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India's financial sector
Ravallion on Asian land reform

The Next Frontier

The Road Ahead for Low-Income Countries

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FEATURES

THE ROAD AHEAD FOR LOW-INCOME COUNTRIES

DEPARTMENTS

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FROM THE EDITOR

A turning point for the world's poor

MANY of the world's low-income countries are again having to make tough policy choices. With food and oil prices touching record highs and global growth on a down trend, countries battling to reduce poverty levels need to juggle to curb inflation, while maintaining growth and social spending. The downturn comes at a time when things were starting to look better for low-income countries, particularly in sub-Saharan Africa, where some economies are now successfully attracting international investors and are seen as a new tier of "frontier" emerging markets (see David Nellor's article in this issue).

So the new, and the not-so-new, hurdles faced by low-income countries make it even more critical for advanced economies and other donors to live up to their commitments on aid levels and keep working closely with recipient countries to improve aid quality. At a series of prominent meetings in 2008—the Accra High Level Forum on Aid Effectiveness on September 2–4, the UN Summit on the Millennium Development Goals in New York in late September, and the Financing for Development follow-up meeting in Doha in November, among others—a broad array of stakeholders will work toward building consensus and strengthening aid (and development) effectiveness. Alongside aid, it is also critical to move further on opening up major country markets for exports from low-income countries, as well as giving them help to exploit trading opportunities in an increasingly integrated global economy.

This edition of *Finance & Development* examines key issues facing low-income countries today. Masood Ahmed's overview identifies four major macroeconomic challenges that low-income countries are grappling with and outlines possible approaches to tackle them. Three articles explore emerging trends, and problems, in the aid business and how to transform the governance of aid. Eckhard Deutscher and Sara Fyson of the OECD examine the changing landscape of donors and find that aid fragmentation poses a major problem, with a proliferation of donors straining the government apparatus of some smaller countries. Aid unpredictability is another major difficulty, say Oya Celasun and Jan Walliser. It prevents countries from making full and good use of the money. The 2005 Paris Declaration on Aid Effectiveness is a dynamic, action-oriented road map that attempts to remedy these and other problems in the delivery of aid, Elaine Venter reminds us, but it still remains donor-centric.

Other articles in this issue include an account by Eswar S. Prasad and Raghuram G. Rajan of their new report on financial sector reforms in India; Martin Ravallion and Dominique van de Walle draw lessons on reducing poverty from Vietnam's agrarian reforms; Sanjeev Gupta and Shamsuddin Tareq make a strong case for sub-Saharan countries to mobilize their domestic revenue bases. In addition, Simon Willson profiles Beatrice Weder di Mauro, the first woman on Germany's Council of Economic Experts; and the outgoing IMF Chief Economist Simon Johnson tells us that the new drivers of global growth—emerging markets—will have to fight inflation successfully to prevent future crises.

Jeremy Clift

LETTERS TO THE EDITOR

Mindset adjustment

Jian-Ye Wang and Abdoulaye Bio-Tchané's "Africa's Burgeoning Ties with China" (March 2008) provides a commendable summary of the economic relationships between China and Africa. The authors make six recommendations for strengthening domestic policy areas, which, in theory, should allow Africa to derive the maximum benefit from its deepening economic engagement with China.

However, a focus on these policy areas must go hand-in-hand with a shift in mindset for Africa's leadership. For instance, your authors recommend "preventing the accumulation of unsustainable debt." Left unsaid is the fact that there are political and economic factors (less visible, yet more dangerous) underlying this debt accumulation.

Some politicians feel the need to take a percentage of project-related investments; others skim the top off loans. Domestic policies on demand management and export promotion suffer from shortcomings; governments borrow money without regard to the country's repayment capacity; and megaprojects lead to white elephants. These factors—all reflecting a sense of irresponsibility on the part of certain policymakers—make the paradox of Africa's overindebtedness and underdevelopment easier to understand.

African policymakers must remember that if they are to benefit from Sino-African engagement, they must have the right attitude. Just as the continent needs tetanus shots for its young, Africa is urgently in need of a "mindset adjustment program."

Hippolyte Binazon
Organizational Management Consultant
Cotonou, Benin

Macroeconomists, you call them?

In recent years, I have sensed a perceptible shift in *F&D*'s relationship with its readers. You provide more accessible subject matter as well as additional material on the leading figures of contemporary economic thought. I have a special appreciation for the "People in Economics" section, which profiles living authors whose theoretical and empirical contributions to the development of contemporary economic thought have been significant, even profoundly innovative.

Your profiles have focused on theoretical macroeconomists and researchers, such as Amartya Sen, V. L. Smith, Robert Mundell, Martin Feldstein, Paul Krugman, John Taylor, and Robert Barro. The others have been economic policymakers. I am especially intrigued by this distinction between macroeconomists, policymakers (Otmar Issing, Haruhiko Kuroda, Alice Rivlin), and "practical" economists (Hernando de Soto). After a three-decade quest for convergence of the two branches of modern economic science—macroeconomics and microeconomics—spearheaded by major research programs, is it still meaningful to talk about "macroeconomists"?

Also, in his article on John Taylor (March 2008), Prakash Loungani informs us that A. W. Phillips posited a relationship between the *levels* of inflation and unemployment. To my knowledge, Phillips was instead positing a relationship between *relative changes* in inflation and unemployment (Phillips Curve).

Mahmoud Abdelmoula
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Taylor's success

The article on John Taylor was both interesting and instructive. The author presented Taylor's work as going beyond that of Friedman. But by proposing a systematic and constant reaction from the U.S. Federal Reserve, Taylor is, in fact, merely following the same structural logic as Friedman.

Taylor's advice to economics students seems to me so intuitive that, if such advice were proffered in the exceedingly overcrowded African lecture halls, it would go a long way toward not just enlightening students but also lightening up the formal atmosphere there.

Taylor's success as a macroeconomist would have been complete had he, in his attempts to guide IMF reform, looked explicitly at monetary policy implementation in Africa.

Brice Agonvonon
Benin

Leveraged investing at root of crisis

The article "Subprime: Tentacles of a Crisis" (December 2007) clearly describes the truth about the current financial crisis, where people talk a lot about the mortgage problem and very little about credit default swaps, collateralized debt obligations, and other leveraged structures. Surely the reason for the scant attention to the latter structures is that they are difficult for nonspecialists to understand. (After all, even banks and other holders of these instruments have trouble with their valuation.) You are on target in reminding us that it was leverage and not necessarily the rising default rate in the subprime segment that fueled the current crisis. If we add to this excess liquidity and investors with a high risk appetite, there is bound to be a "fire."

Unfortunately, regulatory solutions to the problem, albeit useful, will be late in coming. By then, a new generation of financial instruments will be putting regulators to the test.

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We welcome letters. Please send no more than 300 words to *fanddletters@imf.org* or to the Editor-in-Chief, *Finance & Development*, International Monetary Fund, Washington, DC, 20431, USA. Letters will be edited.

Spending on the MDGs

Students in Tanzania.

Could countries handle a sudden doubling in their aid? What would they spend the increased aid on, and how can we ensure that the additional spending will reduce poverty? The IMF is part of a multinational effort to find out. And time is short, because the world's major industrial countries have pledged to double the aid they give to sub-Saharan Africa by 2010.

The IMF is working on 10 African country case studies to assess the economic effects of the spending of increased aid. The idea is to find out whether a dramatic boost in aid, promised at the G-8 Gleneagles Summit in 2005, can help countries meet the poverty-fighting Millennium Development Goals (MDGs).

The project was conceived in September 2007, when the United Nations established an MDG Africa Steering Group, which brings together the leaders of multilateral institutions—including the IMF—to identify practical steps needed for Africa to achieve the MDGs. A working group is looking at issues such as education, agriculture, health, trade, statistics, aid predictability, and how development partners can work more effectively on the ground to help Africa reach the MDGs.

The IMF has developed scenarios that will show how macroeconomic policy can be designed to fully spend and absorb the international commitments, which doubles aid to Africa to an average of $105 per capita by 2010. The scenarios are currently being calibrated for use in the case-study countries—Benin, the Central African Republic, Ghana, Liberia, Niger, Rwanda, Sierra Leone, Tanzania, Togo, and Zambia.

The scenarios are based on sector-wide expenditure analyses by the country authorities and development partners. Among other approaches, the IMF is using a new, state-of-the-art model to analyze the effects of increased aid on key variables such as real growth, inflation, the exchange rate, and the current account balance, and to assess how different policy choices can help or hinder progress. The model looks, in particular, for possible "Dutch disease" effects. These occur when aid surges lead to real exchange rate appreciations that make exports more expensive.

A first set of results for an initial set of countries is expected in September 2008. The work on the remaining countries will be completed before the end of 2008.

The recommendations of the MDG Africa Steering Group—and more details on the entire effort—are available at www.mdgafrica.org.

Power in the wind

Prompted by climate change concerns, increased international support, surging oil prices, and continuing anxiety about energy security, investment in renewable energy and energy efficiency reached a record high in 2007, the United Nations Environment Program reported.

The agency's report, *Global Trends in Sustainable Energy Investment 2008*, found that, in spite of the subprime mortgage crisis that engulfed global markets, new investment in clean energy reached nearly $150 billion in 2007, up 60 percent from the year before.

Wind energy captured most of the new funding with more than $50 billion, with solar power gaining almost $30 billion.

For greenhouse gas reduction and efficiency targets to be met, investment in sustainable energy must continue its strong growth, the study cautioned.

Wind turbines off the coast of Denmark.

Investment in the sustainable energy sector is expected to reach $450 billion a year by 2012, surging to over $600 billion a year in 2020. The sector's overall performance during 2007 and into 2008 sets it on track to achieve these levels, the report noted.

Events in 2008

September 2–4, Accra, Ghana
3rd High Level Forum on Aid Effectiveness

September 22, New York, USA
UN High-Level Meeting on Africa's Development Needs

September 25, New York, USA
UN High-Level Meeting on the Millennium Development Goals

October 10–13, Washington, DC, USA
Annual Meetings of the IMF and the World Bank

November 8–9, São Paulo, Brazil
Group of Twenty Finance Ministers and Central Bank Governors Meeting

November 13–14, Washington, DC, USA
Ninth Jacques Polak Annual IMF Research Conference

November 29–December 2, Doha, Qatar
Follow-up International Conference on Financing for Development

Rise of the Undaunted Empiricist

Simon Willson profiles ***Beatrice Weder di Mauro***

FOR the first 41 years of its existence, Germany's Sachverständigenrat, or Council of Economic Experts, was popularly known as the "Five Wise Men." If that sobriquet was a veiled invitation to the country's female economists to attempt entry into a hitherto all-male preserve, the council was into its fifth decade before anybody accepted. Beatrice Weder di Mauro was appointed in June 2004 as the council's first female member. "Friends of mine suggested that now they had better call us the Five Wise Guys," Weder di Mauro says.

The council's gender barrier was not the only hurdle Weder di Mauro cleared by taking her seat on the panel that advises the German government and parliament on economic policy issues. Born in Basel, Switzerland, Weder di Mauro was also the first non-native council member and, then aged 38, one of the youngest council members ever appointed. Not surprisingly, after setting such precedents, she is now one of the best-known economists in the world's third-largest economy.

Today, the Five Wise Guys are at the leading edge of the macroeconomic reforms that could turn the euro area into the world's next economic powerhouse. Because the German economic advisory council has a much higher public profile than that of comparable institutions, such as the U.S. Council of Economic Advisers, Weder di Mauro's council tenure started in a blaze of publicity. But the gloss soon faded as the council researched and recommended a series of radical fiscal and labor market reforms. And whatever celebrity Weder di Mauro may initially have bestowed on a structure as technocratic as Germany's economic advisory council has been absorbed and become part of the panel's own heavyweight persona.

Known for her direct and persistent style of inquiry and research, Weder di Mauro brought to the German council a record as a pathfinder in exploring the role of banks in transmitting financial contagion. She had, in addition, investigated the effects of corruption on developing economies—using the term directly in the days when it was usually referred to by the euphemism of "governance." She also brought to the German council a keen sense of how best to disseminate findings and results. In an assertively independent council that partly relies on the mass media to channel its findings and recommendations, this is a powerful asset.

Something about panels

Weder di Mauro's early research was characterized by a comprehensive approach, irrespective of the scale of the project. Gregory Kisunko, a senior public sector specialist at the World

Bank, worked with Weder di Mauro on a 1996–97 worldwide survey on perceptions of links between political uncertainty, investment, and growth. His recollections depict a driven and single-minded empiricist undaunted by trifling taglines such as "Data not available."

"This was the first and the largest effort to collect raw data on the topic of institutional uncertainty, and she was pushing very hard for extending the country coverage as wide as possible," Kisunko remembers. "The data collection exercise was heroic because it required an organized effort spanning more than 70 countries." Colleagues had been "excited and energized by the novelty and magnitude of her ideas. We all had ideas, but she was always one of those leading the pack."

Unusually, Weder di Mauro's position on the German advisory council is her second tour in such a role in a major European economy. She was appointed in 2002 to Switzerland's Kommission für Konjunkturfragen, the Economic Advisory Board of the Swiss government, and served for two years. What intrigued her enough about national economic advisory panels that she would serve on two, back to back? "It is extremely interesting to do work that is relevant for the policymaking of a country and, at the same time, still keep a foothold in the academic world," Weder di Mauro says. "It's not always easy, though, because what is relevant very often is not interesting for research, and vice versa."

The German advisory council is unique, Weder di Mauro asserts, because it is independent (see Box 1). The government appoints council members, but they have a five-year term deliberately at odds with the four-year election cycle. The council has two main channels of influence, Weder di Mauro believes. One is the public—the council is one of the institutions quoted by the mass media whenever there are new economic developments. The other is its inside route to government. "People often ask whether I feel that our recommendations are being implemented right away," Weder di Mauro observes. "I don't think that's the only way to measure the council's influence. Very often it's more about the longer-term influence that we have in a certain direction."

Views that the council's influence is limited have circulated in the economics community for many years, however. Charles Roberts wrote in the *Cambridge Journal of Economics* in 1979 that—and this still applies today—because the council's reports "are published only in German, they are little known and little discussed outside the German-speaking countries." Weder di Mauro says that, while English summaries are published, council reports are mostly in German because they are addressed to the German government and public.

Adversaries, egos, and tantrums

In 2005, the council's close relationship with the press was all too evident as the German media gleefully relayed colorful reports of fragile egos and internal tantrums among the panel's high-octane lineup. Council members even used newspaper articles and interviews to attack each other, prompting suspicions that they were incapable of working as a team. *The Economist* magazine said Germany's marketplace for economists was "coming apart," and recommended that the fixed-term experts be replaced by fresh councils of economic advisers appointed by each incoming government. That way, the advisers would have more of a stake in seeing their recommendations implemented. A potential public relations crisis was eventually defused and the council's image seems to have survived.

"The reputation of the council is extremely high in Germany," Weder di Mauro asserts. "People do ask whether politicians listen to us. Well they can't really avoid us, as we usually make the government uncomfortable. The council usually criticizes the government, which is why there are no other councils like this. Which government would want to establish such a thing?"

Which, indeed? Particularly a government that had, as Germany's did in 2002–06, run its budget deficit at levels higher than the European Union rules allowed. Germany's fiscal slippage had been caused by a creeping economic malaise of slowing growth and rising unemployment that earned the country the unenviable title of "sick man of Europe." Germany's breach of the EU's budget rules in the early 2000s was especially galling for the nation's economic traditionalists, because the EU rules were based on Germany's own penchant for budgetary rectitude—as set out in its landmark Stability and Growth Act of 1967. Key elements of the EU's fiscal rules, set out in the 1992 Maastricht Treaty, were eased in 2005.

Box 1

Informed judgments—by order

Established in 1963, the Sachverständigenrat's mission statement says its mandate is "to periodically assess overall economic developments in the Federal Republic of Germany and to help economic policymakers at all levels as well as the general public to arrive at informed judgments on economic matters."

The council is required, by the law that established it, to produce an annual report that describes "the current economic situation and its foreseeable development. The Council will investigate the possibilities of simultaneously assuring, within the framework of the free market economy, stability of the price level, a high rate of employment and equilibrium in foreign trade and payments, together with steady and adequate economic growth. The investigation will also include the formation and distribution of income and property."

In its latest annual report, published in November 2007 and entitled "The Gains Must Not Be Squandered," the council acknowledges that policymakers contributed to a German economic resurgence in part by launching extensive reforms in the fields of taxation, the labor market, and the social security system.

But the report also states that positive economic trends have in turn opened up wider opportunities for policymakers. "The key need now is not to waste the chance offered by the expanded opportunities for policy action but rather to seize it . . . just as it is gratifying that the policymakers' financial room for maneuver has expanded, so it is frustrating that a whole series of measures that were considered or adopted during the recent past revealed no clear economic policy strategy but instead smacked of tactical electioneering."

"The existing German rules have huge loopholes that are regularly exploited by politicians," Weder di Mauro says. The German council produced a report last year "with suggestions on how to change the entire constitutional framework for limiting the extent of public debt in Germany." She believes a general decline in interest in, and application of, fiscal discipline lay behind Germany's failure to curb deficits that exceeded the Maastricht rules. "But right now there is a chance in Germany for fiscal reform, with a federal commission looking at the rules of fiscal discipline both for the federal government and for the länder [German states]."

Made in Switzerland

The council's report makes stringent proposals that would enforce the original Maastricht rule that national budget deficits be less than 3 percent of GDP, and that any fluctuation align with the business cycle. And, as if to demonstrate the utility of foreign input into council deliberations, a key innovation in the council's proposal incorporates a fiscal feature first deployed in Switzerland.

"Our proposal has something that we imported from Switzerland: a component that is more strict than the Maastricht rules," Weder di Mauro explains. "It's a special fiscal error-correction account that you have to balance. If the budget deficit turns out to be larger than expected, it is debited to this error-correction account that has to be balanced separately. An unexpected fiscal surplus would also have to be paid into this account. The Swiss implemented it in 2003." This mechanism installs "memory" in the system. "No fiscal rules that I am aware of have a memory. They always say that if you overestimated revenues in the past and run a higher deficit than expected, you don't have to correct for that problem first—even Maastricht doesn't do that. In a way, these rules are promoting an 'I will start my diet tomorrow' way of life," Weder di Mauro says. "But with an error-correction account, you can't just start again on a clean sheet. You have to repair past damage. Having memory in the system creates incentives to make conservative revenue estimates and to keep tight checks on spending."

How receptive, though, are German fiscal traditionalists to tighter discipline principles imported from another country? And might Swiss-born Weder di Mauro, who speaks seven languages, be seen as some kind of foreign agent among the Five Wise Guys, advocating foreign solutions to a domestic problem? "It has never been a problem that I am Swiss and Italian," she states.

Although Weder di Mauro's professional focus has latterly been solidly European and increasingly financial, her upbringing prepared her well for her earlier interests in the macroeconomics of growth and development. She was raised in Guatemala, where her father worked for a Swiss multinational company. For nine years Weder di Mauro attended the German school in Guatemala City, where daily life made early impressions that would guide her later work. Her exposure to Latin America laid the foundations, for example, for her subsequent interest in the role of institutions in promoting economic growth.

"Awareness of institutions and of institutional differences comes very much from my Guatemala experience and was reinforced by a research project with the Peruvian *Instituto de Libertad y Democracia* of Hernando de Soto [profiled in *F&D*, December 2003]," Weder di Mauro says. "The project investigated obstacles to small enterprise in Latin America and found that in many countries the enforcement of rules is often not credible, and that this limits the scope of entrepreneurship and exchange. This applies in particular to financing, which is why informal finance flourishes."

