Agreement. It will bring us in line with the practices of other international financial institutions.

The second element is the funding of an endowment through a sale of a portion of the IMF's gold holdings. The sale

is limited to the 403 metric tons of gold that the Fund has acquired since the date of the Second Amendment of the Articles of Agreement. The sale should provide a substantial endowment. We plan to invest the proceeds from the sale in such a way that the real value of the endowment is maintained. This means that only a portion of the endowment is made available to finance expenditures each year, the so-



IMF Finance Department Director Michael Kuhn: New, diversified income model is "more robust, stable, and sustainable."

called payout ratio. We have a currently targeted payout ratio of about 3 percent, which should give a significant boost to the Fund's income.

The third element is the reinstatement of the long-standing practice of recovering the costs that the Fund incurs in administering the Trust Fund for concessional lending to low-income countries. This cost recovery has taken place since the Fund began to provide concessional lending services when the original Trust Fund was created in 1976, except in recent years, when the same amount of resources was temporarily redirected for debt relief under the HIPC [Heavily Indebted Poor Countries] Initiative. I would want to emphasize that resuming reimbursement has no impact on low-income countries themselves. Moreover, even though demand

for lending under the Poverty Reduction and Growth Facility is currently relatively low, the Board has established safeguards to ensure that this cost recovery will not affect the Fund's ability to provide concessional lending to its poorest members in the future.

**IMF Survey:** What is the timetable for implementation?

**Kuhn:** First, the Executive Board has just endorsed the proposal to amend the Articles of Agreement to expand the IMF's investment authority. This amendment needs to be approved by the Board of Governors and then make its way through national legislatures.

For the gold sale, we need an 85 percent majority of the IMF's Executive Board. The 85 percent majority has a twist, though, because the U.S. Executive Director can vote in favor of the gold sale only if she has first obtained approval from the U.S. Congress. If approved, the gold sales will be phased to avoid the risk of disrupting markets.

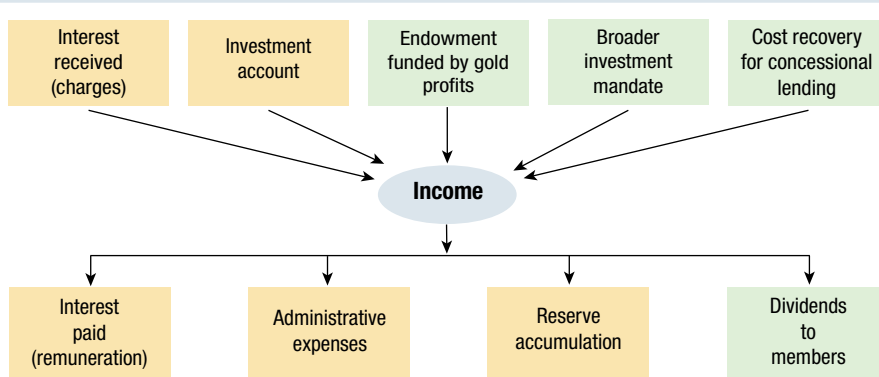
So we won't see the full effect of these measures immediately, but we estimate that three or four years from now, we should be back in the black.

**IMF Survey:** Can you describe the modalities of the gold sale?

**Kuhn:** We will sell either to a central bank that is willing to buy gold, or in conjunction with the already established official gold sales program—the Central Bank Gold Agreement. We will coordinate with other official holders of gold to sell in such a way that we do not increase the overall amount of official gold sales. Naturally, the sales will be conducted within a strong framework for governance and controls, and with a high level of transparency. We are the world's third largest holder of gold, and we are keenly aware of our responsibility not to disrupt the gold market.

## The IMF's new income model

The IMF will implement a plan to draw on additional revenue sources to better align the IMF's income model with its activities. Green boxes below represent new elements.



**IMF Survey:** What is the IMF's revenue objective from the endowment?

**Kuhn:** Our objective would be to generate returns that would allow us to pay out 3 percent of the endowment while maintaining its real value in the long term. Annual investment returns will, of course, vary. Indeed, much of our income will come from investment returns from the endowment and from the reserves previously placed in the investment account.

We will deal with fluctuations in investment returns like any other institution that lives off an endowment—by determining a medium-term payout ratio that can be sustained. The returns will depend on the risk-return profile of the asset allocation the Executive Board will be comfortable with, and a full assessment of acceptable levels of different types of risk will be undertaken given the public nature of the funds to be invested.

We will need to tread carefully in implementing the new investment authority, which opens up a range of new investment assets—stocks, a more globalized portfolio, and so on. For example, we will need to take great care to avoid any actual or perceived conflicts of interest. And we also intend to start with a more passive investment strategy relying on widely used benchmark indices.

**IMF Survey:** Given that we're making a loss right now, do we have to repay that money once the new income model is in place?

**Kuhn:** The loss is right now reflected, like the financing of our lending operations, in the ups and downs of the currency balances we hold with our member countries. We currently finance a loss by drawing down these balances, which increases our interest expenses and reduces our reserves. While there's no requirement to pay it back, once our income rises, any surplus will help increase those balances and rebuild our reserves.

