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RESEARCH: Kydland on his work and its impact

Finn E. Kydland, together with Edward E. Prescott, received the 2004 Nobel Prize in economics for their studies on the forces behind business cycle fluctuations and the time consistency of economic policy. In an interview, Kydland explains how his work has contributed to "dynamic macroeconomics," why economists should turn their attention to issues spanning life cycles, and why he is intrigued by diverse country studies such as those of Ireland and Argentina.

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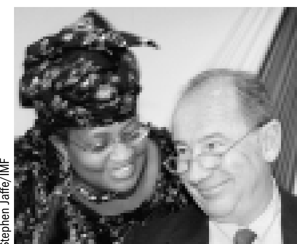
Stephen Jaffe/IMF

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China Photos/Getty Images

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Henrik Gschwindt De Gyor/IMF

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What's on

May

22–23 Annual Meeting, European Bank for Reconstruction and Development, Belgrade, Serbia

23–24 World Bank, "Annual Bank Conference on Development Economics 2005: Securing Development in an Unstable World," Amsterdam, The Netherlands

29–30 UN Economic Commission for Latin America and the Caribbean–IMF Seminar, "Policies for Growth in Latin America and the Caribbean," Santiago, Chile

June

1–3 World Economic Forum–Africa Economic Summit, Cape Town, South Africa

1–3 InterAction Annual Conference, "Charting a Course for Relief and Development," Washington, D.C.

2–3 APEC Meeting of Trade Ministers, Jeju, Korea

5–7 Organization of American States General Assembly, Fort Lauderdale, Florida

6 OECD–African Development Bank, Fifth International Forum on African Perspectives, Paris

10–11 Group of Seven Finance Ministers' and Central Bank Governors' Meeting, London

13–17 IMF seminar on large taxpayer issues for tax officials in the Asia and the Pacific region, Bangkok, Thailand

15–16 IMF-Singapore Regional Training Institute conference, "Managing Fiscal Risks in Asia," Singapore

20 Annual U.S.-E.U. Summit, Washington, D.C.

29–July 1 ECOSOC Substantive Session, High-Level Segment, New York

July

1–5 International Conference on AIDS in Asia and the Pacific, Kobe, Japan

5 IMF seminar for legislators, Lao P.D.R.

6–8 Group of Eight Summit, Gleneagles Hotel, Gleneagles, Scotland

September

6–7 IMF High-Level Seminar on "Strengthening the Financial Stability Framework," Washington, D.C.

14–16 High-level plenary meeting, UN General Assembly, to review progress on UN Millennium Declaration commitments, New York

26–27 IMF and World Bank Annual Meetings, Washington, D.C.

26–30 International Atomic Energy Agency General Conference, Vienna, Austria

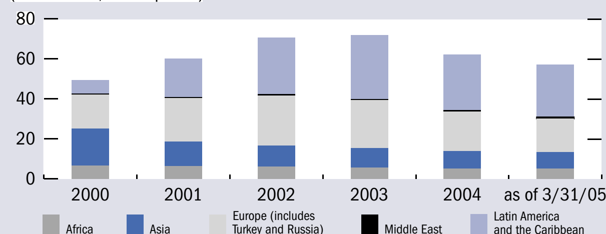
IMF Executive Board
For an up-to-date listing of IMF Executive Board meetings, see *www.imf.org.external/np/sec/bc/eng/index.asp.*

At a glance

IMF financial data

Total IMF credit and loans outstanding, by region

(billion SDRs, end of period)



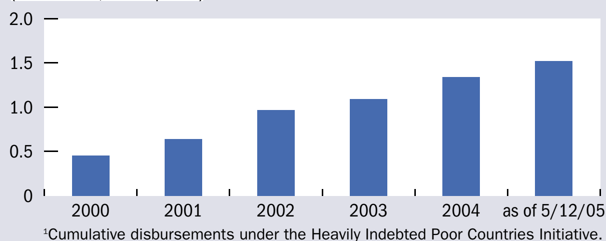
Largest outstanding loans

(billion SDRs, as of 3/31/05)

Nonconcessional		Concessional	
Brazil	15.36	Pakistan	1.04
Turkey	13.19	Zambia	.57
Argentina	8.35	Congo, Dem. Rep. of	.53
Indonesia	6.02	Ghana	.29
Uruguay	1.64	Tanzania	.27

HIPC debt relief[1]

(billion SDRs, end of period)

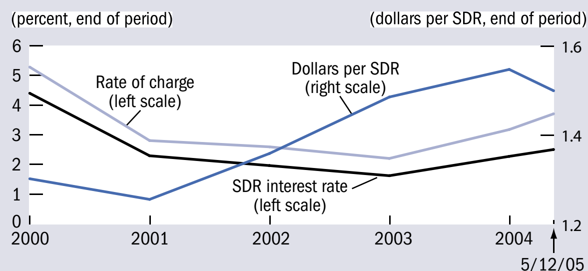


[1]Cumulative disbursements under the Heavily Indebted Poor Countries Initiative.

Related rates

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

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



Note on IMF Special Drawing Rights

Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

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De Rato calls for joint efforts to sharply boost Africa's growth

With the highest growth rate in a decade and the lowest inflation in a quarter of a century, Africa now has a unique opportunity to boost growth, raise living standards, and reduce poverty, IMF Managing Director Rodrigo de Rato told African leaders at the African Development Bank's Annual Meetings Symposium in Abuja, Nigeria, on May 17. His remarks came at the beginning of a four-nation tour, which also included visits to Benin, Niger, and Chad. He exchanged views with a variety of political and civil society leaders on the IMF's role in Africa and the external support, including debt relief, needed to help poor countries achieve the Millennium Development Goals (MDGs) by 2015. He also urged major African cotton producers at a Benin conference to step up efforts to improve the sector's efficiency and avoid resorting to subsidies to support producer prices in the face of the large decline in world cotton prices.

Stephen Jaffe/IMF

Nigerian President Olusegun Obasanjo (right) greets Rodrigo de Rato.

Nigeria. Speaking at the African Development Bank symposium, de Rato underscored the IMF's commitment to help Africa close the gap between economic performance and growth potential. "This gap must be addressed if African countries are to grow at the levels sufficient to achieve sustained improvements in standards of living and to meet the needs of a rapidly expanding labor force," de Rato said. Africa's growth reached an eight-year high of nearly 5 percent in 2004, with inflation under control, but growth of at least 7 percent a year is needed to reach the MDGs. The IMF can provide policy advice, financial assistance, and capacity building, he said, stressing the latter as an integral element of the IMF's work in Africa. The focus in capacity building should be on financial sector reform, public resource management, and trade reform.

During a meeting with Nigerian President Olusegun Obasanjo, de Rato commended the prudent management of the economy last year, saying "fiscal restraint—along with a tight monetary policy and improved terms of trade—have helped strengthen Nigeria's external position and restore macroeconomic stability." He agreed with the Nigerian authorities that as the burden of controlling inflation falls to the Central Bank of Nigeria, it "should implement a monetary program consistent with its disinflation objectives." De Rato also met with finance ministers of the Economic and Monetary Community for Central Africa and Omar Kabbaj, President of the African Development Bank.