The role of banks

Returning to Switzerland, Weder di Mauro completed her education at the University of Basel and was also a research and teaching assistant at the university. "In the past I have had basically two pillars of interest and research," she muses. "One is how to make institutions work so that they promote growth. The second concerns financial crisis contagion, and the role of banks in particular. A third area is coming on stream now: when I was appointed to the German council I tried to refocus my research to work on issues that are more related to Germany in order to exploit synergies." Her current research interests include the impact of real exchange rate changes on job flows in an inflexible labor market and the effects of public sector banks on the reallocation of capital.

It was the second area of interest that led Weder di Mauro to take her first salaried job in 1994 at the IMF in Washington. While at the IMF she took a leave of absence to contribute to the World Bank's 1997 *World Development Report*. "The break-

Box 2

Another conduit for contagion

In a groundbreaking 2001 paper in the *Journal of International Economics*, Weder di Mauro and Caroline Van Rijckeghem identified an indirect channel for contagion between countries that were exposed to the same banks. They found evidence that spillovers through bank lending, as opposed to trade linkages and country characteristics, could help explain contagion.

If the banks shared the same risk models, then a crisis in one country could be transmitted to another country through simultaneous cutting of bank credit lines. Weder di Mauro's findings might align her with critics of the new capital adequacy framework for banks, which is currently being phased in by about 100 countries.

The new framework—known as Basel II because it follows the 1988 Basel I framework developed by the Bank for International Settlements in Basel, Switzerland—is being widely adopted by bank regulators. It establishes a global benchmark for the amount of capital that banks need to hold as standby resources to cover potential risks in their financing and operations.

Critics say Basel II is procyclical—that is, it is too lax on banks' capital requirements in good times and too tough during hard times, exacerbating boom-bust cycles in the process. These naysayers believe that Basel II might lead banks to herd into and out of markets and could eventually pose systemic risk (see related articles in *F&D,* June 2008).

through was this survey that we did, observing firms and asking for their views on obstacles to doing business," Weder di Mauro recalls. This survey approach (with Aymo Brunetti and Kisunko) has since been absorbed into the research mainstream, and much more refined techniques have been developed to take account of institutional issues, she says.

"A very simple question"

From institutions and governance, Weder di Mauro's studies in Washington led to a more prickly and sensitive topic: corruption. In a paper with Harvard's Alberto Alesina, Weder di Mauro asked with characteristic directness, "Do Corrupt Governments Receive Less Foreign Aid?"

"We asked a very simple question," she recalls. "'Is there any evidence that in the past the distribution of aid had taken into account differences in corruption across countries?' And the answer at the time was: 'no.' It has since become generally accepted that corruption is an obstacle to growth and therefore that development systems should pay much more attention to it."

Alesina says this project typifies Weder di Mauro's approach to research. "One of her strengths is her creativity in looking at issues that are important and relevant and not esoteric, but at the same time with a point of view that is quite novel. This was one question left on the table and ready to be addressed in the discussion at the time on whether foreign aid achieved its targets or was wasted." Alesina thinks Weder di Mauro's skills are a good fit for the German council of experts: "She tackles problems head on."

While studying governance, Weder di Mauro also spent two years as a research fellow at the United Nations University in Tokyo. Her 1997–98 sojourn in Japan coincided with the Asian financial crisis and opened up a new area of interest: the role of banks in financial crisis contagion. It helped that her earlier findings on governance and aid flows had made her a natural skeptic of conventional wisdom.

It seems that whenever a major financial crisis occurs, the earliest and most repeated questions are "How could this happen?" and "How is it possible that (insert your target here) did not see it coming?" Weder di Mauro remembers precisely these questions swirling around Tokyo in 1998, and hears eerie echoes today in the context of the subprime mortgage problems in the United States.

In Tokyo, 10 years ago, "people were pointing to trade and also to third-market effects—not only direct trade—to explain part of the contagion. At the time, to me it just didn't sound right. So we started looking for ways in which finance could be part of the contagion process. At that time banks were the major financiers of many of the Asian crisis countries, and there was anecdotal evidence that maybe it was the banks, in reacting to losses in one country by cutting back credit in another, that were conduits for the contagion."

Weder di Mauro says the new Basel II capital adequacy standards for banks will need to be monitored carefully (see Box 2). "If Basel II incorporates risk management systems that respond to prices and ratings and which change in cycles, then in theory it could increase procyclicality. But the real question in my view is empirical: Are capital regulations binding or is economic capital of banks the binding constraint? And if regulatory capital is actually binding, what is the size of the effect on lending?"

After working in Japan, Weder di Mauro in 2001 secured her current position as professor of international macroeconomics at the University of Mainz in Germany. She was part of a 2007 exercise simulating the impact of Basel II on the lending of German banks to emerging markets, finding that the effect should be minimal since banks already seemed to allocate lending according to economic capital.

Two-way teaching

Weder di Mauro was first appointed to the German Council of Economic Experts to finish the term of Axel Weber, who had left to head the Bundesbank. Undaunted by the workload or the attendant publicity, she was reappointed to the council in her own right to a full five-year term last year. The glare of the media spotlight has never bothered her, partly because she knows how journalists work. While at the University of Basel, she and a few faculty colleagues offered courses to train journalists in basic economics. And the teaching ran both ways: the hacks learned about inflation, disinflation, deflation, and stagflation while Weder di Mauro and her fellow bean-counters learned about headlines, deadlines, bylines, and blue lines—and how to explain complex economic insights to a wider audience.

Does designing an economics course for journalists mean she sees a particular weakness in the fourth estate concerning the dismal science? "I wouldn't limit that to journalists," she says. "Everybody could use some basic instruction in economics—and that's part of the role of a body such as the council. If people aren't listening, it's our fault, not theirs." ■

Simon Willson is a Senior Editor on the staff of Finance & Development.

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The Next Frontier

Low-income countries gain ground in a globalized world, but they still face major challenges

Masood Ahmed

BY THE time East Africa's biggest initial public offering debuted in June, shares in Kenya's Safaricom mobile phone company were oversubscribed by more than 500 percent. With over 860,000 shareholders, Safaricom now has the widest shareholder base of any Kenyan company. Media reports said growth potential for the sector is high, because only a third of Kenyans have a mobile phone. Just eight years ago, fewer than 1 percent of Kenyans had a mobile phone.

Throughout the developing world—from the rice paddies of Vietnam to the tropical coastline of Mozambique—countries are making strides in their drive to raise living standards, becoming in the process the next frontier for investors. In Vietnam, the income poverty rate declined from about 58 percent in 1993 to about 16 percent in 2006, and some 34 million people have been lifted out of poverty; while in Mozambique, infant mortality has been cut from 126 per thousand in 2000 to 96 per thousand in 2006.

Given the now near-universal consensus that sustained faster growth is essential for reducing poverty in poor countries, the recent economic performance of many low-income countries, especially in Africa, has been most encouraging. Underlying sub-Saharan Africa's average economic growth of 5.6 percent in 2003–07 are better economic policies (a far cry from the stop-go economic policies that resulted in little or no growth and high inflation through much of the 1980s and 1990s) and improved terms of trade resulting from the most favorable international economic environment since the 1960s.

But this is only one side of the story (see Box 1 on diversity among low-income countries). For the "bottom billion" (Collier, 2007) of this world, the prospects still look bleak. In some sub-Saharan countries, particularly the conflict-ridden "fragile" states with weak institutional structures, it increasingly seems that the economic and social targets embedded in the Millennium Development Goals (MDGs) will not be met. Even South Asia, which is expected to contribute most to global poverty reduction in the next decade, is likely to fall short in meeting agreed targets on primary education, gender parity in tertiary education, and child mortality and malnutrition.

Are these projected outcomes inevitable? No. They depend on how low-income countries respond and how effectively the rest of the world supports their efforts. This article identifies four major macroeconomic policy challenges facing low-income countries today—tackling rising food and fuel prices, making the changing face of aid work to their advantage, developing a stronger private sector and deeper financial markets, and strengthening the quality of their institutions. Some of these challenges do not look new—they are not. But defined by history, timing, and location, they have taken on particular nuances and emphases. Addressing them by implementing the right policies will also require sensitivity to the history, context, and traditions of each country.

Tackling soaring food and fuel prices

Tackling the economic and social impact of soaring food and fuel prices is an immediate priority for low-income countries, some of which are at a tipping point as they confront higher inflation, balance of payments problems, and worsening poverty. These developments threaten to undermine several of the gains made recently by these countries.

Higher food prices have a larger direct effect on the purchasing power of poor households, because these households typically spend more than half of their income on food, compared with less than 10 percent on fuel. The urban poor are the worst affected. When poor families are unable to feed themselves adequately, the share of the undernourished can rapidly rise, and malnutrition among children and pregnant women can have lasting consequences on human development. And, as the report of the Commission on Growth and Development (2008) points out, malnutrition can also affect long-term growth by lowering productivity.

"Higher food prices have a larger direct effect on the purchasing power of poor households, because these households typically spend more than half of their income on food, compared with less than 10 percent on fuel."

Without a timely and targeted collective response, the rise in global food prices could result in an additional 100 million people in low-income countries falling beneath the poverty line. The responses need to focus on immediate and long-term measures. The first priority is for the international community to help poor countries cover additional financing needs from higher food import bills and the fiscal cost of actions that help the poor. The most affected countries

Box 1

What are low-income countries?

Economists often use the label "low-income countries" as shorthand for countries whose average per capita income is below a certain threshold. The World Bank, for instance, puts 49 countries in this grouping; a citizen in one of these countries earns, on average, less than $935 (in 2007 terms) a year, although significant income inequalities mean that many people earn much less than this amount and some can earn many times more. Like all income- or GDP-based groupings, this label has its advantages (one of which is it allows us to discuss, in a somewhat less fragmented way, the shared problems facing these countries), but it belies the profound diversity of these countries. This diversity is related both to static factors of circumstance—for example, geography—and to more dynamic factors of economic progress—that is, how they have fared in their journey toward development (see table).

It is useful then to think of "low-income countries" not in terms of a monolith but a spectrum of development. In terms of their economic performance over the past decade, about a quarter of these countries have seen at least a 50 percent increase in average incomes, another half have seen some improvement in their living standards, while the remaining countries have seen their average incomes stagnate or fall. The idea of a spectrum helps to highlight the unique social and economic contexts and circumstances of low-income countries, but it should not obscure the countries' shared economic goal: to raise the living standards of their people through broad-based economic growth and poverty reduction, thereby providing a life of dignity and opportunity to all.

Along a spectrum

Low-income countries are diverse in many ways, including the rates at which they have grown.

Real GDP per capita growth, 1997–2007	Country
More than 50%	Chad, Cambodia, Myanmar, Mozambique, Nigeria, Sierra Leone, Tajikistan, Vietnam
25%–50%	Bangladesh, Burkina Faso, Ethiopia, The Gambia, Ghana, Kyrgyz Republic, Lao P.D.R., Madagascar, Mali, Nepal, Pakistan, São Tomé & Príncipe, Tanzania, Uzbekistan
0%–24%	Benin, Kenya, Guinea, Malawi, Mauritania, Niger, Rwanda, Senegal, Uganda, Republic of Yemen, Zambia
Less than 0%	Burundi, Central African Rep., Comoros, Dem. Rep. of Congo, Côte d'Ivoire, Eritrea, Guinea-Bissau, Haiti, Liberia, Papua New Guinea, Solomon Islands, Togo, Zimbabwe

Sources: IMF, International Financial Statistics database; and World Bank.
Note: Data not available for Afghanistan, Democratic People's Republic of Korea, and Somalia.

should lower food prices for the poor and the vulnerable through temporary, targeted subsidies or increased aid. But, at the same time, countries should minimize introducing policies that distort prices and prevent achieving market-led solutions in the longer run. This means avoiding untargeted subsidies to lower domestic food prices, direct price controls, or export bans—all of which tend to be a disincentive for producers and could ultimately result in heightened inflationary pressures.

The food and fuel hikes are part of a broader boom that has also seen prices of many other commodities reach new highs. These price spirals have brought a number of macroeconomic management challenges to the fore. First, they have contributed to ***a worrisome build-up in inflationary pressures.*** Headline inflation continues to rise in many countries, which can particularly affect the countries that spend more on food than on other goods by a large margin. Because a quick return to cheap food and fuel prices is unlikely, inflation fears could keep rearing their head. A key policy challenge is to maintain the hard-won gains of bringing down inflation—and inflationary expectations—into single digits.

Second, ***higher food and fuel prices can have a big balance of payments impact*** (see table). According to recent IMF research (2008a and 2008b), the negative impact on many food- and fuel-importing low-income countries has been quite severe—in many cases well over 2.5 percent of GDP and, in the case of Liberia, about 15 percent of GDP, representing nearly all of its international reserves. Although some countries have been able to absorb the impact of price hikes on their balance of payments in the short term because of higher export earnings or capital inflows that have helped finance commodity imports, projections show that in about half of the African countries, the increase in the cost of food imports could exceed 1 percent of GDP in 2008. Such increases are the highest in some of the poorest countries, such as Eritrea and The Gambia (more than 2 percent).

Third, ***although soaring commodity prices have benefited commodity exporters in the short term, they have also strained the capacity of budget management systems to ensure that the commodity-generated revenue is utilized effectively and transparently.*** These countries need to maintain macroeconomic stability while dealing with rising foreign exchange inflows. Fortunately, many of them are determined to avoid the damaging macroeconomic effect of boom-bust commodity prices that sometimes characterized the lax management of past cycles. A number of countries are setting up special arrangements to use these (possibly temporary) resources for maximum long-term advantage.

Finally, ***given that food prices are likely to remain high for some years, low-income countries should seize this opportunity to encourage the expansion of domestic agricultural production.*** Investing in and improving infrastructure, distribution, and storage systems; increasing efficiency through competition; providing a stable regulatory environment and access to financing; and removing trade barriers can all help in enhancing agricultural productivity. In fact, Ravallion and van de Walle (see "Land and Poverty in Reforming East Asia" on p. 38 in this issue) underscore the importance of agrarian reforms in reducing poverty in both Vietnam and China and the lessons this holds for other low-income countries.

Hardest hit

Strong food and oil price shocks are having a big balance of payments impact in many low-income countries in sub-Saharan Africa.

	BOP impact as percent of GDP			
	Food	Oil	Other commodities	**Total shock**
Liberia	–4.5	–11.1	0.3	**–15.3**
Guinea-Bissau	–1.1	–7.6	0.0	**–8.8**
Eritrea	–2.4	–6.1	–0.1	**–8.6**
Comoros	–2.7	–2.9	–0.9	**–6.5**
Togo	–0.4	–5.6	0.6	**–5.5**
Gambia, The	–2.7	–2.3	0.0	**–5.1**
Malawi	–0.8	–2.9	–1.0	**–4.7**
Sierra Leone	–0.9	–3.7	0.1	**–4.4**
Guinea	–1.6	–3.6	1.0	**–4.2**
Madagascar	–0.7	–3.1	0.0	**–3.7**
Burundi	–0.4	–3.9	0.9	**–3.4**
Ethiopia	–0.8	–2.6	0.4	**–3.0**
Burkina Faso	–0.3	–2.7	0.5	**–2.5**
Central African Rep.	–0.8	–1.8	0.1	**–2.4**
Benin	–0.6	–2.0	0.3	**–2.2**
Congo, Dem. Rep.	–1.5	0.0	0.0	**–1.5**
Zimbabwe	–0.4	–1.7	0.8	**–1.3**

Sources: Adapted from IMF (2008b); UN Comtrade; IMF, World Economic Outlook database; and IMF staff calculations.

Note: The balance of payments (BOP) impact is calculated as the trade balance change resulting from changes in the terms of trade for each country. It measures the effect of the expected increase in prices of exports and imports in 2008, compared with 2007 (volumes of trade are as of 2007), as a share of GDP. The oil prices used in the calculations are $71.1 a barrel in 2007 and $112 a barrel in 2008. Data as of June 30, 2008.

Making aid work better

The second challenge is to make aid more effective. About half the low-income countries continue to depend heavily on external aid to finance their development programs. After nearly two decades of stagnation, aid volumes have begun to rise significantly in recent years, and a concerted international effort is attempting to make aid more effective in reducing poverty and promoting development. Many new donors have entered the development financing arena. This scaling up of aid has brought fresh opportunities for recipient countries, but also put pressure on donors and recipients to make sure that aid is used and managed effectively (see "Improving the Effectiveness of Aid" on p. 15 in this issue).

The emergence of "nontraditional" bilateral donors (that is, those who are not members of the OECD's Development Assistance Committee, or DAC), global funds, private foundations, corporations, and nongovernmental organizations is changing the donor landscape. The non-DAC bilateral donors, which outnumber the 23 DAC donors, include Brazil, China, India, Malaysia, Russia, Venezuela, Saudi Arabia and other oil-rich countries in the Middle East, as well as some recent members of the European Union. Together these donors are estimated to have provided more than $12 billion in financing in 2006. According to some estimates, China and India are providing about $3 billion in combined aid a year, and both are developing larger aid programs.

Alongside new donor countries, global funds that are focused on specific objectives, especially in the health sector, are fast becoming prominent vehicles for the delivery of financing and programs. Integrating these "vertical funds" into a country-based "horizontal delivery infrastructure" is a priority for aid effectiveness. And private donors, including major foundations, are also contributing a substantial amount of aid. For instance, the Bill & Melinda Gates Foundation alone provided more than $2 billion in grants in 2007. In addition, according to OECD estimates, nongovernmental organizations in DAC countries are providing a significant amount of funding.

These new players are bringing additional financing, fresh ideas, and new business models into development financing. But the proliferation of donors with smaller shares of total aid is also raising issues of more effective project selection and aid delivery and management (Kharas, 2007). For instance, the average number of donors per country increased from 12 in the 1960s to about 33 during 2001–05. There are more than 230 international organizations, funds, and programs that provide aid—more than the number of developing countries they are meant to assist. Managing aid flows from many different donors is difficult for recipient countries with insufficient administrative capacity, because different donors insist on using their own processes for implementing and monitoring projects. This points to the need for donors to ***harmonize aid procedures*** to deliver better-quality aid that can be better managed by recipient countries.

The Paris Declaration on Aid Effectiveness, adopted in 2005 by donor and recipient countries, sets out 56 commitments for better delivery and management of aid. Its implementation has already spurred important reforms of the aid system, though a lot remains to be done for donor programs to be effectively aligned behind country-based priorities (see "A Work in Progress" on p. 20 in this issue). Key issues are aligning aid priorities better with recipient country goals, ensuring continued debt sustainability, and making aid more predictable (see "Managing Aid Surprises" on p. 34 in this issue). From the recipients' perspective, it is important that the countries that have recently benefited from debt relief ensure that, in accessing increased financing, they don't build up unsustainable debt burdens again.

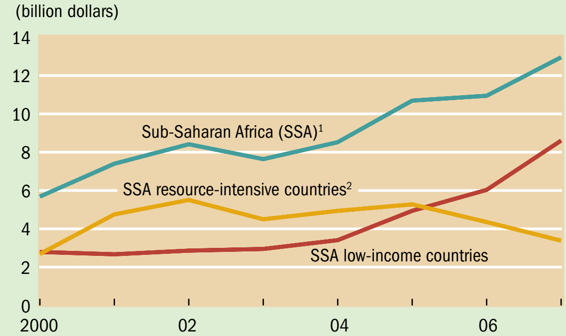
Creating a good business climate

The third big challenge is to develop a business climate that will support a vibrant and competitive private sector, which will create jobs and sustain broad-based growth. Part of the solution to this challenge is to develop liquid and well-functioning domestic capital markets that can support private sector growth.

Stronger integration with global financial markets represents an important opportunity for low-income countries to raise foreign capital and channel it to finance growth-enhancing development. In sub-Saharan Africa, private capital flows have grown almost fivefold in the past seven years: from $11 billion in 2000 to $53 billion in 2007. Such flows have increased rapidly since 2004 to low-income countries as a group, although they have decreased to resource-intensive low-income countries (see chart). And between 2001 and 2007, foreign direct investment (FDI) has remained stable at $15–$21 billion (IMF, 2008c).