**IMF Survey:** Which parts of the Crockett Report did you decide not to use?

**Kuhn:** We did not have the requisite amount of support for the proposal to invest part of our quota resources—that is, to draw on our currency balances with members and invest that money. The countercyclical aspect of that proposal was appealing—in periods of low lending, you could compensate by investing quotas. Overall, the Board thought it wasn't necessary at this stage to adopt that recommendation. We'll have an endowment, and while the endowment will not make us superrich, it will be adequate.

**IMF Survey:** The IMF established an investment account two years ago to address the projected income shortfall following the decline in IMF lending. How is that going?

**Kuhn:** Very well. When we first opened up the investment account in mid-2006, we placed our then-existing reserves—just below SDR 6 billion—into that account, with targeted earnings of 50 basis points over the SDR interest rate on average. We

didn't do that well in the first year, but we're doing quite well this year. The earnings we're receiving so far in this financial year are about 200 basis points above the SDR interest rate. Given the very limited instruments we can invest in under the existing investment authority—only government bonds and deposits and medium-term instruments from the Bank for International Settlements—this return is quite good.

**IMF Survey:** How much does the IMF currently lend?

**Kuhn:** Our lending is currently on the order of \$10 billion. It's not insignificant. Income from lending continues to make a contribution to help pay our overall budgetary expenses, and I would see lending of that order of magnitude to be maintained in the future, though with fluctuations.

**IMF Survey:** Is the IMF doing enough to cut back on the expenditure side?

**Kuhn:** I think so. We are cutting expenditures by approximately \$100 million annually in real terms over the medium term, relative to a previous budget that already had a reduction in real terms. But we are not simply cutting back—we are undertaking exceptional reforms to refocus and modernize the Fund. I'm gratified that all members have accepted the idea that the Fund is an important institution, that what we do is critical to the stability of the international financial system, and that we need to be financed properly.

**IMF Survey:** In the meantime, is there any risk for the IMF if it doesn't have this income?

**Kuhn:** We have significant reserves. They'll help get us through the time it takes to put the elements of the new income model fully in place. The losses we currently do run have been mitigated to a large extent by the measures being taken on the expenditure side. Would I like to have everything in place tomorrow? Of course. But a few years of losses are manageable, since we now have a model in place that's properly funded and has the support of the membership—a model that will last us for decades to come. ■

# IMF to Develop Best Practices with Sovereign Wealth Funds

The IMF's Executive Board gave the green light for further analysis on the role of sovereign wealth funds (SWFs) in the global economy and endorsed a proposal for the IMF to work with SWFs and other relevant parties to prepare a set of best practices for the state investment institutions.

The March 21 board discussion provided an opportunity for Directors to discuss these funds and ways to facilitate the development of a set of voluntary best practices for them. This work would be coordinated with the work of the Organization for Economic Cooperation and Development (OECD) on practices for recipient countries as appropriate.

With SWFs rapidly gaining importance in the international monetary and financial system, the IMF has stepped up its work across a broad range of issues related to these state-owned funds, including their impact on global financial stability and capital flows.

Of course, SWFs have been around for a long time, at least since the 1950s. But their total size worldwide has grown dramatically over the past 10–15 years, with the IMF now estimating that they will rise from \$2–3 trillion today to about \$6–10 trillion within five years. At present, the United Arab Emirates, Norway, Saudi Arabia, China, Kuwait, Russia, and Singapore hold the world's largest SWFs.

The main impetus for the growth of SWFs comes from high oil prices, financial globalization, and continued imbalances in the global financial system that have resulted in the rapid accumulation of foreign assets by some countries.

### Heightened attention

As a result, SWFs are attracting heightened attention from markets, policymakers, national legislatures, and the media, in particular following their recent capital injections—totaling more than \$40 billion since November 2007—into European and U.S. banks that suffered big losses from the



State investment funds have grown rapidly because of high oil prices, financial globalization, and continued imbalances in the global financial system.

subprime mortgage crisis. These capital injections have been welcomed by the IMF and others because they have helped to stabilize markets.

“From the viewpoint of international financial markets, SWFs can facilitate a more efficient allocation of revenues from commodity surpluses across countries and enhance market liquidity, including at times of global financial stress,” according to the IMF's First Deputy Managing Director John Lipsky. “They also tend to be long-term investors with limited withdrawal needs, which enable them to withstand market pressures in times of crisis and dampen volatility,” he adds.

At the same time, says Lipsky, the IMF also acknowledges the concerns of recipient countries and private commentators about the impact of SWFs—reflecting their size and investment strategies—and of the home countries that have been worried about the risk of rising protectionist sentiment.

### Types of SWFs

SWFs have been created for several reasons. According to IMF analysis, five types of SWFs can be broadly distinguished (see the IMF's October 2007 *Global Financial Stability Report*):

- **stabilization funds**, whose primary objective is to insulate the budget and the

economy against commodity (usually oil) price swings;

- **savings funds for future generations**, which aim to convert nonrenewable assets into a more diversified portfolio of assets;
- **reserve investment corporations**, whose assets are often still counted as reserve assets and are established to increase the return on reserves;
- **development funds**, which typically help fund socioeconomic projects or promote industrial policies that might raise a country's potential output growth; and
- **contingent pension reserve funds**, which provide (from sources other than individual pension contributions) for contingent, unspecified pension liabilities on the government's balance sheet.