Benin. In Cotonou on May 18, de Rato participated with cotton farmers, private sector firms, Beninese government officials, and the region's other major cotton producers in a conference, seeking ways to mitigate the negative impact on these economies of sharply declining world cotton prices. He proposed that cotton-producing countries and development partners, including the IMF, take a joint approach that would cover the advanced economies' removal of subsidies to their cotton sectors, improvements by African cotton-producing countries in the efficiency of their cotton sectors, the implementation of policies ensuring macroeconomic stability, and more donor support to help these economies undertake the needed reforms.

Niger. The challenges of raising growth and speeding up poverty reduction, while securing debt sustainability, topped the agenda with President Mamadou Tandja, Prime Minister Hama Amadou, and other policymakers and stakeholders during de Rato's visit on May 18–19 to Niger—a country that reached its completion point and received "topping up" financing last year under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. Talks centered largely on Niger's post–HIPC needs to strengthen water management and road infrastructure in rural areas, where 80 percent of the country's population lives, while continuing with privatization and financial sector reforms. He also visited the Women's Dairy Cattle Project, a nongovernmental organization financed by the HIPC Initiative that is helping to increase rural employment opportunities for women.

Chad. On May 19-20, de Rato spoke with national officials about the increasing importance of transparently and efficiently managing revenues from oil production, which has become the economy's largest sector. He also met with refugees who had fled the conflict in Darfur, Sudan. ■

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In the news

IMF loan to help Turkey build on strong track record

The IMF Executive Board signaled its continued support for Turkey's macroeconomic policy and reform efforts, which have helped to propel growth, lower inflation, and reduce debt in recent years, when it approved a new three-year loan for $10 billion on May 11. "Turkey's economic performance is at its strongest in a generation," said IMF Managing Director Rodrigo de Rato after the Board decision. "The authorities' new three-year program is designed to extend these gains in economic performance and reduce Turkey's remaining vulnerabilities."

Since the 2000–01 economic crisis, Turkey has implemented an ambitious program of macroeconomic and structural reforms, which delivered a decisive break with the country's history of high and variable inflation, and low and volatile growth. Turkey successfully completed the last IMF-supported program earlier this year. During 2002–04, growth has averaged 8 percent a year; annual inflation has fallen from close to 70 percent to below 10 percent, the lowest in more than 30 years; and government debt has declined to 63.5 percent of GNP, from 90.5 percent.

Krista Kennell/Zuma Press

Strong economic track record shows Turkey has broken with its past.

Under the new program, the authorities seek to create conditions for sustained growth that will raise living standards and reduce unemployment; facilitate convergence with the European Union; and bring about an orderly exit from IMF lending. The Board also approved a one-year extension of $3.8 billion in repayments from Turkey arising in 2006. Turkey currently owes the IMF about $20 billion. ■

For more information, please refer to Press Release No. 05/104 and Turkey's Letter of Intent from April 26 on the IMF's website (*www.imf.org*).

Sound policies benefit Tajikistan's economy, but further reforms needed

Civil strife delayed Tajikistan's transition to a market economy, but reforms and relatively favorable conditions more recently have been reducing poverty. In 2004, the economy again grew strongly, and inflation decreased markedly, the IMF said in its annual economic assessment. The IMF Executive Board praised the authorities' sound macroeconomic policies but noted that sustaining rapid growth required stronger commitment to structural reform.

Economic activity continued to diversify rapidly into the services sector. Real household incomes have been on the rise, especially from remittances. Pointing to the critical role workers' remittances have been playing in sustaining growth, the Board encouraged the authorities to take measures to sustain and use more effectively the flow of these remittances. Strengthened fiscal discipline and tighter monetary policy have drastically reduced inflation, and the somoni's exchange rate has remained remarkably stable since 2002. The Board deemed appropriate the current managed float exchange rate regime with intervention limited to smoothing short-term volatility, and it encouraged the authorities to broaden the range of monetary instruments.

Since 2002, strong growth in tax revenues and continued expenditure restraint have contributed to small fiscal surpluses, and measures to improve the external debt profile have halved the debt-to-GDP ratio. Nevertheless, debt management will need to improve further and private sector external debt, including that of the cotton sector, should be recorded and monitored.

Tajikistan	2001	2002	2003	2004	2005 Projections
			(percent change)		
Real GDP	10.2	9.1	10.2	10.6	8.0
			(percent of GDP)		
General government balance					
including Public Investment Program	–3.1	–2.4	–1.8	–2.7	–4.5
excluding Public Investment Program	–0.1	–0.1	0.9	0.3	–0.5
Total public sector external debt	98.4	84.4	66.2	39.7	38.5

Data: IMF staff report, March 2005.

Progress on several key reforms in Tajikistan's poverty reduction strategy has been slow. Weaknesses in the business and governance environment need to be addressed to strengthen the development of the private sector, and obstacles to greater competition removed. Measures are required to improve the financial viability of the energy sector. Local government interference in agriculture needs to be eliminated and access to financial services improved, while the debt overhang in the cotton sector needs to be resolved. Although initial reform measures have been implemented in education and health care, the remaining agenda for public administration reform is substantial. ■

For more information, refer to IMF Public Information Notices No. 05/56 (Singapore), No. 05/42 (Tajikistan), and No. 05/57 (Cameroon) on the IMF's website (*www.imf.org*).

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Cameroon records solid growth, but needs better fiscal performance, investment climate

Aided by continued political stability, Cameroon's economy grew at a solid pace in 2004, the IMF said in its annual economic review. But although average per capita income rose, it remained below the levels of the early 1990s. The IMF Executive Board welcomed the country's sound growth, low inflation, narrowing external current account deficit, and the progress made in reforming the health and education sectors. The regional currency union has helped Cameroon maintain macroeconomic stability with low inflation, but serious challenges remain.

Cameroon's fiscal position deteriorated in 2003–04. If this continues, it could undermine macroeconomic stability, growth, and poverty reduction. In 2005, the authorities intend to strengthen fiscal performance and financial management through an ambitious program that seeks to mobilize nonoil revenue and contain nonpriority spending while increasing investment spending. The Board stressed the need to improve fiscal reporting and strengthen debt management, including by developing and implementing a realistic debt-servicing plan. Further, the authorities should clarify the external debt position of public enterprises to allow for a comprehensive debt sustainability assessment.

Limited progress has been made in removing long-standing impediments to private sector growth, including inadequate investment in infrastructure and human capital, poor service delivery from troubled state enterprises, and an investment climate clouded by weak governance. The Board said infrastructure investments and a stronger legal system will be key to improving the business climate and restoring investor confidence, adding that efforts to improve governance and fight corruption need to be redoubled.

The authorities intend to build a track record of policy implementation through a 2005 program monitored by the IMF. The Board said this would help maintain a stable macroeconomic environment and pave the way for a medium-term reform program that could get financial support from the IMF. A 2000 Poverty Reduction and Growth Facility arrangement with the IMF was derailed in 2004. ■

Cameroon	2000[1]	2001[2]	2002	2003	2004 Estimates
			(percent change)		
GDP at constant prices	5.3	4.3	4.2	4.5	4.3
Consumer prices	2.8	4.5	2.8	0.6	0.3
			(percent of GDP)		
Current account balance (including grants)	–4.1	–6.4	–7.0	–2.4	–1.6
External debt (net present value)	n.a.	n.a.	54.8	42.5	43.4

Data: IMF Public Information Notice, April 2005.
[1]Data for fiscal year July 2000–June 2001.
[2]Data for fiscal year July 2001–June 2002.