Rising flows

Private capital flows to low-income countries in sub-Saharan Africa have been increasing.



Source: IMF (2008c).
[1]Excludes South Africa and Nigeria.
[2]Excludes Nigeria.

A number of countries in sub-Saharan Africa in fact are achieving a "frontier emerging market" status as their financial markets mature sufficiently to permit portfolio investment by international investors (see "The Rise of Africa's 'Frontier' Markets" on p. 30 in this issue). Consider Ghana. It entered the global capital market in September 2007 with a $750 million bond issue that was more than four times oversubscribed. With terms similar to those for Ghana, Gabon issued $1 billion in bonds to repay its Paris Club debt.

Several African countries that have made significant progress toward macroeconomic stability and debt sustainability have also succeeded in selling treasury bills in their own currency to foreign investors. At the end of June 2007, foreigners held more than 14 percent of domestic currency government debt in Zambia, 11 percent in Ghana, and a significant share of such debt in Tanzania and Uganda (Wakeman-Linn and Nagy, 2008).

But although some African countries are doing well, progress is uneven. Indeed, data show that although the share of private capital flows to sub-Saharan Africa is growing, such flows are neither evenly spread across countries nor large or diversified, particularly if FDI is excluded (Ratha, Mohapatra, and Plaza, 2008). After all, between 2000 and 2007, South Africa and Nigeria accounted for nearly half of the FDI, and South Africa accounted for more than 85 percent of the portfolio inflows (IMF, 2008c). And for many low-income countries, official aid flows and inward official sector FDI by state-owned entities of other governments still account for the bulk of external capital flows.

To attract more investment and outside capital, countries need to liberalize their economies. Creating the right policy framework and developing a sequenced liberalization strategy are critical to successfully integrating with the global economy. But opening up the economy to outside capital flows has its risks—and here low-income countries can learn from the experience of today's emerging market economies.

Instituting well-designed capital account policies and financial liberalization strategies is a multistep process. In the short term, it involves reviewing capital account regulations to enhance transparency, consistency, and efficiency. In the medium term, a well-sequenced and well-timed liberalization strategy is needed—longer-term and more stable flows should be liberalized first, leaving enough time for implementing robust regulatory and supervisory frameworks for private sector financial institutions to take root. In addition, countries should have in place the ability to monitor capital inflows. Only then would a full lifting of existing controls be appropriate.

Low-income countries need to strengthen all aspects of local debt and equity market development—from the legal and the regulatory to the infrastructural. By developing the appropriate currency borrowing (and creditor) mix, countries can play a key role in enhancing the depth and liquidity of these markets, and in creating healthy conditions for corporate borrowers to access markets.

Strengthening institutions

The fourth challenge is to improve the institutions needed to foster development (see, for example, the 2005 report of the Commission for Africa). It is now broadly accepted that a key to development lies in the quality of a country's political, legal, and economic institutions. Research has shown that institutions can matter far more than geography (see Acemoglu, Johnson, and Robinson, 2008; and Rodrik, 2004), but also that quality institutions are as much a result of economic prosperity as they are its cause.

The relationship of good institutions and economic prosperity may not always be linear or straightforward, but it is clear that weak institutions undermine the political will or means necessary to put in place appropriate policies or implement key reforms. Also, stable political and legal structures in which property rights are enforced are critical in attracting investors, as is a degree of equality in society that allows different segments to participate in economic life (Acemoglu, 2003). More, and better, investment is one of the main ingredients of sustained growth.

Low-income countries have implemented important political and institutional reforms in recent years. Many of these countries have switched to democratic institutions and multiparty elections. According to the report of the Commission on Growth and Development (2008), "In many countries [in sub-Saharan Africa], if not most, a new generation of leaders is in power, committed to growth and to more open and accountable government. Institutions have also improved in a number of places." But more remains to be done in many of these countries.

Although many nations face serious institutional challenges, the international community has focused on so-called fragile states—countries characterized by weak institutional capacities and governance, social tension, and political instability—in

Box 2

The IMF's role in low-income countries

With more than one billion people still living on less than $1 a day, extreme poverty remains a critical issue for the international community, especially in the low-income IMF member countries—which are two-fifths of its total membership.

The IMF is committed to supporting low-income countries in making progress on eradicating extreme poverty, achieving the Millennium Development Goals, and moving toward middle-income status through its three key functions—lending, technical assistance, and economic surveillance and policy advice.

The IMF's focus is on macroeconomic and financial stability, which are the underpinnings of sustained growth and poverty reduction. Within this overall focus, work in individual countries reflects their specific needs and economic circumstances. The IMF recognizes that the countries themselves lead their development goals and efforts, and that it must work closely with a broader group of donors and agencies in providing this support.

Lending. About 80 percent of the IMF's lending programs are with low-income countries. The IMF provides concessional financing to poor countries facing balance of payments problems through the Poverty Reduction and Growth Facility and, for temporary needs arising from external shocks, through the Exogenous Shocks Facility. For countries that do not need financial assistance, the Policy Support Instrument underpins the design of effective economic programs and signals IMF endorsement to donors, multilateral development banks, and markets. Many low-income countries are also eligible for initiatives aimed at reducing external debt. Countries that have obtained debt relief are spending, on average, four times as much on social services than on debt service.

Technical assistance. The IMF provides assistance and training to help member countries strengthen their capacity to run good fiscal, monetary, exchange rate, and debt policies. On average, the IMF sends four times more technical assistance missions a year to low-income countries than to the rest of its members. In recent years, the IMF has reinforced its efforts by establishing regional technical assistance centers in the Pacific; the Caribbean; East, West, and Central Africa; and the Middle East.

Surveillance. Low-income countries benefit from the regular advice on macroeconomic policies that the IMF provides to all 185 members. The IMF is also strengthening its tools to help these countries reap the full benefits of globalization while managing its risks, for instance, by providing support in other areas that are critical to growth, particularly trade, and by making financial sector analysis an integral part of its policy advice in the surveillance of individual economies.

other words, countries caught in the conflict and bad governance traps (Collier, 2007). Fragile states have 9 percent of the developing world's population but 27 percent of the extreme poor (living on less than $1 a day). International organizations use different measures to judge fragility, generally combining aspects of the capacity and accountability of institutions with indicators related to conflict risks. In 2006, the World Bank identified 35 countries as fragile.

"Eradicating extreme poverty can be achieved only if countries that are now poor sustain many years of faster growth and if the benefits of this growth are shared broadly among their populations."

Such states increasingly lag behind other low-income countries in terms of growth and development. In 2007, the World Bank–IMF's *Global Monitoring Report* estimated that, by 2015, extreme poverty levels in fragile states will have risen to more than 50 percent. It is also important to note that while development assistance to fragile states rose from $9.7 billion to $26.2 billion between 2002 and 2006, these flows are very uneven. In 2005 and 2006, two-thirds of the aid was concentrated in four countries—Afghanistan, Democratic Republic of Congo, Nigeria, and Sudan.

Fragile states are often unable to mobilize sufficient international support at the critical early stages of their reform efforts, although technical assistance efforts can help post-conflict economies in restoring the functioning of some of their key institutions (see Box 2). For instance, as part of its capacity-building efforts, the IMF worked extensively with the Bank of Rwanda—the country's main supervisor and regulator of the financial sector—to help the bank restore its core functions, following the collapse of the country's economy and financial sector in the wake of the 1994 genocide. Beyond technical assistance, a good example of globally coordinated action was the recent success in reducing Liberia's debt after its ruinous 14-year civil war period.

The challenges ahead

Eradicating extreme poverty is a first-order challenge for our generation. This can be achieved only if countries that are now poor sustain many years of faster growth and if the benefits of this growth are shared broadly among their populations. Recent work by many economists and development specialists has shown that although the precise drivers of growth vary across countries, and national leadership plays a key role, there are lessons to be drawn from international experience in what is likely to work and what is not. For some low-income countries, the challenges ahead appear daunting. But it is worth remembering that many of the countries that are now emerging markets faced similar prospects a decade or two ago.

This article focused on some key challenges that macroeconomists and financial specialists will need to address in low-income countries and in the international development community as it tries to help these nations. Other specialists—for instance, health and education professionals, and infrastructure and environmental specialists—will need to work in their complementary domains because growth and development entail progress on a broad spectrum of fronts. Good macroeconomic and financial management is the necessary foundation for these broader efforts. And mobilizing the broad support and the political will to achieve these goals is a cause in which we all can participate. ■

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Improving the Effectiveness of Aid

Eckhard Deutscher and Sara Fyson

LEVELS of aid have begun to recover and seem likely to continue to increase following a protracted decline in the 1990s. Yet both donors and recipient countries generally agree that aid is still underperforming in terms of development effectiveness. It has become clear that what matters in reaching development goals is not just the amount of aid but also the quality of that aid.

Decades of development assistance have shown, for instance, that if countries are to become less dependent on aid, they must be able to determine their own priorities and rely on their own systems to deliver that aid. Donor-driven aid does not lead to sustainable results. Moreover, asymmetries in the aid relationship, whereby donors respond to their own constituencies rather than to citizens' needs in developing countries, have distorted the accountability of domestic institutions in recipient countries.

Experience has also shown that if donors do not channel funds through recipient country institutions, these countries will not strengthen (or in some cases even develop) the governance structures and capacities to pull themselves out of poverty. In addition, disparate actors and interests have led to the uncoordinated delivery of aid—again putting severe strain on local government systems.

In the face of these hurdles, donors and partner countries have committed to transform the way aid is delivered. The goal is to improve the quality of aid and achieve greater development impact. Over one hundred donors (bilaterals and multilaterals) and developing countries endorsed the Paris Declaration on Aid Effectiveness at the High-Level Forum in Paris on March 2, 2005. In doing so, they agreed for the first time to measure their success, or failure, at making aid more effective through a set of 56 commitments. Following the endorsement of the Paris Declaration, the way in which aid is delivered was set to undergo wide-ranging reform. Expectations were high: aid would be better coordinated, increasingly aligned with country priorities, and delivered in a harmonized way; donors would commit to support national ownership; development results would be measured; and donors and countries would be mutually accountable.

Now, at the halfway point between the endorsement of the principles and commitments in the Paris Declaration and the date set for their implementation (2010), the question is, has aid effectiveness improved? Addressing continued inefficiencies in the governance systems at both the international and country levels has become a high priority, and a series of high-level meetings in 2008 make this year

A proliferation of donors and projects has made the governance of aid more problematic

Photo above: Distributing food aid in Niger. Relief aid is a small part of the complex aid world.

critical for evaluating such efforts and building consensus to move forward and strengthen aid effectiveness.

This year's meetings include the Accra High-Level Forum on Aid Effectiveness and the United Nations Summit on the Millennium Development Goals (MDGs) in New York in September, and the Financing for Development follow-up meeting in Doha in November. Commitments undertaken and promises made in previous forums (notably in Monterrey in 2002; and in Paris and in Gleneagles in 2005) will be reviewed and new impetus will be given to reforming the way aid is delivered.

This article highlights the challenges created by ineffective aid and how transforming governance mechanisms are a way to address these challenges. It outlines a set of recommendations to strengthen aid effectiveness while recognizing that there are no easy solutions or one-size-fits-all approaches and that national conditions vary in the delivery of aid. Improving the effectiveness of aid entails addressing complex policy challenges at both the international and country levels—not least because development cooperation is an inherently political process.

Assessing the problems

The institutional complexity of the global governance of aid presents real difficulties, given that more than 280 bilateral donor agencies, 242 multilateral programs, 24 development banks, and about 40 United Nations agencies are working in the development business. The increasing number of private foundations and the existence of so many nongovernmental organizations (NGOs) add to the complexity. The proliferation of donor activities—including an estimated 340,000 development projects around the world—leads us to question current ways of managing the aid business.

Indeed, a slew of factors combine to make aid effectiveness less than optimal. They include lack of aid predictability, issues of coordination among the large numbers of donors, and aid fragmentation—all of which have real implications at the country level.

Lack of predictability. According to preliminary data, a recent Survey on the Implementation of the Paris Declaration (OECD-DAC, 2008a) showed that in any average country only 45 percent of aid arrives on time, as scheduled by donors. This lack of predictability means that government authorities in developing countries will have difficulty planning or responding to citizens' needs if funding does not arrive when new hospitals and classrooms were promised (see "Managing Aid Surprises" on p. 34).

Lack of coordination. Uncoordinated aid also creates problems. In 2005, government authorities in Vietnam received 791 visits (missions) from donors—that is, more than two a day, including weekends and holidays (OECD-DAC, 2006). In Tanzania, for instance, health workers in some districts spent more than 20 days a quarter—almost 25 percent of their working days—writing reports for different donors. Given the lack of capacity at the country level and the precedence given to responding to donor demands, it is difficult to imagine how civil servants can focus on things that really matter.

Aid fragmentation. Fragmentation of aid at the country level is getting worse. Fragmentation occurs not only with the increase in the number of donors but also the proliferation of donor-funded activities. This all too often imposes a heavy burden on developing countries and capacities, and reduces the sustainability and value of the aid received (see map).

A survey by the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) on the scaling up of aid (OECD-DAC, 2008b) shows, for example, that in 2005–06, 38 developing countries received official development assistance (ODA) from 25 or more DAC and multilateral donors. In 24 of these countries, 15 or more donors collectively provided less than 10 percent of that country's total aid but typically each required the developing country to apply their respective and differing procedures and standards.

At the same time, some states suffer from a lack of attention by the donor community with only 10 donors in total. It is time to look critically at the fragmentation of aid and to foster the capacity of governance systems and mechanisms to adjust where donor presence is clearly suboptimal.

The commitment gap

In 2005, members of the Development Assistance Committee (DAC) announced commitments to increase net official development assistance (ODA) to coincide with the Millennium+5 Summit in New York. If delivered, these commitments would entail an additional \$50 billion net ODA a year to be provided by 2010 (in 2004 dollars). Net ODA increased from \$69 billion in 2001 to \$107 billion in 2005, boosted by major debt write-offs qualifying as ODA. In 2006, there was a slight decline in ODA, and 2007 figures saw a further decline following the end of the exceptional debt relief to Iraq and Nigeria in 2005 and 2006. Nigeria accounted for almost a quarter of total net ODA to Africa in 2006.

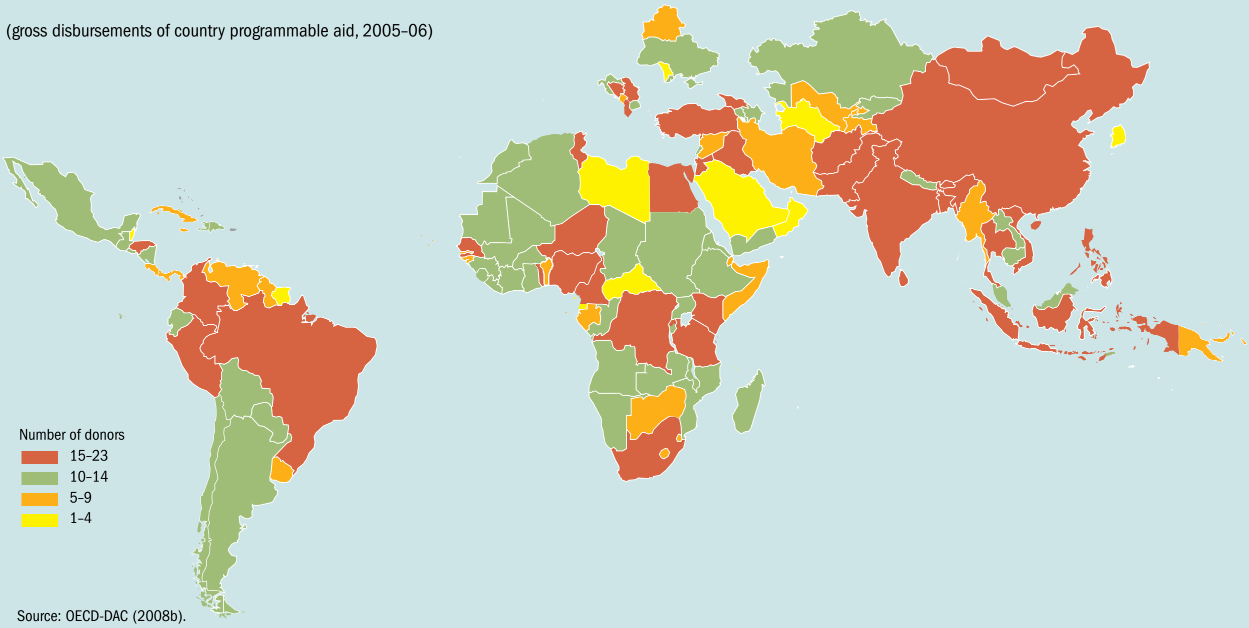
Because debt relief is expected to decline over the coming years, the annual increase in other forms of aid will have to be substantial if the donors' commitments are to be met. Forward spending plans for gross country programmable aid (CPA) were published by the DAC for the first time in May 2008. The DAC defines CPA as the total resources that are available to developing countries. It is calculated as the total gross ODA minus humanitarian aid, debt relief, administrative costs of donors, imputed student costs, promotion of development awareness, research, costs of refugees in donor countries, food aid, aid from local governments in donor countries, and core grants to NGOs in donor countries and to international NGOs.

The spending plans show that the 23 members of the DAC; the World Bank; African, Asian, and Inter-American Development Banks; the main UN organizations; and the health and environmental global funds together will increase their CPA by some \$20 billion during 2004–10 (including the higher replenishments of the soft loan facilities of the World Bank, the African Development Bank, and the Asian Development Bank). Despite this, the DAC estimates that nearly \$30 billion remains to be earmarked to reach the overall aid levels implied by the targets set by DAC members individually for 2010 (OECD-DAC, 2008b).

Aid fragmentation: Too many donors contributing too little?

The map shows the number of donors together providing just one-tenth of a country's aid.

(gross disbursements of country programmable aid, 2005–06)



Source: OECD-DAC (2008b).

An expanding donor base

New emerging trends in the aid business—particularly the involvement of new big donors—together with promises to scale up aid make discussions and consensus at the international level on transforming the governance of aid count more than ever.

Even if promises relating to scaling up may not be met (see box), it is likely that aid levels will continue to rise. This is for a number of reasons.

Many more sources of funding have emerged and are likely to both provide opportunities and amplify some of the problems relating to the effectiveness of aid. A broad range of emerging and transitional economies are expected to increase the proportion of aid, including recent members of the European Union; Middle Eastern funds; China and India; and others such as Thailand, Malaysia, and Singapore.

Private sources of development finance are also becoming increasingly important and include private foundations, NGOs, and the private sector (through new initiatives such as Project Red, alongside more traditional corporate social responsibility roles). Moreover, new global initiatives (such as the Global Alliance for Vaccines and Immunizations [GAVI] and the Fast Track for Education) will all increase resources available for development.

Although information on ODA provided by states that are not part of the DAC is insufficient to assess aid volumes, their share of aid globally is likely to increase (Manning, 2006). A study in 2005 estimated that non-DAC donors represented some 12 percent of global aid in 1999–2004, although this differs at the country level—in some countries, non-DAC donors represented more than 33 percent of their aid (Harmer and Cotterrell, 2005). Moreover, private capital flows have increased. According to *Global Development Finance 2008* (World Bank, 2008), emerging economies attracted a record $1 trillion in net private capital flows.

Tackling the difficulties

Because aid delivery involves multiple stakeholders and is not subject to a single political authority, transforming the governance of aid at multiple levels is an attempt to address these very real and significant obstacles.

Moreover, governance mechanisms are beginning to appear at the international and the national level, which can facilitate progress in a number of areas.