### Benefits and concerns

SWFs offer a variety of economic and financial benefits. They help avoid boom-bust cycles in their home countries and facilitate the saving and transfer across generations of proceeds from fiscal surpluses related to commodity exports and privatizations. They also allow for greater portfolio diversification and focus more on returns than is traditionally the case for central-bank-managed reserve assets, thereby reducing the opportunity costs of reserves holdings.

“For economies with plentiful foreign reserve assets, greater and more prudent diversification reflects sound and responsible asset management,” says Udaibir S. Das, an expert on SWFs in the IMF's Monetary and Capital Markets (MCM) Department.

The growth of SWFs has also raised several issues. In addition to official and private commentators' concerns about the impact of SWFs—including their size and investment strategies—they also raise the issue of the expanded role of governments in international markets and industries. Some observers worry that SWF investments may be motivated, in certain cases, by political objectives. ■

Concerns have been raised about how SWFs fit into the domestic policy formulation of countries with such funds. At the same time, countries with SWFs are concerned about protectionist restrictions on their investments, which could hamper the international flow of capital.

### What the IMF is doing

IMF staff will now start work with members and SWFs on the development of best practices, including the establishment of an international working group of SWFs to begin technical discussions and drafting work from April onward.

The set of best practices would cover issues of public governance, transparency, and accountability principles—all of which should help enhance understanding of the operations of SWFs, the IMF says.

“A better understanding of the role and practices of SWFs and the development of a set of best practices could help countries with SWFs benefit from the experience of other countries, strengthen their domestic policy frameworks and institutions, and further their macroeconomic and financial interests,” says Jaime Caruana, Director of the IMF’s MCM Department.

The IMF’s work on these funds has progressed on a number of fronts:

- **Deepening analysis.** To enhance the understanding of SWFs, the IMF is organiz-

ing a survey of SWFs to help identify their investment objectives and risk management practices, as well as such institutional frameworks as governance structures and accountability arrangements.

- **Facilitating communication.** The IMF organized the Roundtable of Sovereign Asset and Reserve Managers in November 2007, which included a preliminary discussion with key SWFs. The roundtable was attended by high-level delegates from central banks, ministries of finance, and SWFs from 28 countries. It helped advance the discussion on policy, institutional, and operational issues facing SWFs, allowing those present to learn from their experiences and views. Participants agreed to continue the dialogue with SWFs.

- **Following up on dialogue.** The IMF is following up with further contacts with SWFs as part of a collaborative process to come up with an agreed view on best practices. “We’ve been engaged in an initial dialogue with sovereign wealth funds to help identify their current practices on issues such as governance and accountability structures, with a view to helping reach a consensus on best practices,” says the IMF’s Adnan Mazarei, who is closely involved in the discussions.

- **Coordinating with other international institutions.** The IMF is coordinating its work on SWFs with the OECD and is also liaising closely with the European

Commission, the World Bank, and others. The OECD is taking the lead on issues related to investment policies and regulations in recipient countries.

- **Working toward delivery.** The IMF will collaborate with SWFs and other stakeholders in developing a statement of best practices. The aim is to present a draft to its Executive Board by the IMF’s Annual Meetings in October.

### Best practices as a public good

The IMF expects that its work on SWFs will provide a public good that may be used by existing and new SWFs to run sound organizations, with good governance structures, robust risk management frameworks, and appropriate transparency. These practices should also help allay some of the prevailing concerns about SWFs, reduce protectionist pressures, and allow the international financial system to remain open.

In addition, the IMF’s efforts would aim to promote a better understanding of the role and significance of SWFs in their countries’ macroeconomic policy framework, as well as help the international community better assess the impact of SWF activity on global financial stability and capital flows.

The IMF has developed similar guidelines in the past, particularly in the areas of fiscal transparency and foreign exchange reserves management. ■

## WEO Analysis

# Managing Housing Sector Boom-Bust Cycles

**A**fter several years of rapid price increases, the housing markets are turning down in several advanced economies, according to new IMF research.

Published in an analytic chapter of the April 2008 *World Economic Outlook*, entitled “The Changing Housing Cycle and Its Implications for Monetary Policy,” the research shows that house price growth has decelerated in many countries.

In a few countries—the United States and Ireland—house prices have fallen during the past year (see Chart 1). Real residential investment has also slowed in several countries, particularly in the United States, Australia, and, especially, Ireland, where it

has fallen by about 3 percentage points of GDP since its peak four years ago.

### Housing sector and the business cycle

Although few people would disagree that such developments may have important implications for the level of economic activity, considerable uncertainty still exists about the link between the housing sector and the business cycle. In particular, there are varying estimates, and analyses, of the extent to which house price fluctuations affect consumer spending and the dynamics of residential investment.