Singapore mounts strong recovery but must sustain competitiveness

After a series of external shocks over the past decade, from the Asian crisis to the bursting of the technology bubble, Singapore's economy experienced a strong turnaround starting in mid-2003—aided by a favorable external environment, supportive macroeconomic policies, and continued structural reforms, the IMF said in its annual economic review. At the same time, sustained fiscal surpluses, an absence of external debt, healthy reserves, and large current account surpluses provided a strong buffer against exogenous shocks, the IMF Executive Board added. Economic growth is expected to moderate in the near term, however, as global demand—particularly for electronics—softens.

The Board welcomed the authorities' resolve to continue identifying new sources of growth in an increasingly challenging regional and global environment. In recent years, the government has undertaken a wide range of structural reforms to adjust to stronger competition from lower-cost economies in the region. These reforms have produced more wage and labor market flexibility, lower business costs and taxes, and a stronger outward expansion of Singapore firms.

Since early 2004, when signs of inflationary pressures emerged, the Monetary Authority of Singapore has maintained a tight monetary stance, which the Board considered an orderly withdrawal of the stimulus provided in recent years. However, if growth slows more than expected, the Board said a more supportive monetary policy may be needed.

The authorities' current fiscal stance is broadly neutral. The Board praised the authorities' use of fiscal policy in recent years to support the economy, while adhering to the objective of a balanced operational budget over the medium term. The prudent medium-term fiscal framework resulted in significant reserve accumulation which in turn strengthened investor confidence. The financial sector remains robust, benefiting from an efficient legal system and good accounting standards. ■

Singapore	2001	2002	2003	2004 Estimates	2005 Projections
			(percent change)		
Real GDP	–1.9	2.2	1.1	8.1	4.0
Average CPI	1.0	–0.4	0.5	1.7	1.6
			(percent of GDP)		
Central government overall balance (FY starting April)	3.5	4.2	6.3	3.1	3.0
Current account balance	–18.7	–21.4	–30.9	–28.8	–23.3

Data: IMF staff report, April 2005.

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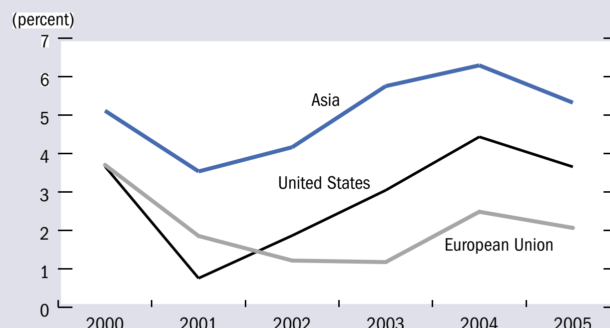
Asia's economic outlook is bright, but risks loom

Decades of rapid growth have made Asia's economies a vitally important part of the world economy. Three out of the world's 10 largest economies are in Asia: Japan, China, and Korea. Asia accounts for about one-fifth of global output and nearly half of recent world economic growth. Global growth in the coming years thus depends, in no small measure, on what happens in Asia. This article examines Asia's economic outlook and shifts in production patterns that are occurring with the recent end of the system of global textile quotas. It is the first in a series of quarterly articles that the IMF Survey plans to run on Asia, which will look at economic trends in the region and topical policy issues.

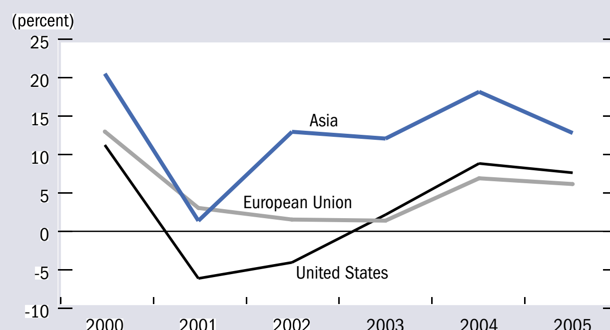
Spectacular economic growth . . .

Last year's growth was the best in almost a decade, well above that of the European Union and the United States.



. . . partly thanks to booming exports

Export growth reached 18 percent in 2004 but is expected to subside to more normal rates in 2005 as the recent electronics expansion matures.



Data: IMF, *World Economic Outlook.*

This year is shaping up to be another good one for the region, with GDP expected to grow by 5¼ percent. This is somewhat slower than last year's rate of 6¼ percent, but last year's growth was the best in almost a decade, partly due to a surge in the region's exports (see chart). In particular, demand for electronics exports boomed as the sector finally recovered from its post–2000 slump, resulting in a 41 percent increase in Asian sales of semiconductors. Export growth in 2005 should subside to more normal rates as the electronics expansion matures, slowing GDP growth to a more sustainable rate. Emerging Asia—China, India, the NIEs (Newly Industrialized Economies—Hong Kong SAR, Singapore, and Taiwan Province of China), and the ASEAN4 (Indonesia, Malaysia, the Philippines, and Thailand)—is projected to grow by 6½ percent, compared with 7½ percent in 2004.

The outlook for other economic indicators is generally favorable. The region's current account surplus is forecast to narrow modestly to 2¾ percent of GDP from 3¼ percent of GDP, reflecting the export slowdown. Meanwhile, regional inflation is projected to remain at 3 percent.

Three major risks loom, however. First, world oil prices have increased again this year, and as of mid-May are around 20 percent higher than they were in December 2004, hurting regional incomes and putting upward pressure on inflation. So, the possibility of further oil price increases is one downside risk. Second, global current account imbalances have continued to widen, threatening to trigger a disorderly adjustment of world currencies and interest rates. The IMF has emphasized that addressing global imbalances is a shared responsibility of countries, requiring more flexible exchange rates in emerging Asia where appropriate, as well as policies to increase national savings in the United States, and further structural reforms in Europe and Japan to boost their growth. Third, as indicated in the IMF's April 2005 *World Economic Outlook,* the risks to growth in the advanced economies outside Asia are predominantly on the downside, which points to a risk that demand for Asian exports may decelerate by more than projected in the second half of the year.

This situation presents some difficulties for the region's policymakers. On the one hand, they need to be prepared for a slowdown in growth, which might warrant some compensating macroeconomic stimulus. But they also need to guard against a rise in inflation, requiring some policy tightening. In such circumstances, policymakers will need to remain vigilant, carefully sifting the evidence before deciding which way

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to adjust macroeconomic policy. They will need to take into account the fact that the monetary stance in most cases is already highly accommodative, with policy interest rates at historically low levels—around 3½ percent in emerging Asia—roughly the same as forecast inflation. For countries with pegged exchange rates, an advantage of moving to increased exchange rate flexibility would be a greater ability to use monetary policy to adjust demand conditions and control inflation. For example, in Korea, the exchange rate appreciated by 17½ percent against the U.S. dollar in the year to mid-May, helping to offset the impact of higher world oil prices.