International partnerships have emerged in the wake of calls for action to change the way aid is delivered, and not just how much aid is delivered. The DAC-hosted Working Party on Aid Effectiveness, for instance, was set up in the context of the international consensus reached at Monterrey on actions needed to promote the global partnership for development and accelerate progress toward the MDGs. The working party includes all 22 DAC donors and the European Commission, 11 multilateral agencies, and 23 developing countries. The partnership has contributed to building consensus between donors and partners on key areas relating to aid effectiveness, in particular, the Paris Declaration. It has also created an authoritative set of aims and standards through a survey instrument that is being applied in 54 countries, against which the practices of all donors and recipient countries are being assessed.

Building donor-recipient coordination. One of the most promising aspects of improved interaction at the country level is the creation of governance mechanisms that result in greater dialogue and coordination between donors and recipients. Joint assistance strategies, for example, identify donors' comparative advantages and provide an independent review of progress in delivering on both donor and recipient commitments. Often, these strategies include channeling a higher proportion of aid through a country's own budget systems, which enhances country ownership over those funds. This type of governance mechanism also fosters increased accountability between partners.

For example, Tanzania has a well-developed framework for mutual accountability, which relies on the work of an independent monitoring group that conducts biennial reviews of both donor and government progress against their various commitments—making both donors and recipients answerable for their promises.

Issue-specific governance networks have also started to respond to the need for greater focus on the country level. New funds and foundations provide substantial new resources to the chosen area of intervention (malaria, AIDS, primary education, and so on). At times they contribute to "upstream harmonization," through initiatives such as the Fast Track Initiative for Education, and they are also aiming to improve the coordination of agencies (or—as it is commonly called—improve the division of labor between donors) in the health sector. In July 2007, an informal grouping was created, bringing together eight health-related organizations, with the aim of fostering coordination across agencies at both the global and the country level as well as encouraging better working practices, particularly within institutions, to achieve quicker results in line with the health MDGs. The Health-8 comprises the World Health Organization; UNICEF; the United Nations Population Fund; UNAIDS; the Global Fund to Fight AIDS, Tuberculosis, and Malaria; GAVI; the Bill & Melinda Gates Foundation; and the World Bank.

Partnerships have also emerged between donors, recipient countries, and ***nongovernmental stakeholders.*** For example, in January 2007, the Advisory Group on Civil Society and Aid Effectiveness was created to bring civil society into the international aid effectiveness agenda, both as advocates of good practice and in their capacity as implementers and sources of aid.

Not yet out of the woods

Although progress has been made in strengthening governance mechanisms at several levels, clearly much remains to be done if the commitments drawn up in 2005 are to be met. The following three challenges are representative.

• **Moving the ownership agenda forward.** Although donors encourage developing countries to set their own strategies for poverty reduction, and the quality of national development strategies has improved, significant weaknesses remain in making national strategies operational. The Evaluation of the Paris Declaration and the Surveys on Monitoring the Paris Declaration note that a country's strategic vision is often not linked to a fiscal policy or budget process. As a result, strategies have few operational implications because resources are not reallocated toward priorities defined in the strategy. Moreover, as argued in the Evaluation of the Paris Declaration (2008c) and the Surveys on Monitoring the Paris Declaration (2006 and 2008a), ownership is narrowly defined with an exclusive focus on the executive authority. Less attention is paid to how the legislature can better shape and own the development agenda. It is also often restricted to the highly technical sectors that are largely shaped and governed by the executive.

When it comes to using a country's own systems (rather than relying on donors' procedures and processes), the lack of progress is particularly stark. Despite advances in the quality of a country's public financial management system, for example, donors have not increased their use of those systems sufficiently (see Chart 1). The use of country systems is also often limited to a specific way of delivering aid. In Rwanda, for instance, the use of country systems is limited to the donors delivering assistance as general and sector budget support, when the aid is provided directly through a government's budget. Donors providing aid in the form of projects do not use country systems as often (2008d).

• **Accountability is still perceived as the weakest link.** Accountability lies at the crux of the good governance of aid. Domestic accountability of recipient countries to their own constituencies depends crucially on aid passing through country systems (for instance, budget execution mechanisms and parliamentary review processes). Mutual accountability between donors and recipients implies that development goals be shared, answerability mechanisms created, and sanctions (soft or hard) put in place should parties fail to deliver.

However, even when mutual accountability frameworks do exist, they are often not implemented. For instance, despite efforts by donors to improve the predictability of aid, little progress was made between 2005 and 2007, making it hard for recipients to plan (see Chart 2).

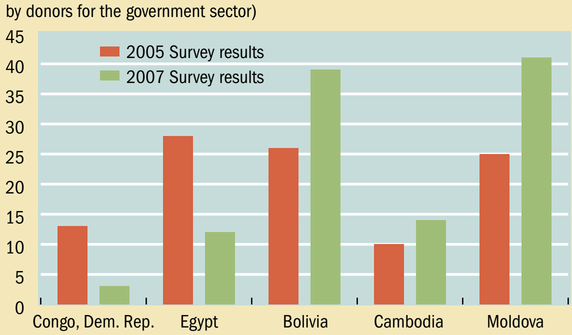
• Finally, despite the creation of a number of governance mechanisms at the international and national levels, **a significant transparency gap still exists** between public pronouncements and how decisions are made about the delivery of aid. At the country level, transparency is often

Chart 1

Limited progress

Public financial management (PFM) systems remain underutilized in many countries surveyed.

(use of country PFM systems as percentage of total aid disbursed by donors for the government sector)



Source: OECD-DAC (2008a).

lacking about how public finances are spent, how contracts are procured, and how results are monitored. On the donor side, communication around the definition of conditionality and decisions regarding the use of country systems are still weak.

Translating commitments into effective aid

The findings in the Surveys on Monitoring the Paris Declaration and the Evaluation of the Paris Declaration point to a number of areas in which real progress must be made to strengthen the effectiveness of aid. The Paris Declaration is a political agenda for action rather than a mere technical agreement. As noted in the 2008 Evaluation of the Paris Declaration: "Real issues of power and political economy come into play, in many cases requiring political solutions." It is hardly surprising, therefore, that changing the governance of aid through purely technical solutions may fall at the first hurdle. With this in mind, there are a number of key lessons as we move forward to the Accra High-Level Forum on Aid Effectiveness and beyond.

Focus on results, not on attribution. More focus needs to be placed by donors on achieving results rather than on being seen to give aid. Many donor agencies require attribution and visibility for the efforts undertaken to assist countries as part of their own accountability requirements at home (and in particular to their taxpayers). But this should not get in the way of making aid more effective.

Enhanced political leadership and demand for aid effectiveness at country level. Developing countries should be engaged politically in the aid effectiveness agenda: they should clearly state their demands for increased alignment, harmonization, and accountability within a robust framework. The division of labor among donors and reducing fragmentation of aid will also require strong local ownership of the development agenda at the country level. Saying "no" to aid that fails to align with country systems may be a first step. To reduce fragmentation of aid, developing countries need to be empowered to better manage donor requests so that they can more easily reject what they do not want.

Two-way accountability. Partner countries should commit to strengthening their country systems as well as building capacity for domestic accountability institutions, such as the legislature and supreme audit institutions. Donors, in turn, must communicate more clearly when aid will be delivered and how, and focus on the more transparent development of policy conditionality. It requires very little political risk to ensure aid is on the budget plan, for example, and yet donors often do not work with country authorities to ensure this basic requirement for the good governance of aid.

Stemming the proliferation of aid agencies. Donors must strive to reduce the number of agencies and their activities in different sectors at the country level. Aid effectiveness is compromised by too many donors with different systems and policies. Clear criteria for new foundations and funds should be developed to ensure their value added.

Communication, communication, communication. Donor self-assessments on the implementation of the Paris Declaration show that DAC members are aware of the need to better communicate both with partner countries and with their own publics on the importance of the aid effectiveness agenda. As one donor noted: "We face a real challenge in explaining to people on the street what these initiatives mean and why they are important." Strong communication on aid effectiveness is key, therefore, to ensuring that political commitments (on both sides) are sustained, in particular as difficult choices lie ahead on managing risks in the use of country systems, untying aid, and attracting new development partners to the table. ■

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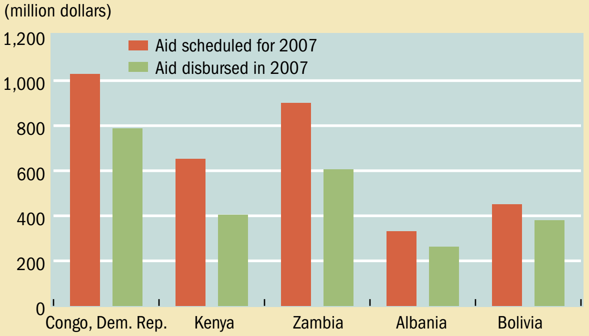
Chart 2

Off target

Wide gaps exist between the levels of aid scheduled by donors for disbursement and actual amounts received.



Source: OECD-DAC (2008a).

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POINT OF VIEW

A Work in Progress

The Paris Declaration renews focus on aid reform but is still donor-centric

Elaine Venter

Overcoming poverty is not a gesture of charity. It is an act of justice. It is the protection of a fundamental human right, the right to dignity and a decent life.

The steps that are needed from the developed nations are clear. The first is ensuring trade justice. The second is to end the debt crisis for the poorest countries. The third is to deliver much more aid and make sure it is of the highest quality.

Nelson Mandela

THE Paris Declaration on Aid Effectiveness is part of a global commitment to reduce poverty and inequality, increase economic growth, develop capacity, and achieve the Millennium Development Goals (MDGs). It provides an action-oriented road map for reforming the delivery and management of aid, with the aim of making aid more effective. Ultimately, improved aid effectiveness will benefit development.

Much has been written about the application of the five Paris commitments and whether we are achieving the goals we set for ourselves (see box). These goals cannot be achieved unless the value of the Paris Declaration as an instrument of change is understood and accepted, the gaps in the declaration are analyzed and addressed, and all relevant stakeholders and groups involved in aid effectiveness are given equal representation in the institutions that provide global leadership on aid effectiveness.

A dynamic opportunity

The Paris Declaration has already begun to change important aspects of aid delivery, management, and evaluation. It has provided new impetus to the discussions—at both the global and the field level—on the importance of improving our ability to deliver and to receive aid, so that it can lead to better development outcomes. The five commitments in the declaration have become part of the language of development and are influencing discussion and country strategy.

Irrespective of whether a partner country signed the declaration or not, donors in general have started to operationalize certain commitments, so they can be implemented in the field (for example, principles of division of labor among donors in providing support to partner countries). The declaration has given aid personnel more operational and administrative responsibility. A more dynamic exchange between donor headquarters and donor field-level personnel means that the delivery of aid can be better aligned with realities on the ground.

The Paris Declaration has also created a measurable and visible opportunity for stakeholders to report on, challenge, or encourage each other to achieve faster progress on commitments made by each of them under the declaration. This can be clearly seen from the findings of the two monitoring reports on the implementation of the declaration, the evaluation report on the declaration, and the numerous partner-country regional meetings that took place in Asia, Africa, and Latin America. The findings of the reports and of the meetings have led to many of the stakeholders adapting their existing development approaches by incorporating Paris Declaration commitments into their policies.

In addition to the monitoring and evaluation activities, and the regional meetings, the Working Party meeting of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) has also become a platform for partners (though there is limited partner participation) to raise their concerns and discuss their experiences. They can also highlight important issues that they would like to see prioritized at international forums. These issues include tied aid, conditionalities attached to assistance, and alignment—to country systems and procurement, incentives, division of labor, and capacity development.

The Paris Declaration has thus not only created a renewed energy for achieving aid effectiveness at the field level, but is also being used by the DAC to develop a better understanding between partners and donors on making aid work better for all.

Having said this, it is important that the Paris Declaration is seen in context. It is important to accept that the declaration will not be the final chapter in creating space for

Paris Declaration commitments

- ***Ownership:*** Partner countries exercise effective leadership over their development policies and strategies, and coordinate development actions.
- ***Alignment:*** Donors base their overall support on partner countries' national development strategies, institutions, and procedures.
- ***Harmonization:*** Donors' actions are more harmonized, transparent, and collectively effective.
- ***Managing for results:*** Managing resources and improving decision making for results.
- ***Mutual accountability:*** Donors and partners are accountable for development results.

Local women parade during a ceremony in Niamey, Niger.

improved aid management because, as good as it is, it still has gaps that can, and should, be addressed.

Limits and conditions

To understand and address the gaps in the Paris Declaration, one must understand how it came into being. The declaration and its monitoring instrument were drafted by the DAC, with input from a handful of partner countries. Because of this, the Paris Declaration reflects mainly the perspective of the developed world on what needs to be done to improve aid effectiveness. And the monitoring indicators and its targets have been negotiated mainly between the more progressive donors (those who have untied aid, do not require recipients to meet with many policy conditionalities, and so on) and less progressive donors (those who require that policy conditionalities be met by the recipients in exchange for aid, do not use the procurement modalities of the country, and so on), with input from a few partner countries that regularly attend the DAC Working Party meetings. Arguably, this is a primary reason for the underlying, possibly unintentional, donor-centric approach that can be found in many of the indicators used to measure the effectiveness of the declaration.

One example of a donor-centric approach is the well-argued matter of tied aid, which—although presented by partner countries as one of the most important challenges to aid effectiveness—is measured against "progress over time." But progress over time should not be much of a concern, because the donors have reported that the majority of their aid is already untied. This brings me to the second example. In my view, there is too little quality control of data presented by the donors and the partners when completing the monitoring questionnaire—for example, a majority of the questions are addressed only to the donors. This makes it very difficult for partners to verify the data provided to them by the donors. As a result, when the donors report that the majority of their aid is untied, it is very difficult to challenge the data.

A third, highly contentious example is that of conditionalities. There is a real risk—though, again, possibly unintentional—that the Paris Declaration will validate the donors' disregard for the autonomous policy space needed by partner countries to develop and experiment with a range of policy options necessary for their own development.

Two of the Paris Declaration commitments are aid ownership and harmonization. Ownership is measured through a desk exercise by the World Bank. It uses the standards of the World Bank to determine the level of ownership in the partner country. This implies that if the World Bank believes that the partners' development strategies should conform to neoliberal ideology to achieve development goals, then that is how the partners will be measured. (For at least the past two decades, aid has been tied to conditionalities that require market-oriented policy reforms. Carlos Oya (2008), from the School of Oriental and African Studies at the University of London, writes that the "new Aid Agenda has become hegemonic, combining neoliberal economic and institutional reforms with poverty reduction under the overarching umbrella of good governance"—as interpreted by the West—namely, an "Anglo-American laissez-faire model of capitalism.") There is thus a clear tension between the sovereignty of countries to determine their own development path and the risk that the Paris Declaration might infringe on this sovereignty. This challenge could easily be addressed by letting partner countries develop specific indicators for ownership, as opposed to letting the World Bank subjectively determine the quality of ownership in a partner country.

Aid harmonization is often seen as a double-edged sword. It has the ability to reduce both the fragmentation of aid to a country and the transaction costs incurred by the country. But at the same time, harmonization can be used to create "donor lobbies" that push for orthodox policy reforms, leaving little room for home-grown partner-country solutions and policies.

Arguably, the most important consequence of the manner in which the Paris Declaration was drafted is the severe criticism it has generated among important stakeholders such as the broader partner-country community (such as the G-77 and the south-south groupings), civil society organizations, and donors and development partners that do not form part of the OECD (such as Brazil, Russia, India, and China). Some of these stakeholders have even failed to acknowledge the status of the Paris Declaration as a global standard for aid effectiveness. In certain quarters, the declaration is seen as a product of the developed world, forced upon the developing world. The participation of these stakeholders at the September 2008 High Level Forum on Aid Effectiveness in Accra will depend, at least in part, on how they view the DAC's role as the facilitator and the "custodian" of the Paris Declaration.

Oversight role

There is a commitment by a majority, if not all, of the DAC donors toward making aid work better for all. The DAC has made nonstop efforts to ensure that Accra in 2008 will be more representative than the Paris meeting in 2005. It has organized several partner meetings in different continents and made substantial efforts to get civil society organizations to participate. The DAC is committed to making sure that the Accra meeting is jointly led by both the donors and the partner countries, and the program has been designed to achieve this goal. Also, in the day-to-day management of its oversight role and through its different joint ventures, the DAC has made a serious effort (including by making funds available) to ensure a broader partner-country participation in its activities.

"The ideal solution is to bring together the development experts to design and oversee the aid effectiveness standards."

But at the same time, partners argue that, in its oversight role, the DAC has created a situation in which the donors police themselves on the progress made on aid effectiveness. The DAC peer-review mechanism is a case in point, in which two DAC members peer-review a third donor, as opposed to the African peer-review mechanism, in which the review is not limited to peers but also opened up to include the active, official participation of other critical stakeholders such as civil society. There is also a concern that the DAC will not be able to substantially increase the participation at its meetings of partner countries and other relevant stakeholders (based on the OECD-membership requirements and the impracticality of opening the DAC to all—more than 100—partners and other non-DAC donors). It doesn't matter how progressive a donor is, it is not acceptable that it should be left to them to represent the partner-country interest.

Global leadership

If we can agree that there is a real need for a standard such as the Paris Declaration, and that the Paris Declaration—though a "work in progress"—is an important foundation for achieving improved aid effectiveness, then what remains to be discussed is whether the DAC is representative enough to retain the oversight responsibility or whether this responsibility should be shared with other global institutions.

Is there an alternative or a complementary body to substitute for or work closely with the DAC in executing its oversight of progress made on aid effectiveness? Many believe, for a variety of reasons, that the United Nations should play a more prominent role in improving aid effectiveness. All states are represented at the United Nations. Most of the stakeholders currently excluded from the DAC—such as the G-77, the G-30, and the south-south groupings—are part of the UN family. The United Nations has the ability, as the custodian of the MDGs, to create a direct link between aid effectiveness and development effectiveness. The newly established UN Development Cooperation Forum has been mentioned as an appropriate platform to oversee the aid effectiveness debate. The presence of the United Nations in all countries and its role as a broker in the debates on official development assistance (ODA) in the field means it has an already-established network to ensure a field-level presence. Also, the United Nations has been actively participating in the DAC and has played a leading role in many of the regional meetings, and thus already has a wealth of institutional knowledge.

But others point out that the United Nations has its own challenges as a big, slow-moving ship. Change takes time. As much as the United Nations facilitates certain discussions at the field level, it also sometimes oversteps its boundaries and acts as a supradonor. Development practitioners and other interested stakeholders argue that UN representatives are mainly political representatives from countries, which could have a negative impact on the reality of managing ODA in the field. The ideal solution is to bring together the development experts to design and oversee the aid effectiveness standards. But a vocal and committed champion for improving aid effectiveness has not yet emerged from the UN family, and this lack of leadership is probably the biggest criticism against the United Nations becoming the custodian of aid effectiveness.

The road ahead

Whether it is the Paris Declaration, the proposed Accra agenda for action, or any other global standard, it should be conceived and monitored by all of its stakeholders and thus, irrespective of where the current oversight of the Paris Declaration resides, it is critical that broad partner-country and CSO participation and leadership of the global standards on aid effectiveness are institutionalized in global processes and bodies.

The conception of the Paris Declaration might have been rather one sided, and its parenting mostly by a single parent, but it is a healthy baby, with tremendous potential. And its current limitations are not insurmountable. It does, however, need the involvement of the entire extended family. It needs to be understood by all that the Paris Declaration is not an end in itself, but a means to an end, and that the Accra meeting is a critical milestone in the current global commitment toward improved aid effectiveness. With a commitment from all and with joint leadership, we will have an exciting and positive road ahead, working toward our overarching goal: achieving development for all. ■

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Next Generation Financial Reforms for India

Eswar S. Prasad and Raghuram G. Rajan

A new report advocates a shake-up in India's financial system to underpin growth

INDIA has grown by leaps and bounds in recent years and is emerging as a major world economic power. After lumbering along at a pace of about 4–5 percent GDP growth a year in the 1980s and the 1990s, the economy has surged in this decade, posting an average annual growth of 8.5 percent since 2005 (see Chart 1). The challenge now is to maintain this growth momentum and provide benefits as well as economic opportunities to a broad swath of the population.