The uncertainty has been compounded by dramatic changes over the past two

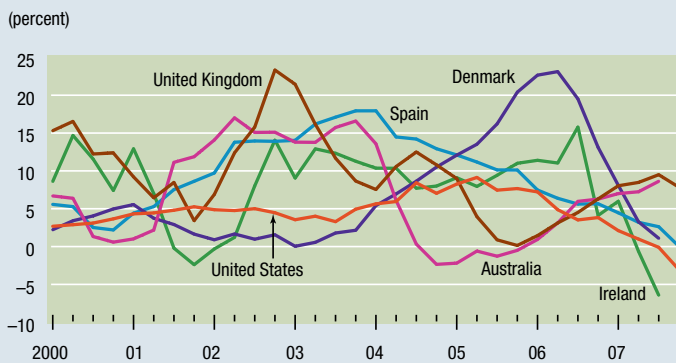
decades in how housing is financed in several advanced economies. These changes have entailed a shift toward a more competitive housing finance model. The new model has made it easier for households to access housing-related credit through diverse funding sources, lender types, and loan products, contributing to the rapid growth of mortgage debt in a number of countries.

Moreover, the prospect of a sharp boom-bust cycle in the housing sector in several advanced economies has reignited the debate on how monetary policy, which seeks to influence inflation outcomes by raising or lowering interest rates, should respond to developments in the housing sector.

Chart 1

### Steep declines

Real house prices have fallen sharply during the past year in many advanced economies.



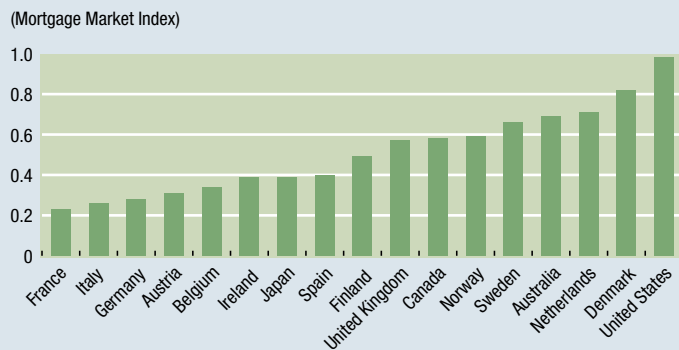
Source: OECD.

Note: First quarter data used for each year.

Chart 2

### Accessing housing credit

The United States, Denmark, and the Netherlands appear to have the easiest access to mortgage credit, as indicated by their higher values on the Mortgage Market Index.



Source: IMF staff calculations.

### Cross-country differences

In our study, we investigate whether the changes in the systems of housing finance over the past two decades have altered the links between the housing sector and economic activity. We also explore the implications of housing sector developments for the conduct of monetary policy. In particular, we aim to answer two questions:

- Are cross-country differences in the role of the housing sector in the business cycle and in the channels through which monetary policy is transmitted related to differences in mortgage markets?
- Have financial innovations changed the way monetary policy should respond to developments in the housing sector?

Our research shows that significant cross-country differences exist in mortgage contracts. We find that the United States, Denmark, the Netherlands, Australia, and Sweden appear to have the most developed mortgage markets, which allow households greater access to housing-related financing, whereas households in continental Europe tend to have more limited access to such financing (see Chart 2).

We also find that the spillovers from the housing sector to the rest of the economy are larger in economies in which it is easier to access mortgage credit and use homes as collateral. This is because movements in house prices influence household spending plans through the role of housing as collateral; for example, increases in house prices

raise the value of the collateral available to households, loosen borrowing constraints, and support spending.

### Transmitting monetary policy

Can monetary policy smooth the impact on the broader economy of developments in the housing markets? Some observers have raised doubts as to whether this is still the case, because greater integration of mortgage markets with the rest of the financial system may have reduced the importance of mortgage credit availability as a channel of monetary policy transmission.

However, we find that financial deregulation may have strengthened the role of housing in monetary policy transmission, because easier access to housing collateral may have linked house prices more closely to monetary policy. We also find that the effects of monetary policy changes on output are larger in those economies in which housing finance markets are relatively more developed and competitive.

### More aggressive stance

Based on these findings, we suggest that the response of monetary policy to changes in the housing sector should vary depending on the level of development of mortgage markets.

In particular, we conclude that economies with more developed mortgage markets could become more economically stable by pursuing a monetary policy approach that responds to house price movements,

particularly when they are unusually rapid or lead prices away from past relationships with fundamentals, in addition to consumer price inflation and the output gap (that is, the difference between potential GDP and actual GDP, or output). But this approach must be followed within a broader risk management framework that recognizes the uncertainty over the factors driving house price dynamics and their impact on the economy.

Paying attention to house price developments does not require changing the existing monetary policy approaches. Rather, these approaches should be interpreted in a more flexible manner—for example, by extending the time horizon over which inflation and output are returned to target. However, it is important that such an approach be applied symmetrically.

An aggressive easing would be justified in response to concerns from a rapid slowdown of the housing sector, but some “leaning against the wind” may also prove useful to limit the risk of a buildup of housing market and financial imbalances.

Finally, it is important to recognize that monetary policy must be complemented by regulatory policies to limit risks of unsustainable house price bubbles caused by imprudent lending practices. ■

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## Commodity Price Boom Underlines Global Links

Emerging and developing economies have become significantly more integrated with the global economy in recent years, against the backdrop of soaring commodity prices and steadily improving institutions and policy frameworks, according to a new IMF study.