The end of textile quotas

The expiration of global textile and clothing quotas at the end of 2004 is having important effects on the region, especially China and the low-income countries in Asia: Bangladesh, Cambodia, Lao P.D.R., Mongolia, Nepal, Sri Lanka, and Vietnam. This complex system of quotas had distorted global textile trade for decades, and its abolition holds out the promise that export orders will finally go to the most competitive firms, resulting in substantial savings benefiting the world's consumers. But for this to occur, protectionist pressures need to be kept at bay.

So far, available information suggests that China, as expected, has been the major beneficiary. Data for the first three months, for example, indicate that China's textile and clothing exports to the United States have jumped sharply—by nearly 60 percent, and by around 180 percent in newly liberalized product lines—although the growth in China's total textile exports in the first quarter of 2005 has remained largely the same as last year. India's exports have also grown rapidly.

These developments, however, have already produced a protectionist response. In mid-May, the United States decided to reimpose quotas on seven categories of clothing imports from China, limiting their growth to no more than 7½ percent over a 12-month period. The European Commission is conducting its own investigation into several textile product categories and, on May 17, announced that it would seek emergency safeguards for two categories of products (T-shirts and flax yarns). China announced on May 20 that it would raise export taxes substantially on 74 products, effective June 1.

Meanwhile, the Asian low-income countries have been doing reasonably well. China's increase in market share has so far come mainly at the expense of middle-income countries, rather than low-income countries, partly because importers have been maintaining diverse low-cost suppliers in case the United States or the European Union imposed bilateral quotas on China. Thus, textile exports of Bangladesh, Cambodia, Sri Lanka, and Vietnam to the United States have actually increased—by 17 percent on average during the first quarter.

Roslan Rahman/AFP/Getty Images

The decade-long phase-out of restrictions on global textile trade concluded on January 1 when quotas were eliminated, benefiting producers such as China and India.

At the same time, there are some ominous signs for the Asian low-income countries. Prices are falling, by almost 12 percent on all apparel imports from China into the United States and by more than 50 percent in certain categories. Over time, this will squeeze the profit margins of Asia's low-income country exporters and erode their overseas orders. If the same geographical shifts in production that took place during the first year of an earlier round of liberalization occur again, an IMF staff study suggests that the textile exports of Asian low-income countries could fall significantly. The decline could range from 8–18 percent, depending on the country, reducing GDP growth for about one year by ½–¾ percentage points.

As this process occurs, the IMF will be aiding the adjustment process through its Trade Integration Mechanism, which was introduced in April 2004 to help member countries meet balance of payments shortfalls that might result from multilateral trade liberalization. Bangladesh has made use of this mechanism. The shift in textile production will play out over the coming years, and the ultimate pattern remains uncertain. ■

IMF Asia and Pacific Department

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Battling fraud ranks among challenges of value-added tax

Close to 130 countries—with the notable exception of the United States—have adopted the value-added tax (VAT) over the past 30 years or so. The VAT is a broad-based tax on all domestic sales that allows businesses to take a credit or receive a refund for the tax charged on their inputs so as to ensure that the tax bears only on final domestic consumption. The distinctive structure of this powerful source of revenue gives rise to special problems of control—an issue that formed part of the agenda of a March 14–16 conference held in Rome, organized by the International Tax Dialogue (ITD)—a joint initiative of the IMF, the Organization for Economic Cooperation and Development, and the World Bank (see box).

The conference, hosted by the Italian Ministry of Economy and Finance, was ITD's first global conference, bringing together tax officials from more than 100 countries and international organizations. They discussed a broad range of VAT policy and tax administration issues, with a particular focus on the need to combat fraud, ease administrative burdens for businesses, and explore means to improve international cooperation.

A universal concern among participants was the question of what to do about VAT fraud. Most VAT payers routinely and legitimately receive refunds on the basis of VAT shown on invoices issued by the taxpayer's suppliers. But fraudulent refund schemes arise when a refund claim is based on counterfeit invoices or on VAT shown on an invoice issued by the taxpayer's supplier, which in fact the supplier has not paid to the government. The VAT is sometimes described as self-policing, because the failure to collect tax at any point in the distribution chain is automatically made up at subsequent stages. Of course, it is this very self-policing feature—and the reliance on invoices issued by a chain of suppliers—that creates an opportunity for fraud.

Traditionally, two of the most effective weapons against fraud have been a good VAT policy framework and a fairly sophisticated risk-based auditing system designed to distinguish between legitimate and fraudulent claims. Given the prevalence and high cost of fraud, and its constantly mutating nature, some countries have also experimented with such innovative approaches as the use of electronic invoices (which prevent counterfeiting) and, more controversially, special bank accounts (which help ensure that the taxpayer's supplier in fact pays the VAT being claimed). Many participants suggested that fraud could also be thwarted by a greater exchange of information among national authorities, but at the same time, participants underscored the need for reducing businesses' compliance burdens and improving audit selection and execution.

Handling international assistance

A topic that attracted particular interest at the conference was the tax treatment of international assistance. It has been a common practice for donors—who provide assistance,

The International Tax Dialogue (ITD)

The ITD is an initiative of the IMF, World Bank, and Organization for Economic Cooperation and Development. It is designed to facilitate experience sharing, networking, and other means of bolstering cooperation among tax officials throughout the world, including by greater information sharing on technical assistance activities in taxation. The ITD's chief communication tool is its website (*www.itdweb.org*), which provides information on key issues in tax policy and administration and on tax laws and practices around the world. The ITD website will be used to facilitate information sharing and coordination of research in preparation for its next global conference. Papers presented at the March 14–16 conference in Rome are also available on the website—including a background paper that summarizes countries' experiences with value-added taxation. Looking ahead, a priority for the ITD is to increase the number of participating countries and expand the opportunities for tax officials in different countries to network with their counterparts.

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including through loans—to insist on exemptions for imports and, in the case of loan finance, to stipulate that the loans not finance tax payments. But, in the case of the VAT, participants pointed out that exemptions on imports result in distortions in favor of imported goods, fraud, and complication of VAT administration. Participants were interested to learn of a change in World Bank policy on this, toward being more open to financing taxes on procurements under loan-financed projects. They also debated possible changes in the donors' attitudes toward expanding the scope of allowable taxation by aid recipients.

Some old issues . . .

While most participants agreed that differentiating rates and using exemptions were poor ways to pursue equity objectives, many participants argued that political realities often made the ideal of a single rate on a broad base hard to achieve. Views differed more strongly as to the appropriate level of the VAT threshold—the level of turnover at which registration for the VAT becomes compulsory. While some argued for a relatively high threshold so as to focus scarce administrative resources on the most important taxpayers, others said a low threshold could play an important role in fostering awareness of and compliance with the wider tax system.

. . . and some new challenges

As tax officials grapple with a more globalized world, one particularly challenging area is financial services, because it does not include easily identifiable transactions that could be charged with a VAT. The prevalent approach of simply exempting financial services is becoming increasingly problematic, and some countries have been experimenting with new approaches—including taxing financial services that involve a specific charge and zero-rating services provided to businesses.

Francis Dean/Dean Pictures

The value-added tax—levied on the value added at all levels of production of a good or service, including, in many countries, on clothing—is now a part of the national tax system in a wide range of countries.