India's financial system—comprising its banks, equity markets, bond markets, and myriad other financial institutions—is a crucial determinant of the country's future growth trajectory. The financial system's ability to channel domestic savings and foreign capital into productive investment and to provide financial services—such as payments, savings, insurance, and pensions—to a vast majority of households will influence economic as well as social stability.

While India's financial institutions and regulatory structures have been developing gradually, the time has come to make a more concerted push toward the next generation of financial reforms. A growing and increasingly complex market-oriented economy, and its greater integration with global trade and finance, will require deeper, more efficient, and well-regulated financial markets.

A shopping mall in eastern India.

These considerations prompted the Indian government to institute a high-level committee—composed of a select group of financial sector practitioners, businesspeople, academics, and policymakers—to map out a blueprint for financial reforms. After more than six months of intensive work, the committee recently delivered its draft report to the government (available at *http://planningcommission.nic.in/reports/genrep/report_fr.htm*). In this article, we summarize the key findings of the report and examine its recommendations.

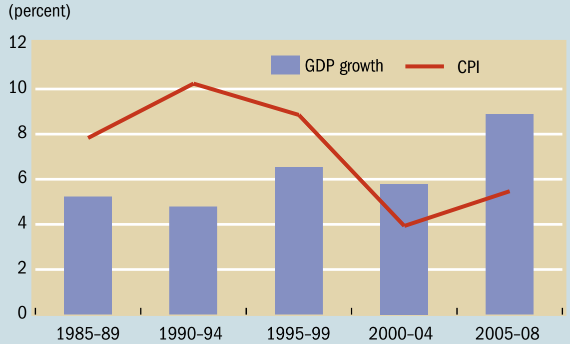
Three main conclusions

Numerous other government committees over the years have looked into specific aspects of India's financial reforms, but this is the first committee mandated to "outline a comprehensive agenda for the evolution of the financial sector." Indeed, the report argues that there are deep linkages among different reforms, including broader reforms to monetary and fiscal policies, and recognizing these linkages is essential to achieve real progress.

Chart 1

Nice combination

Until recently, India has seen strong growth coupled with moderate inflation during the current decade, although now prices are climbing rapidly again.

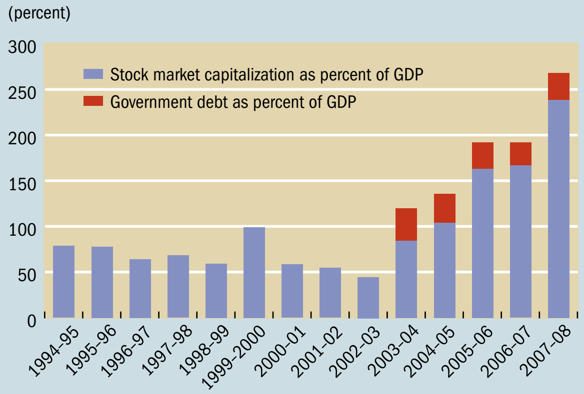


Sources: CEIC; IMF, *International Financial Statistics*; and authors' calculations.

Chart 2

Equity boom

The rapid expansion of India's stock markets has helped fuel corporate growth, but debt markets remain small.



Sources: CEIC; and authors' calculations.
Note: Only publicly traded government debt is included in this chart (breakdown not available before 2003–04). Corporate debt barely shows up on this scale, so we do not include it here. India reports its macroeconomic data on a financial year rather than calendar year basis.

The report has three main conclusions. First, India's financial system is not providing adequate services to the majority of domestic retail customers, small and medium-sized enterprises, or large corporations. Government ownership of 70 percent of the banking system and hindrances to the development of corporate debt and derivatives markets have stunted financial development. This will inevitably become a barrier to high growth.

Second, the financial sector—if properly regulated but unleashed from government strictures that have stifled the development of certain markets and kept others from becoming competitive and efficient—has the potential to generate millions of much-needed jobs and, more important, have an enormous multiplier effect on economic growth.

Third, in these uncertain times, financial stability is more important than ever to keep growth from being derailed by shocks hitting the system, especially from abroad. Although the Indian economy dodged the Asian crisis and the recent subprime crisis, a lot remains to be done to secure the stability and durability of the financial system.

Where things stand

The report finds that the Indian financial system has made significant strides in recent years. India's stock exchanges, in particular, have developed well and become a vital source of funding for enterprises and an alternative savings instrument for households. Stock market capitalization has risen significantly—aided by financial inflows from abroad—and the technical infrastructure of equity trading is state of the art (see Chart 2).

The Indian government has taken a number of steps to improve the banking system. Banking reforms, which started nearly two decades ago, have increased the efficiency of the banking system, and the ratio of nonperforming loans to deposits is about 1 percent—a remarkably low level. Many of the public sector banks have become quite profitable and well capitalized, and they coexist with a vibrant private banking system.

However, in terms of overall financial depth—the size of the financial system relative to the economy—India does not compare favorably with other countries or even most other emerging markets at a similar stage of development. Despite the apparent strength of the banking system, the ratio of private sector credit to GDP is still low by international standards (see Chart 3). Some of the restrictions on the banking system, and the incentives for banks to hold government bonds rather than make loans, have stifled lending. Consequently, the average ratio of loans to deposits in the Indian banking system is much lower than in most other countries.

The government bond market appears large—public debt amounts to about 70 percent of GDP—but much of the stock of government bonds is held by banks, a requirement prescribed by the "statutory liquidity ratio," and is not traded. The corporate bond market remains woefully underdeveloped, with the total capitalization amounting to less than 10 percent of GDP. Regulatory restrictions have also kept certain derivatives markets, especially for currency derivatives, from developing.

The absence of these markets is being felt sorely as India's capital account has become more open over time, potentially leading to greater short-term currency volatility. India is seen as an attractive destination for foreign capital, which has meant large inflows in recent years through various channels, especially portfolio equity investment by foreign investors (see Chart 4). The financial system faces ever-greater challenges in intermediating the rising amounts of foreign as well as domestic capital in an efficient way to the most productive investments. At the same time, it will be important not to let the capacity and expertise to regulate financial markets fall too far behind innovations in these markets.

Clearly, there are big challenges to achieving further financial reforms. Let us start with the big picture.

Fine-tuning macroeconomic policies

Why do macroeconomic policies matter for financial reforms? The links between macroeconomic management and financial development are deep and run in both directions. Disciplined and predictable monetary, fiscal, and debt management policies create a foundation for financial sector reforms. In turn, a well-functioning financial system is essential for the effective transmission of macroeconomic policies.

Whatever their faults might be, India's macroeconomic policies have delivered high growth and, until recently, stable inflation. Why fix what ain't broke? Because, in the memorable words of Bob Dylan, the times they are a-changin'.

Cross-border capital flows—both inward and outward—have ramped up and are likely to remain large and volatile, creating huge complications for monetary policy as these flows affect the domestic money supply, the exchange rate, and so on. Reimposing capital controls is not a good option; even existing controls are losing their potency as agile investors invariably find ways to evade them. The only viable alternative is to have predictable and consistent policies that at least do not create volatility themselves and that give policymakers the flexibility to respond rapidly to shocks.

What are the options for monetary policy, especially now that the demands on it are growing as the economy becomes more open and exposed to a wider array of domestic and external shocks? The Reserve Bank of India (RBI), India's central bank, has done a good job of managing the multiple mandates foisted upon it—keeping inflation under reasonable control, managing some of the pressures on the exchange rate, and coping with capital inflows—all against the background of strong growth. But there is a risk that this high-wire act has reached its limits. The recent volatility in the rupee has revived calls for the RBI to more actively manage the exchange rate, which is becoming increasingly difficult as the capital account becomes more open. Sustained intervention in the foreign exchange market can also create unrealistic expectations about the RBI's ability to manage multiple objectives with one instrument.

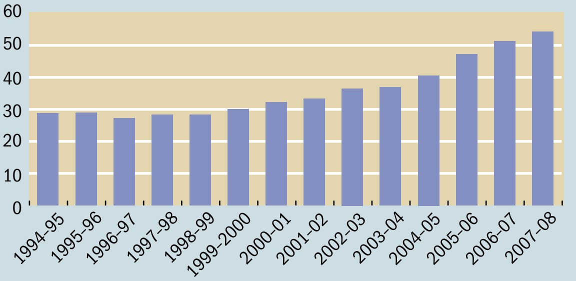
Focusing on a single objective—low and stable inflation—is ultimately the best way that monetary policy can promote macroeconomic and financial stability. This does not mean sacrificing or ignoring growth. Indeed, well-

Chart 3

Under potential

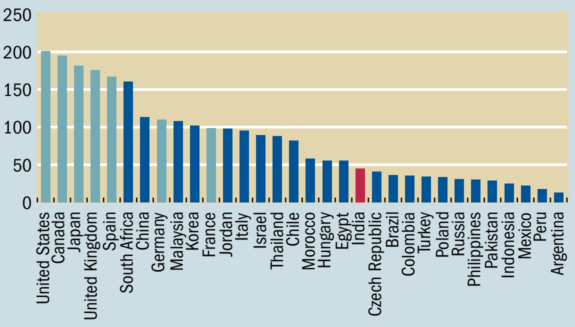
Bank financing has been rising in India . . .

(private sector credit to GDP, percent)



. . . but financial depth remains low by international standards.

(private sector credit to GDP, percent, 2006)



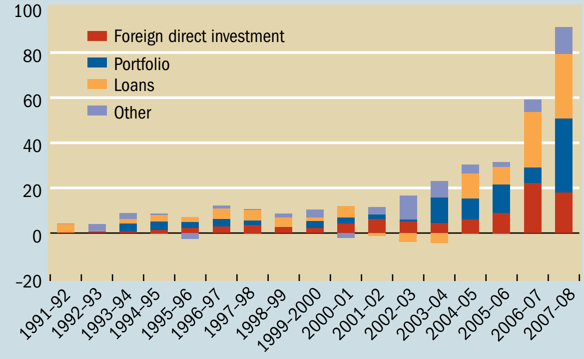
Source: World Bank, *World Development Indicators*.

Chart 4

Pouring in

India is attracting large amounts of portfolio investment from abroad.

(billion dollars)



Sources: CEIC; and authors' calculations.

anchored inflationary expectations may well be the best tonic that monetary policy can provide for growth. Contrary to what some commentators seem to believe, there is no long-run trade-off between growth and inflation, and for monetary policy to try and engineer a short-run trade-off can be dangerous. In short, the inflation objective would in fact make monetary policy more effective and strengthen the RBI's hands rather than pinning them down.

India's fiscal policy also needs a makeover. There has been encouraging progress in reducing the budget deficit, but this may just be a cyclical improvement as a result of a strong economy. Recent events, such as the government's waiver of certain farm loans and the growing oil subsidies, raise serious concerns that fiscal rectitude may fall prey to the election cycle. Large deficits raise the specter of future inflation, and they could also suck up funds that would otherwise be available for private investment.

The size of government budget deficits matters for financial reforms also because the deficit is partially financed by getting banks to buy government bonds. Durable reductions in the fiscal deficit and public sector borrowing requirement are therefore crucial to reduce the constraints on monetary policy (as prospects of large deficits make it harder to manage inflationary expectations) and allow financial sector reforms, especially banking reforms, to proceed.

Promoting financial inclusion

A robust financial system is not much good if most people don't have access to it. Financial inclusion—which means providing not just credit but also other financial services such as savings and insurance products—is a key priority, especially in rural India. Nearly three-quarters of farm households have no access to formal sources of credit and lack instruments to insure against adverse events such as low crop yields due to bad weather. But this problem is not limited to rural areas. The lack of access to formal banking services affects more than one-third of poor households, leaving them vulnerable to informal intermediaries such as moneylenders, and makes the distribution of public transfers less efficient. And the lack of financing and insurance stifles entrepreneurial activities.

Mandated requirements of a certain quantum of lending to government-favored "priority" sectors and interest rate ceilings for small loans, especially to the agricultural sector, may be well intentioned but have ended up restricting rather than improving broad access to institutional finance. Banks have no incentive to expand lending if the price of small loans is fixed by fiat. Partly as a consequence, nearly half of the loans taken by those in the bottom quarter of the income distribution are from informal lenders at an interest rate of more than 36 percent a year, well above the mandated lending rate for banks, which is less than half that rate.

According to the report, the solution is not more intervention but more competition between formal and informal financial institutions and fewer strictures on the former. For instance, freeing up interest rates and then setting up incentives for banks to make loans to priority sectors such as agriculture (rather than just mandating this by fiat) could lead to more credit flowing to these sectors and in a more efficient way. Allowing more banks, especially smaller, well-capitalized and well-governed private banks, to operate and deliver retail services could also improve access to finance—making it more flexible and more attuned to local needs.

"The U.S. subprime problem has highlighted the need for good regulation even in the most sophisticated financial markets. Effective regulation is still more important in a nascent but fast-growing financial system."

A level playing field

Given the size of the Indian banking system and its predominant role in the financial system, banking reforms are a cornerstone of the overall reform program. The Indian banking system has been characterized by an implicit "grand bargain," whereby banks get access to low-cost deposits in return for fulfilling certain social obligations, such as lending to priority sectors and funding the government by buying government bonds. This is becoming an unviable framework as the privileges of banks, including state-owned banks, erode and constraints on them such as priority sector lending, which are often motivated by political rather than economic considerations, increase.

Maintaining public ownership of a large portion of the banking system is not conducive to efficiency. A one-shot privatization is not realistic or even desirable, but there is a lot that can be done even now to facilitate the transition to a more efficient banking system. One step would be to create stronger and more independent boards, perhaps with a private investor owning a large strategic stake, that could manage the large state-owned banks better and with less government interference. Another would be to allow bank mergers, especially to enable smaller and less efficient banks to be taken over. Other steps, such as freeing up banks to set up branches and ATMs with less onerous licensing restrictions, could foster more growth, entry, and competition in the banking system.

Keeping regulation in step with innovation

The U.S. subprime problem has highlighted the need for good regulation even in the most sophisticated financial markets. Effective regulation is still more important in a nascent but fast-growing financial system. The government has an essential role: making the rules of the game clear and flexible enough to cope with financial innovation without stifling it.

For instance, fostering markets for foreign exchange derivatives would help domestic firms with exposure to international trade protect themselves from currency fluctuations. But it does create some risks that foreign investors will use those markets for mounting speculative runs on the currency and that domestic firms will get burned if they buy those derivatives without fully understanding them. The solution is not to choke off these markets but to make them more transparent, subject participants to uniform disclosure standards, and prevent fraudulent behavior. Can all risks be eliminated? Certainly not, but there are definitely ways to shift the balance between benefits and risks in favor of the former.

As in many other countries, a number of financial services firms in India now operate in different financial markets (for example, insurance, banking, and mutual funds), and these markets are becoming more closely linked. These trends imply that regulation of each market in isolation is no longer the right approach. The situation right now is that there are multiple regulators in some areas and none in others. Many regulators for specific areas tend to focus very narrowly, leaving financial firms unsupervised.

"Although a move to a single regulator may be premature in India's context, a lot can be done even within the present framework to improve coordination and to clearly delineate responsibilities among existing regulatory agencies."

Although a move to a single regulator may be premature in India's context, a lot can be done even within the present framework to improve coordination and to clearly delineate responsibilities among existing regulatory agencies. Also, instead of focusing excessively on enforcing a plethora of sometimes archaic rules, it certainly makes sense for regulators to focus on the bigger risk picture, especially in their interaction with large, systemically important, financial conglomerates. Such principles-based regulation will be more conducive to rapidly evolving financial markets and is also more adaptable.

The potential risks of a financial meltdown have made central bankers and regulators very cautious, perhaps rightly so. But excessive caution is not a virtue in itself. It can prevent markets from becoming larger and capable of absorbing shocks, and stifle innovation such as the development of new markets and financial instruments. It could even generate more financial stress (and have perverse effects when such stress does hit the system) if regulators focus on a rigid set of rules rather than taking a broader view of financial market exposures of institutions under their purview.

Connections and small steps

With so many difficult challenges, where does one start? Many of the required reforms are in fact deeply intertwined. For instance, it would make sense to level the playing field between banks and nonbank financial corporations by easing the requirement that banks finance priority sectors and the government. But making these changes while the government continues to have huge financing needs, and without having a more uniform and nimble regulatory regime, could be risky.

The connections stretch beyond just financial reforms to broader macroeconomic reforms, which could reinforce individual financial sector measures. For instance, allowing foreign investors to participate more freely in corporate and government debt markets could increase liquidity in those markets, provide financing for infrastructure investment, and reduce public debt financing through banks. It could also provide an additional risk-bearing buffer in the economy.

India's rich and complex political process being what it is, focusing solely on the big picture could bog down progress. Hence, the report also lists a number of specific steps that could get the process of reforms going and build up some momentum as people see the benefits. Many of these are less controversial but will still require some resolve on the part of policymakers to implement. For instance, converting trade receivable claims to electronic format and creating a structure to allow them to be sold as commercial paper could greatly boost the credit available to small and medium-sized enterprises.

We believe that if other policies are in sync, implementation of this report's blueprint for financial sector reforms could add significantly to India's economic growth and also make a major contribution to the sustainability of this growth, in both the economic and the political dimensions. The absence of reforms, on the other hand, would represent not only a lost opportunity but also a huge source of risk for the economy. ■

Raghuram G. Rajan, a Professor of Finance at the University of Chicago's Graduate School of Business, was the Chairman of the Committee on Financial Sector Reforms. Eswar S. Prasad, a Senior Professor of Trade Policy at Cornell University and a Senior Fellow at the Brookings Institution, was a member of the committee's research team.

Other members of the team who contributed to the report include Rajesh Chakrabarti (Indian School of Business), Vinay D'Costa (ICICI Bank), Ajay Shah (NIPFP, New Delhi), Professor Jayanth Varma (IIM Ahmedabad), and Sona Varma (ICICI Bank). The full listing of the members of the committee and all contributors appears in the preface to the report.

DIALOGUE BOX

Roads

Antoinette Sayeh

Head of the IMF's African Department and former Finance Minister of Liberia

Travel in any African country and you will quickly see that the road is where the action is—where you find people, commerce, and vitality. Travel in any of the poorest African countries emerging from conflict and you see a multitude of impassable roads impeding recovery and nation building.

Developing countries operate under seriously constrained choices, with scarce resources for capital investments. Investments, then, must target those sectors in which their impact will be multiplied manyfold, easing bottlenecks to further development.

Roads are the link to trade—national and international. They allow crops to get to the market, children to get to school, the sick to get to clinics. They can unite a divided postconflict country.

With a good road to the interior and to other nations, those with ports will see increased commerce and revenues; those in the interior will be able to sell their harvest for higher prices—and buy other goods for less.

Roads are also not hard to sell—everyone would love to see a road in their town. The Liberian people, in consulting around our new Poverty Reduction Strategy, overwhelmingly cited roads as their number-one priority for the next three years.

Finally, roads bring into sharp relief the twin challenges of the international community in the poorest countries—making available adequate nondebt financing and building sustainable capacity quickly.

We are all aware of the mistakes of the past; road investments need to be selected strategically, so that the roads we build are the right ones, and so that we protect our investments with sustainable maintenance programs.

Done correctly, roads can spur faster development, paving the way for greater prosperity. In Liberia, they could transform lives, increasing the prospects for sustainable peace.

F&D asked a number of opinion leaders around the world to answer the question, **What's the single thing most likely to double living standards in poor countries over the next decade?** The responses were as diverse as the respondents.