Published in the April 2008 *World Economic Outlook* and entitled “Globalization, Commodity Prices, and Developing Countries,” the study examines this growing integration and assesses its sustainability.

### A new era

Although many developing economies continue to depend on commodity trade, their exports have become much more diversified in terms of both composition and destination. The volume of manufacturing exports relative to real GDP has grown steadily across the developing world, with gains ranging from about 2 percentage points in the Middle East and Africa to more than 20 percentage points in Asia since the late 1980s.

Advanced economies remain the most important destination for exports, but buoyant demand across developing economies has also helped advance industrialization in a broad range of countries. In 2000 U.S. dollars, manufacturing exports to advanced economies have tripled since the early 1990s, whereas those to China have grown even more dramatically, albeit from a low initial level (see chart).

Manufacturing exports to other developing countries in Asia and elsewhere have also picked up. And commodity exports to China and other Asian countries have risen sharply, but even commodity exporters have stepped up their manufacturing trade.

### The current boom

By historical standards, the current commodity price boom has been broad based and sustained, with the prices of many

commodities—oil, metals, major food crops, and some beverages—rising sharply. However, different developing economies have reaped uneven benefits, reflecting differences in the composition and relative magnitudes of their commodity exports and imports. For instance, since 2000, the commodity terms of trade have risen by more than 40 percent in the Middle East but fallen slightly in Asia.

Commodity-exporting developing economies currently experiencing a boom have benefited from it more than from previous booms in a number of ways. Their median total export volumes have grown more than 3 percentage points a year faster than in past booms, as have manufacturing exports. The rapid growth in manufacturing export volumes may have benefited from two policy shifts: in fuel exporters, less real appreciation than observed during past booms;

in nonfuel commodity exporters, greater tariff reduction.

Also, output, foreign direct investment, and domestic investment have all accelerated, whereas foreign borrowing, especially by governments, has slowed relative to past booms.

### Drivers of integration

Although commodity prices have substantial effects in the short term, the study implies that their longer-term contribution to trade and financial integration is relatively minor. In other words, commodity prices were not a key factor in the 26 percent long-term rise in developing countries’ export volumes relative to GDP between the 1980s and 2000s.

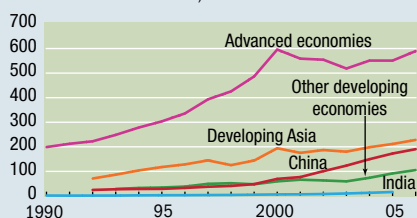
Instead, nearly two-thirds of this increase in export volumes can be explained by better institutions, financial deepening, and reduced policy distortions, which include fewer exchange restrictions, lower tariffs, and diminished overvaluation. The rising integration of developing countries with the world economy also reflects greater trade openness in other developing economies, helping promote South-South trade.

These findings imply that even if commodity prices were to lose their buoyancy, integration is unlikely to be reversed. Ongoing improvements in institutional quality, financial deepening, fiscal prudence, and external liberalization will continue to be important drivers of integration. Nevertheless, many developing economies remain dependent on commodity exports, and increased diversification and further progress on reforms would improve their ability to withstand abrupt changes in commodity prices and support further integration with the global economy. ■

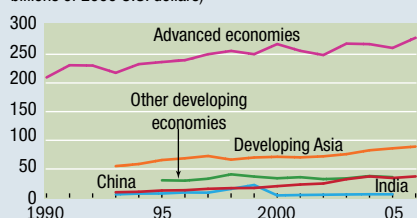
### Export boom

Commodities remain important, but manufacturing exports are surging in emerging and developing economies.

(manufacturing exports, by destination; billions of 2000 U.S. dollars)



(commodity exports, by destination; billions of 2000 U.S. dollars)



Sources: IMF, Commodity Price System database; UN Comtrade database; and IMF staff calculations.

Note: Chart shows exports from emerging and developing economies, excluding India and China.

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## Africa's Economic Expansion Faces Downside Risks

**G**rowth in sub-Saharan Africa (SSA) is expected to average about 6½ percent again this year, driven by oil exporters (see table). Although the region's economic expansion is expected to continue, risks are tilted to the downside. The external environment has become less favorable—with growth slowing in advanced economies, higher oil prices, and unsettled global financial markets—which could hurt growth in SSA.

The IMF's *Sub-Saharan Africa Regional Economic Outlook—Spring 2008* (REO) says that, in light of these risks, there is about a one-in-five chance that the region's growth will drop to less than 5 percent in 2008.

### Growth prospects

Growth in SSA's oil exporters is expected to accelerate to about 10 percent this year, underpinned by production at oil facilities coming onstream in Nigeria and Angola and a new liquefied natural gas plant in Equatorial Guinea. Higher income and wealth are expected to be the main drivers of domestic demand in these countries.

In countries that are not oil exporters, the picture is mixed, with average growth a bit lower than last year. Growth in the middle-income countries is expected to register only about 4 percent this year and, in low-income countries, about 6 percent. In the fragile countries, buoyed by a continued recovery in investment, growth should pick up to 5 percent in 2008, up from 3¼ percent in 2007.