The best way to treat purchases by government bodies, which are often exempted, was also discussed. Some countries now seek to limit revenue leakage from this source by applying the VAT to most government entities. Moreover, international services present practical problems of identifying a taxpayer who can be subject to tax in the jurisdiction and conceptual issues of determining the jurisdiction where the services ought to be taxed. Also problematic are exemptions for services provided by the nonprofit sector and the public sector.

More cooperation, please!

Participants saw greater scope for international cooperation in VAT matters, including through regional cooperation, information sharing among tax administrations, and even international agreements to allocate taxing rights among countries on international services. The next global meeting of the ITD is tentatively set for 2007, with the taxation of small and medium-sized businesses topping the list of possible topics. ■

Michael Keen, IMF Fiscal Affairs Department
and Victor Thuronyi, IMF Legal Department

Value-added tax close to universal[1]

Over the past 30 years or so, most countries across the world have adopted the value-added tax.

	Sub-Saharan Africa	Asia and Pacific	European Union 15 plus Norway and Switzerland	Europe and Former Soviet Union	North Africa and Middle East	Americas	Small Islands[3]
Total[2]	**33 (43)**	**18 (24)**	**17 (17)**	**27 (28)**	**9 (21)**	**23 (26)**	**9 (27)**
1996–present	18	7	0	6	2	1	3
1986–1995	13	9	5	21	5	6	6
1976–1985	1	2	0	0	2	6	0
1966–1975	0	0	11	0	0	10	0
Before 1965	1	0	1	0	0	0	0

Source: *The VAT: Experiences and Issues,* available at *www.itdweb.org.*
[1]Regions defined as in Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT* (2001), except Serbia and Montenegro included in Central Europe.
[2]Figure in parenthesis is number of countries in the region.
[3]Island economies with a population of less than 1 million, plus San Marino.

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Nobel laureate Kydland reflects, talks about what's in store

In 2004, the Nobel Committee awarded Finn E. Kydland and Edward E. Prescott the Nobel Prize in economics, citing their contribution to "dynamic macroeconomics: the time consistency of economic policy and the driving forces behind business cycles." Kydland, the Henley Professor of Economics at the University of California at Santa Barbara, was in Washington, D.C., recently to present a seminar at the IMF Institute. He spoke with Arvind Subramanian, Division Chief in the IMF's Research Department, about receiving the Nobel Prize and the implications of his work for the economics profession.

SUBRAMANIAN: What were you doing when the famous call came from the Nobel Committee?
KYDLAND: I was in Norway teaching dynamic macro at the basic MBA level. A secretary came in, saying that there was a call for me. I wanted to wait five minutes until the break, but she said, "No. No. They are quite insistent." When I answered the phone, there was someone speaking to me in Swedish. The head of the Nobel Committee read what seemed to be a prepared statement and said, "Just so you don't think this is a joke, I have a couple of people here you know." He then put them on the line.

In spite of the currency board, Argentina didn't have credibility among investors—perhaps because they had been burnt several times before.

—Finn E. Kydland

SUBRAMANIAN: There's no question that your work on credibility and commitment has made a huge contribution to economics. But can credibility and commitment be overdone, as some say is the case with the European Union's Stability and Growth Pact? In practice, don't you need the right combination of flexibility and commitment?
KYDLAND: Well, there are two aspects. One is that whatever you commit to ought to be a good policy. It should not be commitment for its own sake, but commitment to something that benefits the people and the economy, and generates growth that is close to the highest possible rate. So, first, the choice of policy has to be wise, but then commitment is indeed extremely important.

SUBRAMANIAN: How do you feel about charges that the Stability and Growth Pact is too much of a straitjacket, that there isn't enough flexibility to adjust to cyclical variations?
KYDLAND: Well, that's not so much criticism of a commitment mechanism as it is criticism of the policy to which Europe has tried to commit. And without having studied it in detail, it could very well be that there isn't enough leeway in the ability to make the debt fluctuate over the business cycle. Economists understand that it's better to make the debt fluctuate cyclically than make the tax rates fluctuate cyclically. So some leeway should be included, but not too little or too much.

SUBRAMANIAN: Let me quote two illustrious economists on real business cycle theory—one of your two contributions cited by the Nobel Committee. First, "If recessions are a rational response to temporary setbacks in productivity, was the Great Depression really just an extended voluntary holiday?" And, second, "The theory of the real business cycle is like the Ptolemaic system that guided ships for centuries but was totally wrong." The first quote is by Paul Krugman; the second is by Larry Summers. Your response?
KYDLAND: Our work created a framework for addressing interesting aggregate economic questions. It has become a standard framework. It's true that our first paper focused on one particular source of business cycles—namely, shocks to productivity or aggregate production possibilities, which, if you interpret it broadly, can include lots of things. But since then, the same framework has been used to study other sources of business cycles, such as monetary shocks and taxes.

SUBRAMANIAN: The stress on microfoundations was very valuable, but people seem less convinced by your explanation that cyclical fluctuations were caused by fluctuations in productivity.
KYDLAND: They were less convinced and it's less important. Though I must say that I haven't seen anything that really overturns our finding that roughly two-thirds of the U.S. business cycle can be accounted for by fluctuations in productivity.

SUBRAMANIAN: But is it fair to say that real business cycle theory is taken less seriously now—microfoundations apart?
KYDLAND: One thing we have learned is that business cycles are not that costly to people. The welfare implications are not that big—at least from normal business cycles. That's not to say, of course, that governments can't implement bad policies and make things much worse. But it may behoove us to devote more attention to longer-run questions where the

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benefits can be really great. As our understanding of economic theory improves and as computers improve, it is natural to turn our attention to things that matter over the life cycle, such as social security, immigration, age and wealth distribution, and so on.

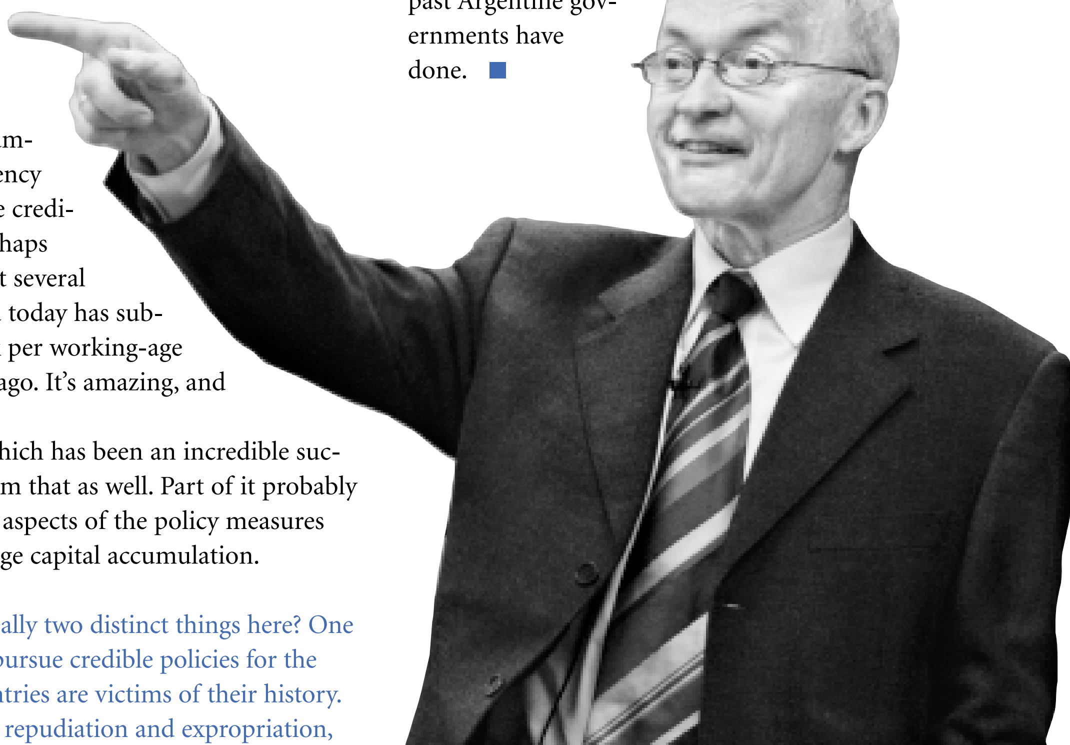
Subramanian: What are your current research interests?