Governance

Domenico Lombardi

President of the Oxford Institute for Economic Policy and Nonresident Senior Fellow at the Brookings Institution

Weak governance is by far the most expensive tax levied on the populations of poor countries. It is regressive, so the poorest of the already poor pay the highest rates, and it is firmly enforced, without exception or appeal.

Despite their weak governance, many poor economies have managed to achieve some noticeable economic and social gains. Yet, in the face of widespread poverty, substantial progress is unlikely to materialize if these countries do not fully address the constraints posed by their underlying institutional weaknesses.

Governance is about fostering relationships of accountability among citizens, government institutions, and private suppliers. Thus it affects the efficiency and effectiveness of how policies are formulated and how resources are allocated.

The experience so far shows that, while building bridges or roads is a costly if reasonably straightforward exercise, forging accountable relationships between citizens and public and private sector institutions has often proved elusive.

The donor community can do more in this respect by focusing on the accountability dimension of the policies and programs it promotes. By encouraging a greater involvement of communities in program delivery and monitoring, for instance, donors can help ensure that the onus of enforcing accountability for results and for the management of resources increasingly shifts from the donors themselves to beneficiaries.

The IMF also has an important role to play by promoting greater transparency, broader consultations, and a stronger accountability dimension in the economic policies it advises on and by strengthening the governance of economic institutions in poor countries.

National ownership

Kumi Naidoo

Honorary President, CIVICUS: World Alliance for Citizen Participation

Economic policies have to be bolder and more expansionary, particularly to stimulate small and medium-sized farming and trading enterprises. Fiscal policies should be focused on substantially scaling up public investment to ensure much better health and education, particularly for girls, because this will lead to smaller and healthier families, and more economic, civil, and political participation by women.

Financial policies should be geared to channeling considerably more lending—hand-in-hand with capacity-building facilities—to productive private investment. Monetary policies ought to be reshaped to target not just inflation but also real environmentally and socially sustainable economic variables, such as increases in incomes and jobs (decent work) and meaningful reductions in poverty.

A major excuse that donors give for not substantially increasing their assistance is that countries lack the "absorptive capacity" to disburse such large new sums of money. In most cases, this is certainly not true: adequate capacities do exist, and if they don't, it is because building such capacity requires substantial investment in education and training at all levels. In many countries, donors contribute to the problem when they overburden national capacities without allowing national coordination of donors. Living standards in poor countries will simply not rise considerably without "national ownership" of the development agenda. A people-first approach to development and the aid architecture will not only build economies but will also empower citizens and facilitate inclusive democracies.

Investment in education

Andrew Kumbatira

Executive Director, Malawi Economic Justice Network

Getting education right in poor countries can significantly spur economic growth and improve living standards. In Malawi, it has been shown that incomes are 12 percent higher for households whose head has completed primary education than for those who did not complete this basic level.

Two of the eight Millennium Development Goals refer to education—universal primary completion and gender parity in primary and secondary schooling. Moreover, according to the World Bank, education—especially girls' education—has a direct and proven impact on child and reproductive health and environmental sustainability.

The quality of education for women also has a positive effect on family health and poverty levels. According to studies, countries with higher literacy rates for women are likely to be at a poverty line that is about half that of countries with lower literacy rates for women. Further, parents with at least a secondary education are nearly twice as likely to give their children treatment for malaria symptoms and their children are half as likely to be stunted. Both maternal and child mortality rates are higher among women with lower levels of education.

Investing in human resources in general, and quality basic education in particular, remains the most critical factor in improving living standards in poor countries in the next decade. After all, as they say, "Show me a poor education system and I will show you a poor country!"

Delivering on promises to meet the MDGs

Eveline Herfkens

Founder of the UN Millennium Campaign

Were the Millennium Development Goals to be met, it would be the equivalent of doubling living standards across the developing world—provided distribution is equitable.

Since the United Nations Millennium Summit took place in 2000, both rich and poor countries have made extensive and specific commitments at many international conferences (at the United Nations; in Doha on trade; in Monterrey on financing development; in Paris on aid effectiveness; and in summits of the Group of Eight [G-8], the European Union [EU], and the African Union).

Developing countries promised to take primary responsibility for their development: to allow participation by all citizens, to address corruption, to deliver basic social services for all, to mobilize more domestic resources, and to manage their public finances more effectively and with accountability.

Rich countries pledged to increase official development assistance: the G-8 with an additional $50 billion a year, and the EU to achieve the 0.7 percent of gross national income target by 2015. Donor countries also committed to improve aid effectiveness. And the Doha development agenda is full of promises by rich countries to reform their trade policies, which deny poor countries the chance to earn their way out of poverty.

The world does not need more international conferences at which governments once again make speeches and pledges. Governments just need to live up to the commitments they have already made—over and over again.

Tackling corruption

Roy Cullen

Member of Parliament, House of Commons, Canada, and author of the book, The Poverty of Corrupt Nations

The factors influencing poverty in the developing world are varied and complex. Geographic location, conflicts, climate, the "resource curse," and weak governance are some of the main drivers. Improving governance and tackling corruption could be key to improving living standards in poor countries over the next decade. Similarly, enlarging the set of tools available to finance entrepreneurial enterprise has huge potential—along the lines advanced by thinkers such as Hernando de Soto and his proposals for unlocking "trapped capital," and by risk-takers such as Muhammad Yunus and the Grameen Bank in delivering more customer-friendly microcredit.

Public and private investment in developing countries, however, will be inhibited by the size and scope of "big ticket" corruption. By big ticket corruption, I mean the theft perpetrated by some senior elected and unelected officials in developing economies, as opposed to the petty bribery that occurs in some of the more junior levels of these bureaucracies to "facilitate" and expedite various administrative processes.

The African Union itself estimates that approximately $148 billion is lost each year in Africa to corruption. Transparency International has estimated that the 10 most corrupt contemporary leaders have embezzled in the range of $32 billion and $58 billion from the citizens. How many hospitals, schools, and roads would that have bought?

Boosting productivity

Enrique V. Iglesias

Secretary-General, Iberoamericano, and former President of the Inter-American Development Bank

In the final analysis, the income per capita of a country is the combination of two factors: the number of working people and the productivity of each worker. In the majority of poor countries, the proportion of people working is high, but the proportion of people with a formal job is low. Moreover, the productivity increase of workers in the formal sector is so small as to be irrelevant.

Productivity in the poorer countries of Latin America is 30 percent lower than in the United States. Differences between productivity levels of poor and rich countries are widening rather than narrowing. Two necessary conditions to increase the proportion of formal and qualified employment are more public and private investment, and better and more qualified workers.

Efforts have to be made in Latin America to increase investment as a proportion of GDP. With investment levels at below 20 percent of GDP, increasing worker productivity is almost impossible. Private investment is necessary, but it needs to be complemented, especially with public investment in infrastructure and in education.

Latin America has made a huge effort to increase human capital by extending primary education to the entire population. However, secondary education has an enormous impact on worker productivity, and there is still a long way to go to achieve acceptable levels. Investment in secondary education paves the road toward increasing worker productivity. And this is the only way to increase income per capita in those countries where a large portion of the population works, but both their productivity and their salaries are miserable. ■

The Rise of Africa's "Frontier" Markets

A number of sub-Saharan countries are beginning to attract investors to their financial markets

Downtown highrises in Dar es Salaam, Tanzania.

David C. L. Nellor

SEVERAL African countries, with developing financial markets that are likely to attract institutional financial investors, are promising candidates to become part of a second generation of "emerging market" countries.

The same crucial developments that presaged the arrival of institutional financial investors in emerging markets in the 1980s are taking place in parts of sub-Saharan Africa today—growth is taking off, the private sector is the key driver of that growth, and financial markets are opening up (see box). The global environment has played a key role. The search for yield, triggered by significant global financial market liquidity, has encouraged investors to expand their horizons.

But the new generation faces a more complex, more integrated global environment than did emerging markets of a quarter century ago. Then, institutional investors accessed emerging economies largely through equity markets and, in some cases, foreign currency debt issues. Today, these investments are but a part of the picture. Investors are immersed in a wide range of financial activities, including domestic bond and foreign exchange market instruments. Financial technology is more complex too.

Financial markets gradually became more sophisticated and complex over the past 25 years. Today, however, financial technology is transferred to African emerging markets more or less simultaneously as it is developed in sophisticated markets—although lack of market depth and infrastructure does inhibit its application.

That means that the second-generation emerging markets in Africa face significant immediate challenges to which their predecessors could adapt over a quarter century. For one, maintaining financial sector stability will be challenging. With most of the financial flows intermediated through domestic banking systems, Africa's central banks have to strengthen considerably their supervisory capacity to manage the sophisticated financial activity that has emerged almost overnight. At the same time, policymakers have less scope to manage these activities. For instance, prudential-based approaches to manage capital flows, such as taxes on short-term flows, can be bypassed more easily because of the availability of derivative transactions that were not used in emerging markets a generation ago.

This article identifies sub-Saharan African countries, beyond South Africa, that offer institutional investors the prospect of good returns and a means to diversify risk through investments in financial markets. It recognizes how the changed global environment affects policy and raises issues investors are thinking about as they move into these markets.

Who coined the term?

The International Finance Corporation coined the term "emerging market" in 1980 to refer to developing countries with stock markets that were beginning to demonstrate the features of the mature stock markets in industrial countries. Emerging markets—which afford the opportunity to participate in economies through financial investments—have been identified in all regions of the world. In Africa, only South Africa so far has been seen as an emerging market (see "Emerging Markets Emerge" on p. 54 of this issue).

Identifying emerging markets

The compilers of emerging market indices decide whether a country is an emerging market by assessing the nature and sophistication of the stock market in relation to the degree of development of the economy. Recently, Standard & Poor's—which in 2000 took over the emerging market financial indices from the International Finance Corporation (IFC)—has used the term "frontier markets" to describe countries with markets that are smaller and less liquid than those in the more advanced emerging markets. Many of the emerging markets in the 1980s might have been called frontier markets under today's classification.

The term emerging markets is used here to identify countries in sub-Saharan Africa that have financial markets and attract investor interest. The broader usage of the term emerging market in this article suggests that a positive response to several questions helps establish membership in the emerging markets group:

- Has there been a takeoff in growth?
- Is that growth led by the private sector, and has public policy embraced market-led growth?
- Are there financial markets in which to invest?

Eight sub-Saharan countries that meet these criteria and are headed toward emerging market status are benchmarked against the founding members of the Association of Southeast Asian Nations (ASEAN), which were among the early emerging markets identified by the IFC.

A growth takeoff

Emerging markets are attractive to investors because they offer rates of return that are high relative to mature markets and offer opportunities for investors to diversify risk. High GDP growth signals that there are opportunities for investors to "buy" into the country's overall prospects or seek out opportunities by identifying undervaluation in specific sectors. Growth prospects in emerging market countries are likely to be based on technological catch-up, significant output gaps, young populations, and faster population growth than in mature markets. The processes that bring about growth may differ by country, but a track record of solid growth is common to emerging markets. The potential for risk diversification might arise at the country level when growth trends are not synchronized with mature market economies.

Attitudes toward Africa's growth prospects are influenced by Asia's experience of export-led growth. Analysts argue that export-led growth is critical if African countries are to sustain high growth and ask whether there is scope for export-led growth, particularly in the nonresource sector. Although the export-led growth model might not be as viable today as when growth was taking off in the first-generation emerging markets, Africa has potential for significant growth through import substitution and intraregional trade, as well as through traditional export markets.

Two tests could be used to determine which countries have reasonable prospects of establishing the preconditions for growth—one for resource-rich and one for resource-scarce countries.

Africa's resource-rich countries have a poor long-term track record for macroeconomic performance. When commodity prices were high—particularly for oil—governments spent more than their economies could absorb and exchange rates strengthened and choked off their nonresource sectors. But when commodity prices fell, the nonresource sectors failed to revive. The recent boom in commodity prices offers a laboratory experiment on growth prospects for African resource producers. How are they coping with the macroeconomic stress imposed by sustained high commodity prices? The high prices of resources in recent years have no doubt contributed to higher growth rates, but this could be a false signal; growth in these countries could again deteriorate when commodity prices turn down—the well-known resource curse.

One way to assess the prospects for these countries is to examine how they are performing today, compared with previous episodes of high commodity prices. Is there anything to suggest that this time their performance after the boom could be different? The best emerging market prospects would be resource producers that have installed sound economic institutions to avoid the boom-bust cycle of the past. Take the case of Nigeria. Since the current oil boom started in 2004, its economic performance has been far better than in previous booms in 1974–78, 1979–83, and 1990–94—whether measuring non-oil growth or inflation (see Chart 1).

The key to this good performance is that fiscal policy has been set with an eye on the ability of the economy to absorb the domestic demand consequences of spending booming oil revenues. Use of a budget oil-price rule, which allowed spending of oil revenues in line with absorptive capacity and saving oil revenues above this budget price, was effective in breaking the link between growing oil prices and budgetary outlays that led to booms and busts in the past. If this fiscal rule can be sustained, the prospects for ongoing growth are strong.

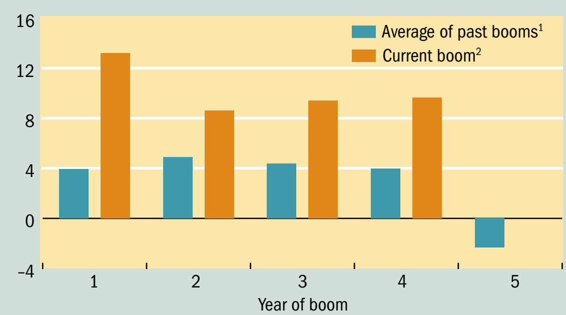
Africa's resource-scarce countries have also had to deal with macroeconomic stress: the significantly higher commodity

Chart 1

Handling the boom in Nigeria

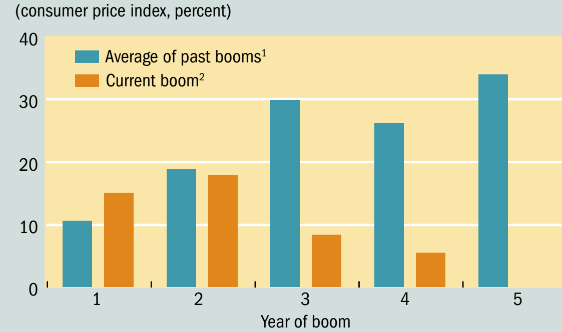
During the first four years of the current boom, Nigeria's non-oil GDP has grown much faster than it did in earlier cycles . . .

(GDP growth, percent)



. . . while consumer prices have risen much more slowly.

(consumer price index, percent)



Sources: Nigerian authorities; and IMF staff.
[1]The previous booms were in 1974–78, 1979–83, and 1990–94.
[2]The current boom began in 2004.

prices they must pay. Which countries have nevertheless performed well? Some countries have seen high prices for their own commodities offset the high oil prices they must pay, but certainly not all. An ability to sustain growth demonstrates not only economic resilience but also a break from the past.

Growth can be looked at against terms-of-trade developments (see Chart 2). Several countries whose terms of trade turned negative—that is, the overall prices of their exports fell relative to imports—nonetheless have recorded solid growth. This is because their better policy frameworks have helped them adjust to the higher import prices. Also, because they have built significantly higher international reserves, the countries have had a cushion while this adjustment is taking place. While recognizing that policy challenges are mounting, the track record so far signals both better policies and an economic flexibility that augurs well for growth prospects.

Private sector–led growth

Successful emerging market countries feature the private sector as the engine of growth, irrespective of their form of economic organization. Institutional investors want to have confidence that policy will continue to support private sector development and that private property rights will be protected; here they share the interests of foreign direct investors. Africa generally fares poorly in measures of the attractiveness of the business environment, and this makes the continent a less attractive destination for investors. Stronger performance in this area is likely to be well rewarded with additional investment.

The first-generation emerging markets used policy actions to help establish them as emerging markets, and some African countries are doing likewise. Indonesia, for example, offered an extensive range of tax breaks as one indicator of its interest in investment. By the early 1980s, having established its credentials, it eliminated these benefits and adopted a conventional tax structure while continuing to sustain its competitiveness through its macroeconomic policy. In Africa today, Mozambique, which came out of a lengthy conflict, has restored private sector confidence by such actions as providing attractive fiscal arrangements for mega projects, including the massive Mozal aluminum operation. Having demonstrated a track record of strong economic performance and respect for private sector rights, Mozambique is establishing a balanced tax environment that, along with macroeconomic stability, makes it an increasingly attractive investment destination.

Investing in financial markets

Only recently have Africa's financial markets attracted significant interest from institutional investors. Just as first-generation emerging markets welcomed institutional investors to their equity markets, African countries are doing so now. African equity market capitalization was about 20 percent of GDP in 2005, comparable to the level reached by ASEAN in the late 1980s. By 2007, Africa's equity market capitalization had surged to over 60 percent of GDP. Africa's domestic bond markets are attracting interest in a way not seen in first-generation emerging markets. Trading of domestic and foreign debt in the international markets has accelerated rapidly. Emerging Markets Traders Association data show that trading in Africa's debt markets (excluding South Africa) more than tripled in 2007, reaching about $12 billion (see Chart 3).

Nigeria, as the largest country in this group, dominates the trade. During 2005–06, Nigeria received Paris Club debt relief and bought back much of the remainder of its external debt. Since then, trade in Nigerian debt has been mainly in domestic issues. Nigerian debt trading ranked 21st globally at the end of 2007; this is equal to or exceeds many first-generation emerging markets. Using a variety of investment vehicles, Nigeria's banks raised about $12 billion in capital over 2006–07, much of it from offshore investors.

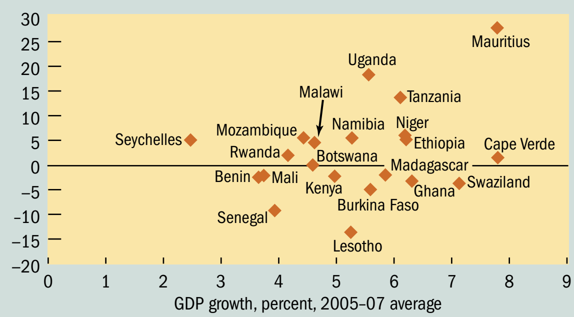
The criteria for an emerging market set out here—growth, private sector–led growth, and investible markets—can be identified in eight sub-Saharan African countries: Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda, and Zambia.

Chart 2

Growing during adversity

Several sub-Saharan African countries whose terms of trade[1] turned negative have still recorded solid growth.

(terms of trade, 2005–07 average)



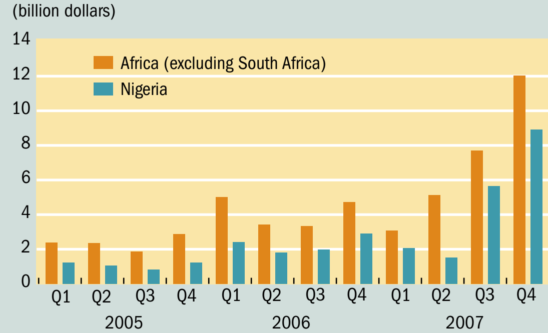
Source: IMF, *World Economic Outlook* (April 2008).
Note: Fragile states, oil-exporting countries, Zimbabwe, and South Africa are not included.
[1]Terms of trade measures the overall prices of a country's exports relative to imports.

Chart 3

Debt trading booms

Foreign trading in Africa's debt markets more than tripled in 2007, reaching about $12 billion, with Nigeria dominating.

(billion dollars)



Source: Emerging Markets Traders Association.

Together these countries account for about 40 percent of the region's population outside South Africa and almost one-half of its GDP.

Measuring up

Emerging markets in sub-Saharan Africa (SSA) today compare favorably with the first-generation emerging markets.