Inflation in the region should increase slightly to about 8½ percent if macroeconomic policies hold firm. Inflationary pressures arise mainly from oil prices, which are expected to increase by about 35 percent this year, and higher food prices.

### Looming risks

A pronounced global slowdown would weaken the prices of non-oil commodities

### A mixed growth picture

The expansion is expected to continue in sub-Saharan Africa, but could stall if risks materialize.

(GDP growth, percent)

	2005	2006	Est. 2007	Proj. 2008
Oil-exporting countries	7.7	7.3	8.8	9.9
Middle-income countries	4.9	5.2	5.1	4.0
Low-income countries	7.0	6.6	6.9	6.1
Fragile countries	3.7	2.6	3.3	5.0
<b>Sub-Saharan Africa</b>	<b>6.2</b>	<b>6.1</b>	<b>6.6</b>	<b>6.5</b>

Sources: IMF, African Department database, March 31, 2008; and World Economic Outlook database, March 31, 2008.

and represent a large shock for SSA. Higher oil prices would reduce domestic demand, boost headline inflation, and worsen the current account and net foreign asset positions of net oil importers. Finally, less favorable financial conditions would reduce external financing and hurt growth.

SSA also faces significant internal risks. Conflicts still ravage the Darfur region of Sudan and the Horn of Africa. Moreover, conditions remain fragile in the Democratic Republic of Congo, and post-election violence in Kenya has undermined investor confidence and tourism and could delay donor support and stall structural reforms needed to sustain recent growth. The conflicts in Darfur and Kenya are also affecting neighboring countries.

But the IMF says that SSA is less vulnerable to a worsening of the global environment than it was in the 1990s. Smaller current account and fiscal deficits, lower inflation and debt, higher foreign reserves, and stronger policy frameworks have all helped make the region more resilient.

How countries should respond if the downside risks are realized depends on, among other things, their initial conditions; inflation and inflation expectations; fiscal position; and vulnerability, including their levels of foreign debt and reserves. Although policy responses can help mod-

erate the effects of external shocks, not all countries will have room to ease monetary and fiscal policies if the downturn is pronounced.

Several countries, especially the oil exporters, must maintain macroeconomic stability while dealing with still-rising foreign exchange flows. They should identify ways to ensure that their economies can effectively absorb higher spending and make spending and saving decisions in a medium-term framework that takes long-term sustainability into account.

### Medium-term challenges

The region's most pressing challenge will be to accelerate growth and achieve the Millennium Development Goals. But, although more SSA countries are enjoying robust growth, only a few seem well positioned to halve poverty by 2015.

The spring 2008 report focuses on what SSA must do to spur investment. The region's future economic performance will hinge on reforms that improve the investment climate, reduce the cost of doing business, and strengthen governance. A few countries have made encouraging progress on this front, with Kenya and Ghana leading the way on broad-based reforms. In southern Africa, Madagascar, Mauritius, and Mozambique have lifted regulatory obstacles.

Although recent reforms have helped improve governance in a few countries, more needs to be done. Among the region's priorities are to strengthen tax systems, establish transparent and comprehensive budgeting procedures, promote accountability and transparency, and enhance budgetary control. High-quality infrastructure, especially a reliable power supply, will also be critical for accelerating growth and greasing the wheels of the economy. Policymakers need to handle regulation and pricing well to improve the supply and provide the right signal to markets. ■

## Asian Growth Easing, but Will Remain Strong

Growth in Asia is forecast to decline by 1¼ percentage points to 6.2 percent in 2008 owing to the slowdown in advanced economies, but will remain buoyant—led by continued strong performances by China and India, says the April *Regional Economic Outlook for Asia and Pacific*.

“We see 2008 as a challenging year for Asia,” said David Burton, Director of the IMF’s Asia and Pacific Department. “Economic growth has held up well so far, but the region will not escape unscathed from the slowdown under way in the United States and, to a lesser extent, Europe.

“Already, exports to the United States and the European Union, and electronics exports in general, have begun to slow. Retail sales volume growth has declined in many countries, while industrial production and consumer confidence are easing in parts of the region,” Burton told an April 11 press conference.

### Inflationary pressures rising

But inflationary pressures are now strong or rising across most of Asia. Whereas the initial rise in headline inflation reflected supply-related food price shocks and higher global commodity prices, price increases are now starting to become more broad based.

Asian financial markets have not been immune to the global turbulence. Equities are sharply lower than at the beginning of the turmoil, although price-earnings ratios remain elevated, and spreads have risen substantially. Risk aversion remains high, and fund managers in the region have reportedly shifted allocations toward safer investments. However, Asian markets have functioned well overall, and there are few signs of a credit squeeze.

### Key regional trends

The report identified the following key trends in the region:

**Asian growth.** Emerging Asia is forecast to slow from 9.2 percent in 2007 to 7.6 percent this year, before picking up modestly in 2009. Growth in China is projected to decline by about 2 percentage points this year, to 9.3 percent, mainly owing to slowing exports. And India’s economy should cool as well, as lower investment brings overall growth to just below 8 percent. Economies with large trade and financial exposure to the United States and Europe—for example, Singapore and Hong Kong SAR—will also see significant declines. In industrial Asia, growth is forecast to decline by ½ percentage point to 1.7 percent in 2008, with growth in Japan falling from 2.1 percent to 1.4 percent over the same period.