Kydland: One is country studies. I find it interesting to work on two quite diverse economies like Argentina and Ireland. Argentina followed very bad policies for decades. In my Nobel Lecture, I called it the time consistency disease. The surprising thing about Argentina is that once you put the numbers into a standard model, the model says that Argentina should have grown much faster in the 1990s. That suggests, for example, that in spite of the currency board, Argentina didn't have credibility among investors—perhaps because they had been burnt several times before. And Argentina today has substantially lower capital stock per working-age person than it had 20 years ago. It's amazing, and very depressing.

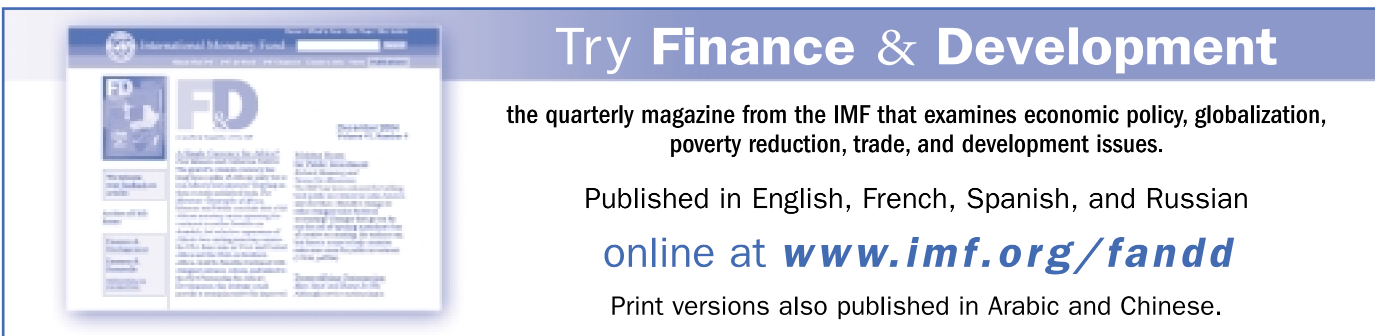
Then you have Ireland, which has been an incredible success story. One can learn from that as well. Part of it probably has to do with the long-run aspects of the policy measures they put in place to encourage capital accumulation.

Subramanian: Aren't there really two distinct things here? One is the need for countries to pursue credible policies for the future; the other is that countries are victims of their history. If you have a history of debt repudiation and expropriation, it's really difficult to erase that. If you look at debt-to-GDP ratios in the developing world, India's is very, very high, about 80–90 percent. But over the past few years, interest rates actually have been coming down, even though deficits and debt have been going up. One explanation is that India has less of a credibility problem; it does not have a history of repudiating debt, overtly or through inflation, and markets are willing to cut it more slack. People compare debt to GDP around the world, but one shouldn't do it too mechanically, because it's not just about the future, but also about the past.

Kydland: That's a very good point. India is benefiting from the fact that its past governments haven't done things similar to what past Argentine governments have done. ■



Kydland: "One thing we have learned is that business cycles are not that costly to people."



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Doha trade talks: the main risk is a "gutless" agreement

Lankes: "Much of the benefit of trade reform is domestic and can be reaped unilaterally, whether or not other countries liberalize as well."

At a time when the global community is focused on breaking the deadlock in the Doha Round of multilateral trade talks—with an eye on the December Hong Kong ministerial meeting of the World Trade Organization (WTO)—the IMF is stepping up its push for freer trade, on the part of developed and developing countries. Hans Peter Lankes, Division Chief in the IMF's Policy Development and Review Department, spoke with Christine Ebrahim-zadeh of the *IMF Survey* about these issues in the context of a recently concluded IMF review of its work on trade.

The IMF has long urged its member countries to liberalize their trade restrictions and to engage in multilateral trade liberalization. And, over the past few years, it has intensified its focus particularly on the effects of the trade policies of the industrial countries. "IMF management is quite active in urging rich nations to open their markets to developing countries to help spur economic growth," Lankes said. "But it's not about developing countries versus industrial countries," he added. While developed countries can play a critical role in removing market access restrictions, reducing tariff escalation, and cutting agricultural and other subsidies, there are good reasons for developing countries to also liberalize their own trade regimes. "Much of the benefit of trade reform is domestic and can be reaped unilaterally, whether or not other countries liberalize as well. And there is also mileage to be gained from developing countries opening their markets to each other. They tend to be more restrictive to each other than they are to industrial countries," he said.

While most countries welcome, in principle, the prospect of a freer trading environment, some are apprehensive. Countries that fall into the latter category are notably the least developed countries and some small island economies in Africa, the Caribbean, and the Pacific, who feel they will be damaged by the loss of preferential access that their exports to developed country markets currently enjoy. In response to this—and the legitimate concern that these countries' balance of payments might suffer in the short term—the IMF introduced, almost a year ago, the Trade Integration Mechanism (TIM). The TIM enables the IMF to assist member countries in meeting balance of payments shortfalls that might result from multilateral trade liberalization. To date, Bangladesh and the Dominican Republic have requested support under the TIM, and a number of others have shown interest.

Fear of revenue loss

Another area of concern for a wide range of developing countries is the prospect of losing revenue from dismantling their tariffs and other trade-related taxes, which are often a major source of government finance. These fears may have some basis in reality, Lankes agreed. The IMF staff review looked at country experience and found that nearly half of the low-income countries that cut their tariff rates over the past 20 years, and suffered an associated revenue loss, recovered less than 70 percent of this lost revenue from other sources. Some of the poorer countries have been unable, or unwilling, to recover lost trade tax revenues through strengthened domestic taxation.

But it doesn't have to happen this way. In fact, country experience has varied. While many of these countries have encountered real difficulty in dealing with the revenue consequences of trade liberalization, others have managed to cope. Several have recouped lost trade tax revenue from domestic sources—for example, by making committed efforts to broaden tax bases by eliminating exemptions, simplifying rate structures, and improving revenue administration, or strengthening the domestic consumption tax system and carefully sequencing trade liberalization with domestic tax reforms.