	ASEAN[1]	Select SSA[2]
	1980	2007
GDP (annual growth, percent)	7.5	6.9
Inflation (annual CPI, percent)	16.5	7.3
Financial depth[3]	28.9	29.1
Size of government[4]	11.0	22.1
International reserves[5]	3.1	9.4
Debt[6]	27.0	12.0
Foreign direct investment[6]	1.3	4.8
Portfolio inflows[6]	0.1	0.3

Source: IMF, *World Economic Outlook* (April 2008).
[1]Indonesia, Malaysia, the Philippines, Thailand, and Singapore.
[2]Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda, and Zambia.
[3]Money supply as a percentage of GDP.
[4]Government expenditures as a percentage of GDP.
[5]As a percentage of the following year's imports.
[6]As a percentage of GDP.

The new frontier and the old

This group of African countries compares favorably with the ASEAN countries of 1980 (see table). ASEAN was already experiencing strong economic growth in 1980 but, in many other areas, the ASEAN countries looked quite different than they do today—and the African candidates perhaps have lower vulnerability and greater economic stability than the ASEAN countries had in 1980. Growth in sub-Saharan Africa is strong, as it was in Asia. Unlike the high ASEAN inflation in the 1980s, inflation in Africa is single digit. High international reserves and low debt-to-GDP ratios—the result, among other things, of debt relief—characterize the African countries relative to the ASEAN countries of 1980. Government, however, comprises a larger share of the African countries than it did in the ASEAN countries.

The macroeconomic policy challenges for the African markets are similar to those faced by the ASEAN countries in the 1980s. African markets tend to use monetary aggregates as the basis for achieving inflation goals, supported by a managed float exchange rate policy. With financial liberalization and other structural changes, the stability of money demand and relationships between monetary aggregates and inflation becomes problematic. As questions arise about their credibility, central banks look for more effective ways to meet their needs. In Africa today, a goal of some central banks is to move to inflation targeting. Some ASEAN countries adopted inflation targeting for much the same reasons, but not until after the Asian financial crisis of the late 1990s.

Because market participants seek to exploit differences in market valuations, it is crucial that investment destination countries meet market tests for consistency of policy. The experience of the ASEAN countries during the 1990s Asian crisis shows that artificial exchange rate stability along with independent monetary policy encourages destabilizing short-term investment flows. Investors perceive a stable exchange rate (or a one-sided risk to appreciation in the oil economies) and look to benefit from interest rate differentials; this so-called carry trade characterized Asia in the late 1980s and 1990s and is already moving into Africa. The fear of letting exchange rates float (which allows this carry trade) is driven by concern that exchange rate volatility will complicate business planning and, in the oil economies, that a currency that rises and falls with oil prices will be a permanent drag on non-oil growth and employment. A tension between macroeconomic stability and permitting exchange rate flexibility is likely to become even more evident as countries target inflation.

Complex financial instruments are already being introduced in African financial markets. These markets have not had the opportunity to mature gradually in the way that their predecessor emerging markets did in the 1980s. In 1980, investors in equity markets generally followed a conventional buy-and-hold strategy—portfolio flows were relatively long term and sovereign debt issues were traded in global financial market centers. In contrast, institutional investors are entering Africa's markets through a variety of instruments—equity and local currency fixed income, as well as in both physical and derivative instruments. The technology transfer from emerging markets elsewhere into Africa's nascent emerging markets is limited only by market depth and regulatory and market infrastructure.

African central banks must give adequate weight to financial sector stability against a tradition in the region that has long focused on financial sector development. The banking system is the main conduit through which foreign inflows are intermediated, and so bank capital and risk management practices must be monitored carefully. However, the challenges for central banks go well beyond assessing the capacity of the capital base of a commercial bank to absorb the kinds of shocks that lead to more nonperforming loans. Links between various parts of the financial markets, such as banks and the stock markets, must be assessed, as must the foreign exchange market implications of macroeconomic-driven shifts in bank balance sheets. The learning curve for central banks today in terms of implementing effective risk-based and consolidated supervision is much steeper than for the first-generation emerging markets. And, for some first-generation emerging markets, such as the ASEAN countries during the 1990s Asian crisis, this proved to be a challenging task.

A tremendous opportunity

The rise of some African countries to emerging market status gives them a tremendous economic opportunity. Access to capital markets is a key ingredient to high and sustainable private sector–led growth, and this access had long seemed out of reach for Africa; it is now a reality. Evidence is already mounting that financial flows are being translated into growth in financial intermediation in these countries. To help ensure sustained growth, the countries must ensure that macroeconomic policy and capital account prudential policies are tailored to avoid the traps of volatile short-term flows, and that supervision promotes financial sector stability and effective intermediation. ■

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Managing Aid Surprises

Countries cannot make full use of aid when it is unpredictable

Oya Celasun and Jan Walliser

A FREQUENTLY voiced concern of countries that receive development aid is that assistance flows are not predictable. In most years, the amount of aid disbursed differs widely from the amounts expected, and because most aid recipients lack access to international capital markets, they cannot borrow externally when expected aid fails to arrive. As a result, recipient governments are forced to adjust spending plans at short notice when promised aid is not provided or when additional aid is disbursed unexpectedly. Enhancing aid predictability has therefore been a key objective of the international agenda enshrined in the 2005 Paris Declaration on Aid Effectiveness.

A government's inability to predict aid flows affects not only the level of government spending but also its composition and effectiveness. Unexpected aid shortfalls could force governments to disproportionately cut investments in physical and human capital, while aid windfalls could disproportionately boost government consumption—which, unlike investment spending, can be adjusted without much delay and planning. Thus, unpredictable aid may not only be more difficult to manage, but also affects how the money is spent, thereby reducing its intended impact. Such short-term distortionary responses to unexpected aid shortfalls and windfalls are more likely for budget aid—the kind of aid that flows directly into a government's budget—because recipients have full discretion on where to spend such aid.

Aid predictability and aid volatility are distinct concepts, although they are often used interchangeably. Aid is predictable if recipients can be confident about the amount and timing of aid disbursements. Aid is volatile if it moves up and down significantly between two time periods. Although measuring predictability requires very detailed data, it is the more relevant concept in studying aid effectiveness issues.

Yet, little systematic empirical work is available about aid predictability. This article summarizes the results of our study (2008), which provides comprehensive empirical evidence on the predictability of aid.

Promises, promises

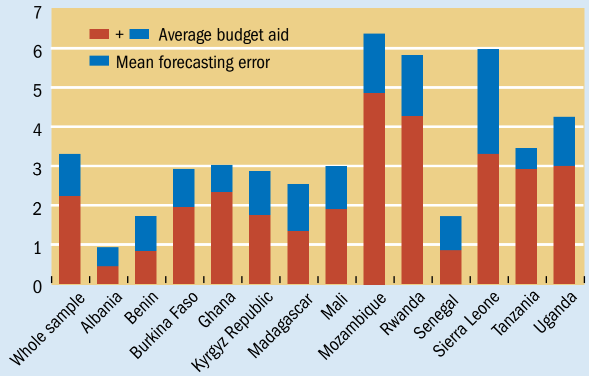
Does aid arrive on schedule? We use two sources of data to examine this question. A first data set, comprising aid disbursements and commitments reported by donor agencies to the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD-DAC), has comprehensive time and country coverage. But it includes neither separate data on project and budget aid nor a direct measure of aid expectations, because aid commitments reported by donors do not necessarily correspond to

Chart 1

Degree of unpredictability

On average, disbursed budget aid differed from the amount expected by about 30 percent.

(percent of GDP, 1993–2005)



Source: Celasun and Walliser (2008), using data in IMF staff reports from 1992 to 2007 for a set of 13 countries.

the amounts of aid expected by recipients. Also, OECD-DAC data do not include detailed fiscal data to evaluate the impact of unpredictable aid on government spending.

A second, new data set—derived from IMF-supported programs—provides detailed information on joint macroeconomic programming exercises by IMF staff and recipient governments. It includes projections and outturns of aid and a large set of other fiscal and macroeconomic variables. It can thus be used to identify aid expectations of recipient countries and differentiate between budget and project aid. However, it has limited country and time coverage. Both data sets have advantages and disadvantages in addressing different research questions (see Table 2 in Celasun and Walliser, 2008).

Both data sets show that aid is highly unpredictable. According to OECD-DAC data, during 1990–2005, on average, annual aid disbursements in sub-Saharan Africa deviated from aid commitments by 3.4 percent of GDP. Other regions also show deviations of disbursements and commitments in the range of 1.7–2.4 percent of GDP during 1990–2005. But, contrary to the common belief that donors systematically disburse less aid than they commit, low aid predictability in both data sets is a result of disbursements falling short as well as exceeding expectations and commitments, in particular in sub-Saharan Africa. This shows that managing unpredictable aid flows involves both aid shortfalls and windfalls.

Predictability of budget aid is strikingly low even for better-performing recipient countries. In data on IMF-supported programs, budget aid disbursements deviate from projections by about 1 percent of GDP, which represents about 30 percent of disbursed budget aid, on average (see Chart 1). The degree of predictability varies considerably. For example, Sierra Leone, a postconflict country, received 6 percent of GDP in budget aid—and 50 percent of this aid arrived unexpectedly, implying that half of each year's budget aid was either cut or added while the budget was under implementation. By contrast, in Ghana less than 25 percent of budget aid was unexpected.

Donor behavior

Donors may have several reasons for adjusting the flow of aid unpredictably.

Reason for difference between expected/announced and disbursed aid	Is donor behavior undermining aid effectiveness? Budget aid	Project aid
Technical, project-related		
Slow project implementation speed	n.a.	No
Difficulties meeting donor-specific project disbursement procedures	n.a.	Possibly
Country circumstances and conditions		
Major shift in policy or country circumstances, including emergencies	No	No
Specific conditions not met	Possibly	Possibly
Donor-related		
Administrative delays and slow response by donors	Yes	Yes
Aid reallocation or additions to aid envelopes for political or donor-related reasons	Yes	Yes

Source: Celasun and Walliser (2008).
Note: n.a. = not applicable.

The donor side

Most previous research has assumed that lack of aid predictability results mostly from unjustified bureaucratic and administrative delays by the donors. However, donors may also have valid reasons for not being able to provide fully predictable aid (see table). These valid reasons need to be distinguished from reasons not justified by aid effectiveness concerns to understand when lack of predictability negatively affects the potential development impact of aid.

As a purely technical matter, project aid disbursements may be in chunks (for example, for major infrastructure) and unexpected delays in project implementation by the recipients would lead to unexpected shortfalls in disbursements. Such shortfalls, however, would not be of concern from the aid effectiveness perspective. Delays in project disbursements may also result from recipients not meeting specific procedural requirements for safeguarding aid resources (such as procurement rules for project aid). Whether such delays are justified by aid effectiveness concerns largely depends on how relevant the procedures are in preventing aid from being misspent.

Major shifts in recipient country circumstances would clearly justify changing disbursement patterns. Fundamental shifts in a country's policies or governance that put in doubt a recipient's commitment to use aid for the intended purposes could result in donors withdrawing announced aid to prevent resources from being misspent. In some circumstances, aid must be disbursed unexpectedly to be effective. Emergency aid, by nature, is hard to predict, and such unexpected additions to disbursements in response to natural disasters and major economic shocks enhance rather than hinder aid effectiveness.

A more controversial and complicated question is whether specific conditions meant to ensure that country objectives are aligned with donor objectives justify lack of predictability. Such conditions, which are typically applied to budget aid, can include specific policy actions (for example, structural changes to the economy) or indicators (for example, increases in school enrollment rates). If recipients do not comply with such conditions, aid may be reduced or delayed.

In recent years, many budget-support donors have adopted measures to reduce the impact of specific conditions on annual predictability. They have done this by making financing decisions early in the budget cycle and by downplaying the importance of any one action or indicator as a condition for disbursement, instead relying on broader sets of performance measures.

Excessive administrative delays in donors' aid bureaucracies, cumbersome approval and disbursement processes, and intrayear aid reallocations that prevent the timely disbursement of announced and expected aid for a recipient country clearly present a problem for effective assistance. Donors may also add to or subtract from their originally planned aid to a recipient country during the year in response to political developments in, or based on the aid needs of, other recipient countries. Such intrayear reallocations also hamper aid planning.

Stable program relationships matter

Statistical analysis helps determine whether some of the observable characteristics of recipient economies are responsible for the low predictability of aid flows. OECD-DAC data, which have the required comprehensive coverage, show that recipient countries that have more stable relationships with donors—as signaled by a *sustained* track record of implementing IMF-supported programs—receive more predictable aid. This relative stability of donor-recipient relations could reflect a higher degree of trust or sound macroeconomic policy implementation by the recipient country. Also, statistical analysis shows that a longer, continuous engagement with the IMF reduces aid windfalls ("surprise disbursements") but not aid shortfalls. More stable country-donor relationships appear to result in better aid projections and less need for donors to step in unexpectedly with higher aid. The mere existence of an IMF-supported program, by contrast, does not matter for predictability.

Emergencies in recipient countries also explain some of the measured lack of predictability, because donors do not live up to their aid commitments in years when there are large disbursements of emergency aid. This finding indicates that donors sharply increase their commitments during emergencies without necessarily delivering on these promises, a possible indication that aid envelopes are being shifted toward emergency responses and away from other aid activities in the same country.

Our study does not find any other factors—such as governance or terms-of-trade shocks—to be strongly linked with predictability. In addition, a significant part of the lack of predictability cannot be directly linked to long-term donor relations or emergencies. The unexplained part of low predictability may reflect both technical factors in the case of project aid, but also specific conditionality and administrative delays by donors (as outlined in the table).

Adjusting to shortfalls

By using this IMF-based data set—which covers 13 countries with long-term program relations during 1992–2005—adjustments to budget aid surprises can be broken down into changes in tax revenue, current spending, domestically financed investment spending (total public investment spending minus investment spending funded by project aid), domestic bank financing (financing by the central bank and commercial banks), net debt service, and other categories. The other category mostly reflects nontax-revenue and nonbank-financing items.

How prevalent are budget aid shortfalls? Budget aid disbursements fall short of projections in about 60 percent of the fiscal years covered in the sample. The average budget aid shortfall is 1.1 percent of GDP (see Chart 2, top panel). The management of these aid shortfalls is often made more difficult by simultaneous tax revenue shortfalls (0.3 percent of GDP) and current expenditure overruns (0.3 percent of GDP). Recipients therefore typically need to address simultaneously aid shortfalls, tax revenue shortfalls, and current expenditure overruns, amounting to 1.7 percent of GDP. They do so largely, in order of magnitude, through higher domestic bank financing (0.7 percent of GDP), reductions in debt service or increases in arrears (0.4 percent of GDP), cuts in domestically financed investment spending (0.3 percent of GDP), and other financing sources outside regular channels—such as privatization or nontax revenue (0.3 percent of GDP).

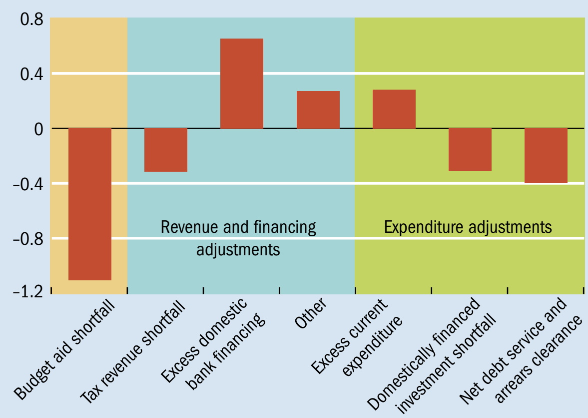
What emerges as a key adjustment pattern for aid shortfalls is a mix of additional domestic financing and cuts in investment spending, while current spending is, on average, higher than projected. The data thus confirm that recipient governments would normally not be able to reduce current spending (mostly salaries) but largely concentrate expenditure adjustments on budgetary investment spending. Governments operating in an environment of uncertain budget aid may restrain their budgetary investment expenditures if they do not receive aid early in the budget cycle. Persistent uncertainty about budget aid disbursements also undercuts simple budget management responses to shortfalls, such as the delay of investment spending from one year to the next.

Chart 2

Adjustments to aid surprises

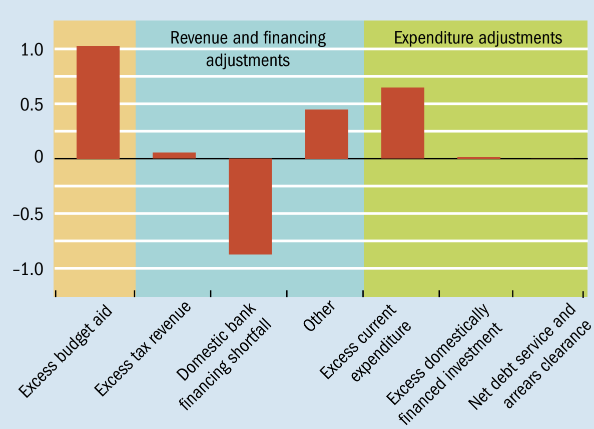
Countries adjust to aid shortfalls by raising additional domestic financing and by cutting investment spending . . .

(percent of GDP, 1993–2005)



. . . and to aid windfalls by reducing domestic bank debt and increasing current expenditure.

(percent of GDP, 1993–2005)



Source: Celasun and Walliser (2008), using data in IMF staff reports from 1992 to 2007 for a set of 13 countries.

Structural differences in countries' policy frameworks can result in different adjustment patterns for similar aid shortfalls. For instance, member countries of the West African Economic and Monetary Union (WAEMU), which do not have access to monetary policy instruments and have limited or no ability to borrow from the central bank, had to cut investment spending more deeply than did other countries. On average, WAEMU countries compensated for half of the aid shortfall with a cut in investment spending and financed less than a third of the shortfall through the domestic banking system. Non-WAEMU countries cut investment spending by one-sixth of the aid shortfall, financing three-quarters by borrowing from domestic banks.

Adjusting to windfalls

Additional budget aid finances the repayment of debt or additional government consumption. Higher-than-expected disbursements of budget aid take place about 40 percent of the time, and average 1 percent of GDP for the IMF data set (see Chart 2, bottom panel). On average, none of the excess aid and revenue goes toward additional domestic investment spending. Instead, recipients reduce domestic bank debt (0.9 percent of GDP) and increase current expenditure (0.6 percent of GDP), benefiting from the fact that countries collect more nontax revenues in periods of aid windfalls. Aid windfalls typically come too late in the budget year and thus cannot be spent on items other than current expenditures.

Saving aid windfalls allows building up space for future aid shortfalls and could be part of a strategy to manage unpredictable aid. But, surprisingly, even countries that have received excess aid for several consecutive years appear to use most, if not all, of the extra aid for reducing debt rather than additional expenditure.

With almost identical budget aid and revenue windfalls, WAEMU countries expanded current expenditure by much less (0.4 percent of GDP) and saved more (0.5 percent of GDP) by paying down bank debt as compared with their non-WAEMU counterparts. These policies reflect a larger degree of self-insurance by WAEMU countries, given the tighter domestic borrowing limits faced by governments. In both WAEMU and non-WAEMU countries, little, if any, additional investment spending took place in response to aid windfalls.

How to improve predictability

One of the key results of our study is that low predictability of budget aid can hurt aid effectiveness (see box). We also conclude that a number of areas in the debate on aid effectiveness and improving donor practices need further consideration. First, ***the predictability debate should be linked more closely to the original question of aid effectiveness.*** In some cases, donors are justified in being unpredictable. Laying out upfront the circumstances under which donors are not expected to be predictable—for example, in cases of major emergencies—would help implement the aid effectiveness targets of the Paris Declaration.

Second, ***data collection should be improved*** to measure more accurately the impact of low predictability. It is critical to record the mutual expectations of donors and recipients alike to capture aid flows expected by recipients. Better data would help explain low predictability caused by conditionality, administrative delays, and sudden adjustments by donors.