**Trade.** Asia’s trade performance remains positive, despite lackluster electronics exports. Part of the explanation is strong growth of exports to “nontraditional” markets in Latin America, eastern Europe and

Russia, and the Middle East. Import growth has picked up in recent months, even when excluding oil, suggesting some strength in domestic demand, the report said.

**Inflation.** Inflation pressures are rising across most of Asia. In recent months headline inflation momentum has increased noticeably in India and the southeast Asian countries of Indonesia, Malaysia, the Philippines, Thailand, and Vietnam and has picked up anew in China, after having leveled off in late 2007. Core inflation has also risen, as food and commodity price rises have begun to generate some second-round effects. Moreover, producer price inflation is now running above headline inflation across much of the region, pointing to the potential for margin squeezes and further price pressures ahead.

**Exchange rates.** Exchange rate trends have become less uniform across Asia. While the region’s currencies as a whole have appreciated marginally in nominal effective exchange rate (NEER) terms since the previ-

ous forecast in October 2007, much of this is being driven by the sharp appreciation of the Japanese yen as carry trades are being unwound. Emerging Asian currencies as a group have weakened somewhat, led by the newly industrialized economies and India. Notably, the Chinese renminbi, while appreciating further against the U.S. dollar, has appreciated only modestly in NEER terms.

**Delinking unlikely.** Despite buoyant domestic demand so far, growth in Asia is unlikely to delink from economies outside the region. In particular, there is evidence that spillovers from the United States, in particular to China, have risen in recent years and that financial contagion and global confidence effects (certainly in play at the moment) could raise significantly the size of such spillovers. ■

### Still buoyant

Asia’s performance will be affected by the slowdown in advanced economies.

(real GDP growth; year-on-year percent change)

	2006	2007	Proj.	
			2008	2009
Industrial Asia	2.4	2.3	1.7	1.7
Japan	2.4	2.1	1.4	1.5
Australia	2.6	4.1	3.2	3.1
New Zealand	1.5	3.1	2.0	2.1
Emerging Asia	9.0	9.2	7.6	7.9
NIEs <sup>1</sup>	5.6	5.6	4.0	4.4
Hong Kong SAR	7.0	6.3	4.3	4.8
Korea	5.1	5.0	4.2	4.4
Singapore	8.2	7.7	4.0	4.5
Taiwan Province of China	4.9	5.7	3.4	4.1
China	11.1	11.4	9.3	9.5
India	9.8	9.2	7.9	8.0
ASEAN-5 <sup>2</sup>	5.7	6.3	5.8	6.0
Emerging Asia, excl. China	7.2	7.2	6.1	6.3
Emerging Asia, excl. China and India	5.6	5.9	4.9	5.2
<b>Asia</b>	<b>7.2</b>	<b>7.4</b>	<b>6.2</b>	<b>6.4</b>

Sources: CEIC Data Company Ltd.; and IMF, World Economic Outlook database.

<sup>1</sup>NIEs = newly industrialized economies.

<sup>2</sup>ASEAN-5 = Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

## Latin America: Still Resilient, but Risks Ahead

**D**eteriorating global economic conditions will present the first major test of the improved macroeconomic policy frameworks that most Latin American and Caribbean (LAC) countries have put in place during the past decade, the IMF said in its *Regional Economic Outlook for the Western Hemisphere*.

Much of Latin America enjoyed strong growth between 2002 and 2007—the best sustained performance since the 1970s—because of the strong policy frameworks and favorable global economic conditions. With the exception of a handful of countries, that growth was accompanied by relatively modest inflation.

But in response to a tightening of financial markets and a slowdown in growth in the advanced economies, the IMF projects that economic growth in the region will fall from about 5.6 percent last year to 4.4 percent in 2008 and 3.6 percent in 2009 (see table). At the same time, inflationary pressures that began in 2007 as a result of strong domestic demand and rising world food and energy prices will persist.

Risks to the growth outlook are skewed largely to the downside. Among them are a fall in exports if global growth slows more than expected or persistent inflation pressures, which could lead to difficult policy choices.

“Navigating this period of financial turbulence and heightened uncertainty is the key near-term policy challenge,” said Anoop Singh, Director of the IMF’s Western Hemisphere Department.

### Region better placed

“The region is better placed than in the past to absorb the sharp slowdown foreseen in global growth,” the IMF noted in its report. The high level of reserves coupled with strong banking systems, lower public debt levels, reduced public sector financing requirements, and generally flexible exchange rates provide Latin America with

more room to deal with adverse global developments than in the past.

One major plus, so far at least, has been the stability of money and bond markets in Latin America despite the turmoil in financial markets in the advanced economies. Still, the region has not totally escaped the problems roiling global credit markets, in which that had their roots in the subprime mortgage market in the United States.