Will revenue considerations be an obstacle to trade liberalization in the future? Not necessarily, Lankes noted. The prospects for further trade liberalization are likely to depend in part on the extent to which they will cause trade tax revenue to decline further and on whether countries are able to deal with such revenue losses. The difficulties are ultimately not so much technical, he said, as political. The proper design and implementation of accompanying domestic tax reforms

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are not trivial tasks and require a commitment to the reforms needed to strengthen domestic tax systems.

Regionalism has its risks

While many developing countries have hesitated to open up at the multilateral level, in recent years the number of bilateral and regional trade agreements has surged, often involving developing countries. What is behind this? When not purely political, Lankes said, the proliferation of South–South agreements is, more often than not, driven by developing countries' desire to strengthen their collective ability to compete in the global marketplace. North–South agreements can sometimes be explained by a similar motivation, but the search for preferential market access is also a strong driver. In the case of central American and U.S. textile sectors, for example, the argument for trade integration under the Central American Free Trade Agreement is to better compete with China.

"In practice, the moment you negotiate a regional agreement, you also create some structural resistance to multilateral liberalization."

—Hans Peter Lankes

Another important reason for regionalism's popularity is that the negotiating process tends to be simpler and quicker than the seemingly more cumbersome and drawn-out WTO process. This is true particularly in the services sector, which involves a range of difficult issues, including regulatory policies, competition, and investment policies. "Countries have taken the attitude that 'if it doesn't work at the multilateral level, then let's work something out at a bilateral or regional level," Lankes said.

Is this trend worrisome? There is an uneasy relationship here, that is not without risks, Lankes explained. Countries continue to pay lip service to the supremacy of multilateral agreements and insist that regional measures are meant to be intermediate steps that represent progress in terms of liberalization and are fully compatible with a multilateral agreement. "In practice," Lankes noted, "the moment you negotiate a regional agreement, you also create some structural resistance to multilateral liberalization." For example, Lankes explained, a country's export industries may have been lobbying hard for trade liberalization, because they had an interest in the main trading partners opening up. And, if they get preferential market access to some of their largest partners, they may have much less of an incentive to lobby for further trade liberalization: multilateral liberalization would reduce their competitive advantage over other countries. As a result, "even if the purpose of regional agreements is to liberalize and act as a stepping-stone to broader global liberalization," he noted, "discrimination is introduced."

Another risk, according to Lankes, is that "in many poor countries, the very few experienced trade negotiators they have may be sucked into regional trade negotiations with very little capacity left to think through the multilateral." And, finally, there is the administrative problem: if a country has different customs regimes for products originating from different countries, significant complexity is introduced. "It is a headache to manage," Lankes said, "and it opens the door to greater abuse."

Nevertheless, many governments believe there is a very positive side to these agreements. In their view, regional agreements can yield important benefits and the downside can be minimized by designing them correctly. "You can make sure that the agreements don't include overly large preference margins or build in an automatic reduction of these preference margins over time," Lankes explained. Some arrangements also include useful corollaries that focus, for example, on designing sensible banking regulation as a prerequisite for financial services liberalization. And some are coupled with technical assistance that seeks to strengthen international property protection, labor laws, and environmental rules.

Determinants of success

WTO members want to wrap up the entire Doha Round by the end of 2006. Who needs to do what to ensure success? For starters, industrial countries need to take some very serious steps to reform their agricultural protection. The good news is that on May 4, trade ministers meeting in Paris managed to unblock the talks that had gotten stuck on technicalities in this area. But there is still considerable work to do, and the ability of the different parties to make serious progress in areas such as services—which have been relegated to the shadows of the talks on agriculture—remains largely untested.

The main risk for the Doha Round, Lankes said, is that "it becomes a gutless agreement." He worries that negotiators will declare victory without making any real progress in liberalizing trade on the multilateral front. "A watered-down agreement," he said, "may not really be worth very much and could give further impetus to bilateral and regional initiatives." ■

The full texts of "Review of Fund Work on Trade," and the background studies, "Trade Conditionality Under Fund-Supported Programs, 1990–2004" and "Dealing with the Revenue Consequences of Trade Reform," are available at *www.imf.org.*

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Weighing trade options for developing countries

With the stop and go of the Doha Round of multilateral trade negotiations, the demise of textile and clothing quotas, and a further proliferation of regional trade agreements, developing countries are awash in both challenges and opportunities in the area of trade. What do they stand to gain or lose, what policies offer the wisest course, and how effective has the IMF been as an advisor on trade matters? There was much to discuss when academics and staff from the IMF, the World Bank, and the U.S. International Trade Commission gathered on April 28 for a conference sponsored by the Trade and Investment Division of the IMF's Research Department.

Peter Neary (University College, Dublin and Center for Economic and Policy Research) opened the discussion with the advice that, just as medical treatment needs to be based on a correct diagnosis, so, too, should trade reforms be grounded in a solid understanding of how restrictive a country's trade regime really is. Sounds elementary, but, as he made clear, it is not easy to construct an index that perfectly reflects the restrictiveness of trade policies. Still, given its policy relevance, it is better to estimate proxies for that perfect index than abandon the effort. On the basis of his own work and that coauthored with James Anderson, Neary clarified the kind of questions index numbers are designed to answer, proposed methods underpinned by theoretical models, and discussed the pros and cons of different approaches to implement them.

Just as medical treatment needs to be based on a correct diagnosis, so, too, should trade reforms be grounded in a solid understanding of how restrictive a country's trade regime really is.

—Peter Neary

Trade and growth

Looking at the relationship between trade liberalization and economic efficiency, a large body of evidence suggests that greater import competition increases firms' productivity. Most of these studies, however, focus solely on the effects of reducing tariffs on final goods. Mary Amiti (IMF), analyzing the effects of reducing tariffs on both inputs and final goods, concluded that sharply higher benefits are associated with lowering tariffs on intermediate inputs and that importing firms enjoy the largest gains thanks to access to a wider variety of foreign intermediate inputs, or learning effects. Using Indonesia as an example, she found that a 10 percentage point fall in output tariffs increases productivity by 1 percent, while the same reduction in input tariffs produced a 10 percent productivity gain for importing firms.

Can changes in a country's level of protection (tariffs, for example) raise an economy's growth rate? James Cassing (University of Pittsburgh) and Stephen Tokarick (IMF) demonstrated that the effect could go either way—the cost of a country's tariff structure, as a proportion of national income, could rise or fall with factor accumulation. Whether higher tariffs raise or lower the growth rate depends, they said, on rates of factor accumulation, factor intensities across sectors, and elasticities of substitution between factors. The bottom line is that while higher tariffs may raise or lower an economy's growth rate, they cannot make small countries better off in a welfare sense. Thus, focusing exclusively on a country's growth rate could be misleading.

How IMF conditionality fits in

Encouraging countries to liberalize their trade regimes has long been an important part of the conditions attached to IMF-supported programs. Over the past decade, in fact, about two-thirds of IMF-supported programs have had such conditions. But have these conditions hastened trade liberalization? Shang-Jin Wei and Zhiwei Zhang (both IMF) examined the circumstances in which trade reforms in these programs took root, with special attention paid to the question of whether a country's willingness to reform ("ownership") matters greatly. On average, conditions relating to trade policy were found to be associated with higher trade openness (after accounting for other factors that may affect trade openness), but only when there was ownership.

New era after quotas

As for trade in textiles and clothing, January 1, 2005, marked the end of the 10-year phase-out of the quotas on these items agreed under the 1995 Agreement on Textiles and Clothing. Although exporters have had a decade to make needed adjustments, Joseph François (Tinbergen Institute) showed that, in effect, the phase-out was so backloaded that very few adjustments had actually taken place. One result of this has been delay in the integration of China and India into the global textile and clothing sector and the potential for a substantial further surge in exports from both countries after 2005. ■

Zhiwei Zhang
IMF Research Department

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina	September 20, 2003	September 19, 2006	8,981.00	4,810.00
Bolivia	April 2, 2003	March 31, 2006	171.50	60.00
Bulgaria	August 6, 2004	September 5, 2006	100.00	100.00
Colombia	January 15, 2003	May 2, 2005	1,548.00	1,548.00
Croatia	August 4, 2004	April 3, 2006	97.00	97.00
Dominican Republic	January 31, 2005	May 31, 2007	437.80	385.26
Gabon	May 28, 2004	June 30, 2005	69.44	27.78
Paraguay	December 15, 2003	September 30, 2005	50.00	50.00
Peru	June 9, 2004	August 16, 2006	287.28	287.28
Romania	July 7, 2004	July 6, 2006	250.00	250.00
Total			**11,992.02**	**7,615.32**
EFF				
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	187.50
Total			**794.40**	**311.23**
PRGF				
Albania	June 21, 2002	November 20, 2005	28.00	4.00
Azerbaijan	July 6, 2001	July 4, 2005	67.58	12.87
Bangladesh	June 20, 2003	June 19, 2006	400.33	251.83
Burkina Faso	June 11, 2003	August 15, 2006	24.08	10.32
Burundi	January 23, 2004	January 22, 2007	69.30	35.75
Cape Verde	April 10, 2002	July 31, 2005	8.64	1.26
Chad	February 16, 2005	February 15, 2008	25.20	21.00
Congo, Republic of	December 6, 2004	December 5, 2007	54.99	47.13
Congo, Democratic Republic of	June 12, 2002	June 11, 2005	580.00	53.23
Dominica	December 29, 2003	December 28, 2006	7.69	3.48
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	June 4, 2004	June 3, 2007	98.00	70.00
Ghana	May 9, 2003	May 8, 2006	184.50	105.45
Guyana	September 20, 2002	September 12, 2006	54.55	27.79
Honduras	February 27, 2004	February 26, 2007	71.20	40.69
Kenya	November 21, 2003	November 20, 2006	225.00	150.00
Kyrgyz Republic	March 15, 2005	March 14, 2008	8.88	7.62
Mali	June 23, 2004	June 22, 2007	9.33	6.67
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Mozambique	July 6, 2004	July 5, 2007	11.36	8.12
Nepal	November 19, 2003	November 18, 2006	49.91	35.65
Nicaragua	December 13, 2002	December 12, 2005	97.50	41.78
Niger	January 31, 2005	January 30, 2008	6.58	5.64
Rwanda	August 12, 2002	February 11, 2006	4.00	1.14
Senegal	April 28, 2003	April 27, 2006	24.27	13.86
Sierra Leone	September 26, 2001	June 25, 2005	130.84	14.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	19.60
Tanzania	August 16, 2003	August 15, 2006	19.60	8.40
Uganda	September 13, 2002	September 12, 2005	13.50	4.00
Zambia	June 16, 2004	June 15, 2007	220.10	49.52
Total			**2,877.63**	**1,315.03**

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

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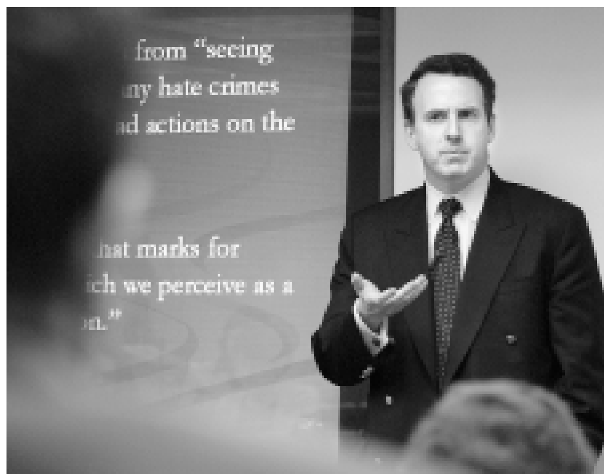
Markets and the politics of hatred

The cool, logical thinking of economics would at first glance seem as far removed from the hot emotions of hatred and racism as it can get. But think again. According to Professor Edward Glaeser of Harvard University, politicians often decide to spread hate-creating stories about a group they wish to exclude from state spending in order to discredit opponents whose policies would benefit that group. According to this logic, egalitarians may foment hatred against rich minorities, whereas redistribution opponents may seek to build hatred against poor minorities. Glaeser, who presented his thoughts at a recent IMF seminar, even thinks that economics can help explain hatred of blacks in the U.S. South, the genocide of Jews, and the recent surge of anti-Americanism in the Arab world. "An economic model of hatred can use the economic focus on incentives and equilibrium to create predictions about where we should expect to see outbreaks of hatred," he writes.

According to Glaeser, psychology—the discipline traditionally tasked with studying emotions such as hatred and discrimination—will get you only so far in understanding the dynamics of those feelings in politics because it is centered mainly on the individual. "If psychology has improved economics by giving us a richer understanding of the individual, then perhaps economics can improve psychology by giving it a better understanding of the market."

False beliefs

Glaeser argues that truth is seldom relevant to hatred. Hatred relies on people accepting, rather than investigating, stories about crimes committed by the "out" group. "The central lesson is that hatred is always built with stories of past and future crime of the object in question," he says, adding that it is "political divisions that create the incentives to build hatred." To illustrate that hatred often is driven more by effective storytelling than fact, Glaeser points to a recent survey of anti-Americanism around the world.



Henrik Gschwindt De Gyor/IMF

Glaeser speaking at a recent IMF Institute seminar on political economy and hatred: "Truth is seldom relevant to hatred."

In Vietnam, a country with which the United States was at war 30–40 years ago, less than 4 percent of the population hold a "very negative view" of the United States. In contrast, anti-American feelings in Argentina run high (23 percent expressed a "very unfavorable opinion"), and seem to be rooted in a tendency of local politicians blaming outside actors (such as the IMF, as well as the United States), for the recent economic crisis and ensuing hardship. In Argentina, the United States is politically relevant; in Vietnam, it is not, even though history would suggest the Vietnamese have more reason to hold a grudge against Americans than the Argentines, Glaeser said.

Truth does not always prevail

Glaeser's research holds an important lesson for anyone wanting to influence public opinion. Repetition is key to disseminating a message, whether that message is false or true. Unless people have a strong incentive to seek out the truth—and in politics, they don't because there are few tangible costs associated with voting for the "wrong" person or party—they won't. Groups hurt by a negative message would, therefore, do better to actively counter these messages than to think that the truth will automatically prevail. ■

Camilla Andersen
IMF External Relations Department

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