### Possibly weakening external surpluses

The slowdown in global growth, which could be worse than expected, could hurt Latin America by reducing demand for its exports and bringing down the prices of many of the commodities that Latin American countries sell abroad. International prices for the LAC region’s main commodity exports “have in aggregate risen by 150 percent since 2003.”

Strong current account surpluses (which measure trade in goods and services and profits and interest payments), a major source of strength in recent years, also began to weaken in 2007, because high import growth outpaced export growth in many major countries such as Argentina, Brazil, Colombia, and Venezuela. The external current account surplus, about 1½ percent of GDP in 2006, registered a small surplus in 2007, but is expected to slip into a small deficit in 2008. Moreover, strong capital flows are expected to moderate this year. As a result, LAC countries will accumulate international reserves at a slower pace than last year. Although projected to be \$500 billion (12½ percent of GDP) at year’s end, they are quite high by historical standards and provide a strong buffer against adverse international developments.

### Growth decelerates

Real GDP is projected to continue to grow in Latin America, although it will slow in 2008 and further in 2009.

(real GDP growth; annual rate, percent)<sup>1</sup>

	Avg.			Est.	Proj.	
	1995–2004	2005	2006	2007	2008	2009
Latin America and the Caribbean	2.6	4.6	5.5	5.6	4.4	3.6
South America	2.4	5.2	5.6	6.4	5.2	4.1
Central America	3.7	4.7	6.3	6.5	4.7	4.6
The Caribbean	4.0	6.0	7.8	5.7	4.4	3.8

Source: IMF, *World Economic Outlook*; and staff estimates.

<sup>1</sup>Weighted average, by purchasing power parity.

### Inflation pressures remain

Inflation in the region rose from about 5 percent in 2006 to 6 percent last year and is expected to remain at that level in 2008, with some countries exhibiting inflation much higher than that.

The run-up in international prices of fuel and, especially, food prices has been particularly troubling because of the strong “impact on the poor, especially in the low-income countries,” the IMF said. One of the important effects of the good growth and inflation performance in the LAC since 2002 has been a marked reduction in poverty and some reversal of income inequality.

External food and fuel inflation explains about 30 percent of domestic inflation, according to the IMF analysis. Much of the rest is explained by “excess demand pressures,” the IMF said.

In some countries, those demand pressures have been exacerbated by strong procyclical government spending, which began to outpace revenue growth in 2007, reducing structural balances. “Primary fiscal balances in the region are expected to fall to about 2.4 percent of GDP in 2008—down from the historical peaks of about 3.5 percent of GDP in 2005–06—with public debt falling slightly to 48 percent of GDP,” the IMF said. ■

**IMF to Back Liberia with Debt Relief and New Financing**

The IMF has announced a series of measures to support Liberia with debt relief and new financing.

Over the past two years, the Liberian government has implemented significant reforms to rebuild its economy and reduce poverty after a ruinous 14-year civil war. On March 14, Liberia took another important step toward reintegrating with the global economy: it cleared its longstanding overdue obligations of \$888 million and normalized its financial relations with the IMF.

In response, the IMF's Executive Board agreed to restore Liberia's voting rights in the IMF and its eligibility for IMF resources; provide financial support totaling \$952 million under the IMF's Poverty Reduction and Growth Facility and its Extended Fund Facility; and offer debt relief, along with other creditors, to cover at least \$4.4 billion of Liberia's \$4.7 billion debt. These measures should help catalyze support for Liberia from the donor community.

The IMF has actively supported efforts to rebuild Liberia's economy since Ellen Johnson-Sirleaf (above), Africa's first elected female head of state, took office in 2006.



Chip Somodevilla/Getty Images

**New Study on African Trade**

Sub-Saharan Africa's share in global trade has declined since 1970. But the region is benefiting from the recent commodity boom, which has reoriented its trade toward Asia's rapidly growing emerging economies, such as China and India.

A new IMF study, *Sub-Saharan Africa: Forging New Trade Links with Asia*, analyzes the trade patterns emerging in sub-Saharan Africa and finds that the region is performing below its export potential.

To help realize the region's full trade potential, the study recommends policies to maintain macroeconomic stability, build infrastructure, reduce the cost of doing business, liberalize trade, and reduce shipping costs.



Jewel Samad/AFP/Getty Images

**Bangladesh Receives \$217 Million in Emergency Assistance**

The IMF's Executive Board approved on April 2 a disbursement of \$217 million in emergency assistance to Bangladesh to help the country cope with damage from a November 2007 cyclone that had followed severe monsoon-related flooding.

IMF Deputy Managing Director Takatoshi Kato noted that the damage to the country's agricultural sector would reduce economic growth in FY2008. "The balance of payments has been adversely affected by the disasters, largely owing to a substantial rise in food imports," he said, adding that support from the IMF and others in the international community would be crucial.

**Côte d'Ivoire Receives \$66 Million in Postconflict Assistance**

The IMF Executive Board approved in April \$66 million in emergency postconflict assistance for Côte d'Ivoire to help strengthen the country's foundation for sustained recovery. IMF First Deputy Managing Director John Lipsky

praised the country's progress toward achieving reunification and peace, saying that "a climate of political dialogue is evident, and the improved security situation is beginning to pay off in better economic outcomes."

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