Third, the persistence of the predictability problem, especially for budget support, would suggest ***reconsidering some of the mechanisms of aid delivery to these countries.*** One possible way is to lengthen aid allocation periods and tie them to slower-moving country indicators rather than reconsidering fast-disbursing aid volumes annually within annual conditionality frameworks (Eifert and Gelb, 2006). That would remove discretion over aid disbursements, but it would still allow donors to rapidly cut aid if policies and/or governance in a country deteriorate sharply. The implication for the international aid architecture would be important. Currently, many aid budgets are set annually, and multilateral institutions need to replenish their resources for low-income countries every three years. Longer-term commitments to budget aid—say, over a 10-year horizon—would imply that aid funding mechanisms, including for multilateral institutions, would have to be reconsidered. ■

Key findings

The analysis shows that lack of predictability hurts investment outlays, which are cut in periods of aid shortfalls but not raised during aid windfalls. By contrast, government consumption rises in response to aid windfalls. This finding is further illustrated by a review of the bilateral relationship between key variables:

- A 1 percent of GDP aid shortfall is associated with a statistically significant downward adjustment of investment spending of 0.1–0.2 percent of GDP, whereas investment spending does not rise with aid windfalls.
- Government consumption does not fall during aid shortfalls, but a 1 percent of GDP aid windfall is associated with a 0.6 percent of GDP rise in consumption.
- Domestic bank financing is used to absorb both aid shortfalls and windfalls, but to a different degree. A 1 percent of GDP aid shortfall is associated with additional domestic bank financing of 0.5 percent of GDP. A 1 percent of GDP aid windfall is associated with a reduction of domestic financing (domestic debt repayment) that is larger (0.8 percent of GDP) than the additional bank financing during aid shortfalls.

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Land and **Poverty** in Reforming East Asia

Martin Ravallion and Dominique van de Walle

Lessons from Vietnam's agrarian reforms

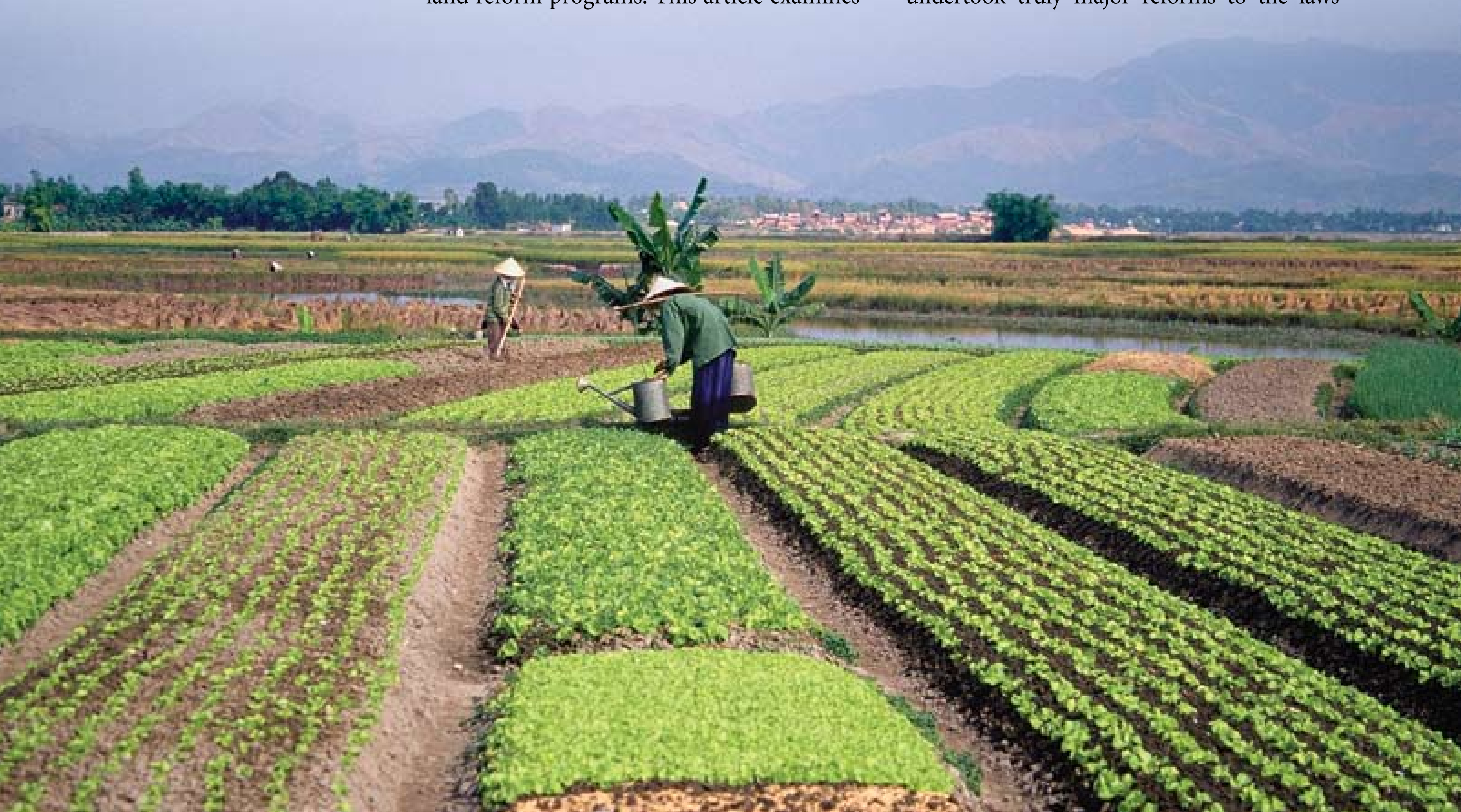
BOTH CHINA and Vietnam have made enormous progress in the fight against poverty, and the evidence suggests that rural economic growth has played a large role in this success. Using each country's own definition of poverty, with a constant real poverty line over time, China's poverty rate fell from more than 50 percent in 1981 to about 20 percent in 1991 and 5 percent in 2005. In Vietnam, poverty fell from almost 60 percent to 20 percent during 1993–2004.

Land is the most important non-labor asset in any developing rural economy. The institutions determining how land is used are thus at the core of efforts to fight poverty. China and Vietnam both have had major land reform programs. This article examines the role these major agrarian reforms played in the subsequent progress against poverty and searches for lessons for the future.

We also look at what China might learn from Vietnam's different path in its land policies and what other countries can learn from these star performers. Lessons include the importance of the agricultural sector in the early stages of a pro-poor growth process, the potential role of market-oriented reforms in absolute poverty reduction, and the need to address pressures spurring rising inequality as reforms get under way.

Shift from collectivized farming

In the 1980s and 1990s, China and Vietnam undertook truly major reforms to the laws



and regulations governing agricultural land. Prior to that, both countries had collectivized their farming, but both came to realize that this system was not performing well.

Although collectivized farming could ensure low inequality within each commune, this came at too high a price in terms of efficiency, because working in large brigades and sharing the output dulls the incentive for effort. The cooperatives and collectives were dismantled and the land was assigned to individual households in the commune, who had to agree to provide an output quota to the government but could keep the rest for consumption or sale. This system clearly had better incentives, and agricultural output rose accordingly in both countries.

After this important step, promarket reforms to agrarian institutions were put in place in both countries, though Vietnam has gone further. China has still not taken Vietnam's radical, and controversial, step of introducing a legal market in land-use rights.

How the reforms worked

The reform processes in China and Vietnam were not solely concerned with efficiency. Highly inequitable outcomes from the agrarian reforms would have met with popular resistance in the short term and potentially derailed future progress against poverty by stifling the economic opportunities of a large share of the population. Future reform prospects in other areas of policymaking would also have been jeopardized by perceived failures in the initial agrarian reforms.

However, policymakers faced a potentially major threat to the reform process. As in many developing countries, the center had to rely heavily on decentralized implementation of these reforms, down to the commune level. This raised concerns about local elites—whose interests are not well served by the central government's aims—taking over the process for their own purposes. Were these concerns justified? Our research focused on Vietnam's agrarian reforms, which we compared with other observations about the process in China. We first studied how land-use rights were allocated on breaking up Vietnam's collectives. Individual households had to be assigned the use rights for virtually the entire agricultural land area of a country in which three-quarters of the workforce depended directly on farming.

We used econometric models of both household consumption and the behavior of local party cadres to assess the administrative allocation of land achieved by the decollectivization process against explicit counterfactual allocations. One of these was an equity counterfactual in which land was allocated equally within communes and the other was the allocation that would have maximized aggregate consumption, which would have been the competitive market allocation under our assumptions. The model relating consumption to landholding (and other explanatory variables) was used to simulate these counterfactuals; Ravallion and van de Walle (2008) describe the methods in detail.

What we found was not consistent with the picture that some commentators painted of an unjust land allocation stemming from the power of local cadres to capture the process. However, the observed allocation was significantly different from what would be expected of a competitive privatization at market-clearing prices. The consumption-efficient allocation would have put greater weight on education and given less weight to household size, labor force, minority groups, and male heads of household. The reform reinforced existing gender inequities in favor of male heads of household at a cost to efficiency. We find no evidence that land allocation unduly favored those with government or semigovernment jobs.

"Our results point to an effort by the authorities to protect the poorest and reduce overall inequality, at the expense of aggregate consumption."

Vietnam's reform to privatize land-use rights achieved a more equitable outcome than one would have expected from a fully efficient allocation that would have been achieved through free markets. There were both gainers and losers relative to the efficient market allocation, but the gains tended to favor the poor. This can be seen in Chart 1, which plots the estimated loss incurred by the sampled farm-households—judged relative to market allocation of land—against initial consumption. The lower left quadrant shows greater net gains (negative losses) for the poor.

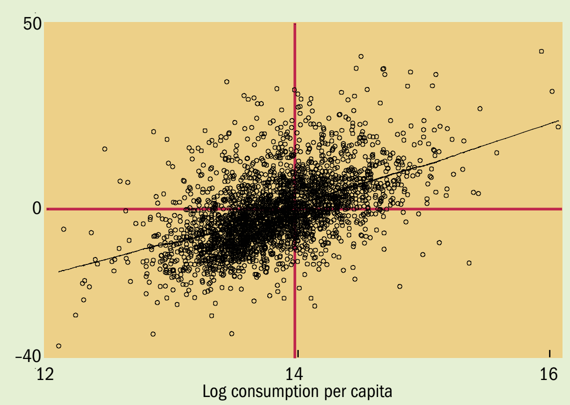
Our results point to an effort by the authorities to protect the poorest and reduce overall inequality, at the expense of aggregate consumption. The solution that was reached entailed an equity-efficiency trade-off, indicating that both

Chart 1

Pro-poor reform

Compared with a market allocation, Vietnam's reforms to privatize land-use rights favored the poor.

(percent loss from actual land allocation relative to efficient allocation)



Source: Ravallion and van de Walle (2008).
Note: The vertical line is the poverty line for rural Vietnam.

objectives were valued positively. Our (more casual) observations and other evidence suggest that the same was probably true in China's decollectivization process.

Reform had winners and losers

A farming household in China cannot sell its land and use the money to finance a new nonfarm enterprise, or move to the city to take up work. Land is not a marketable asset, but is allocated, and at times reallocated, by the local administration, sometimes with the involvement of the village assembly. There have been long-standing concerns about the possible inefficiencies of this system; notably, whether better farmers get enough land and whether the threat of losing one's (limited) rights over the land deters farm investment and dulls the incentive for off-farm work and entrepreneurship.

In response to these concerns, the Chinese government has recently tried to discourage land reallocations. There has also been more widespread use of land rental arrangements among farmers; although these are typically informal (oral) understandings among friends and family, they have probably helped make the allocation of land more efficient, in lieu of a legal market in land-use rights.

Vietnam took a different route than China. The new land law introduced in 1993 attempted to foster free transactions in land-use rights. But there was much debate. Some observers believed that this reform would allow a closer approximation of the efficient allocation, but at the expense of equity. The prospect of renewed class differentiation—the re-emergence of a rural proletariat—has fueled much debate about the wisdom of Vietnam's efforts at liberalizing land markets. This has been a concern in China as well, and has arguably been the main factor stalling market-oriented reforms to land laws.

A long-standing view in some quarters is that even from an equal starting point, the market mechanism will generate excess inequality. However, the same features that helped ensure an equitable allocation at the time of decollectivization—including relatively high and equal human capital—may well have operated to moderate any un-equalizing forces generated by the emerging market economy. And the fact that other policy reforms, including more open external policies, were creating new opportunities for diversification and growth is clearly relevant to the outcomes of these reforms.

What does our research for Vietnam suggest? We find signs that, after legal reforms to introduce a market in land-use rights, land was reallocated in a way that attenuated the inefficiencies of the initial administrative assignment of land. Households that started with an inefficiently low (high) amount of annual cropland tended to increase (decrease) their holdings over time. The adjustment was not rapid; in the aggregate, only one-third of the initial proportionate gap between the actual allocation and the efficient allocation was eliminated within five years. And there was continuing local government intervention in some regions. But it seems that the market mechanism did start to take hold.

The market worked more rapidly for some types of households than others. Overall, the transition process favored those who initially had too little land. The speed of market adjustment was also affected by location and demographic shocks, and the new market-driven process favored households with long-term roots in the community, better education, and with more land in other (non-annual cropland) categories.

Did these efficiency gains from introducing land markets come at a cost to the poor? One should not be surprised to find a higher incidence of landlessness. Many farmers will no doubt benefit from the new opportunities to use their limited wealth in other ways, including spending on consumer durables and housing. But there will also be losers from such a reform. Welfare losses can occur for those who were previously landless, who receive lower wages than without the reform, and for farmers who find that other benefits provided by the cooperatives were retrenched once their role in land allocation was removed.

Our analysis of the survey data for Vietnam—spanning a decade after legal reforms to introduce markets in land-use rights—confirms the expected rise in the landlessness rate among many of the poor. Similarly, it was the initially poor who saw the highest pace of urbanization over time. Even so, the postreform landlessness rate tends to be higher for the rural non-poor in Vietnam as a whole, as can be seen from Chart 2, which plots the average landlessness rate against household consumption per capita for both 1993 and 2004. Landlessness rises with living standards. Between 1993 and 2004, it fell for the very poorest as well as for the rich, and rose slightly for those in the middle of the distribution. The empirical analysis suggests that, by and large, it is not the currently poor who took up the new opportunities for selling (or buying) land and acquiring land titles, but the relatively well off. Access to formal credit appears to have improved overall (and displaced informal credit), though more markedly for better-off households. Among equally poor households, the landless are less likely to receive credit from formal sources, including the targeted antipoverty programs.

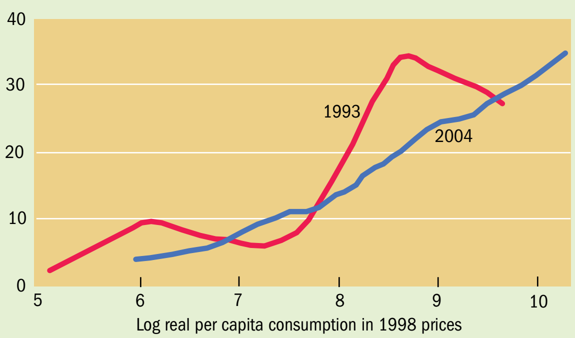
We find little sign that rising landlessness has undermined the gains to the poor from the relatively equitable assignment of

Chart 2

Transition from farming

The poorest are least likely to be landless, but there has been a rise in landlessness in the (dense) middle of the distribution.

(landless households, percent)



Source: Ravallion and van de Walle (2008).

land-use rights achieved at the time of Vietnam's decollectivization. Even in the South's Mekong Delta—where there are signs of class differentiation—poverty has been falling among the landless, albeit at a lower rate than for those with land. However, we find no sign that this pattern is emerging elsewhere in Vietnam; indeed, as a rule, the landless are enjoying rates of poverty reduction similar to (or even higher than) people with land.

On the whole, rising rural landlessness appears to have been a positive factor in Vietnam's process of poverty reduction, as farm households take up new opportunities, notably in the labor market. This does not imply that any policy effort to encourage landlessness will be poverty-reducing; it is one thing to give people the opportunity to sell their land to take up more rewarding opportunities, but quite another to compel such changes by forcing farmers off their land. Policies should focus instead on making land markets work better for poor people and on complementary efforts to enhance nonfarm opportunities, notably for the landless rural poor, who tend to have less access to credit for financing investments in nonfarm enterprises.

What are the lessons?

At the start of this article we noted both similarities and dissimilarities between Vietnam's agrarian reforms and those of China. There are historical and contextual factors to consider in understanding the difference in agrarian-reform policies. For example, China had a more deeply rooted tradition of collectivized farming and (in contrast to Vietnam) had largely succeeded in displacing the peasant-family economy. This alone made for a more rapid transition in Vietnam.

While acknowledging that these differences between the two countries had an important influence on the policies chosen, China should not ignore the lessons from the experience of its neighbor. Vietnam's more radical approach of introducing a land market did not have the dire consequences predicted by those who favored the Chinese model of administrative land allocation. Starting from a relatively equitable allocation of land, introducing free exchange did not end in peril and poverty for the rural population, though (as in any major policy reform) there are both losers and gainers. Vietnam's experience also reminds us that the efficiency gains do not happen overnight, and may well take many years to be realized. But gains can be expected, including gains for the poor.

There are also lessons for other countries today. As many developing countries strive to raise farm output in the wake of the dramatic increase in food prices, they should pay close attention to the reforms that may be needed to ensure that individual farmers can respond to market incentives. The reforms will be specific to each country, but countries that still have the kinds of land policies that Vietnam has been so successful in dismantling could benefit by studying that experience.

There are broader lessons for other countries, going beyond the specific reforms to land policies undertaken by China and Vietnam. Their experiences reaffirm that reforms can work when they are sensitive to the context, including concerns about equity in the process and its outcomes. Their experiences also confirm that poor people respond to market incentives when given the opportunity. And the importance of strong state institutions (including at the local level), and a leadership committed to poverty reduction, is confirmed by the experience of both China and Vietnam.

These are generic lessons. We would also point to a more specific lesson—namely, the role played by the evidently high priority both countries gave to agriculture and rural development in the early stages of the reform process. This quickly benefited the poorest segment of society and laid the foundation for the success of later reforms. The high priority given to this sector also helped attenuate the pressures for rising inequality (though Vietnam has been more successful than China in avoiding rising inequality). Yet many low-income, primarily rural, developing countries think they can jump-start their economies by rapidly developing a modern, relatively capital-intensive, manufacturing sector. So they largely ignore their agricultural sectors. This approach has had disappointing outcomes, particularly in countries with high initial inequality in human resource development; indeed, it may even increase poverty through the financing methods (notably the heavy taxation of agriculture) and price distortions that are needed.

"Poor, primarily rural, economies cannot reasonably hope to bypass the key steps in actively promoting agricultural and rural development that China and Vietnam took from the early stages of their reform processes."

Poor, primarily rural, economies cannot reasonably hope to bypass the key steps in actively promoting agricultural and rural development that China and Vietnam took from the early stages of their reform processes. That is an important message for the many low-income countries today that would like to emulate the successes that China and Vietnam have had against absolute poverty. ■

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Economic Forecasts: Hard to Rely On?

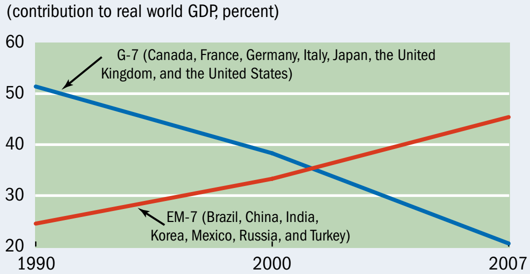
FORECASTS of economic growth can help policymakers and the private sector plan ahead and make decisions. But how accurate are these forecasts? The answer is that forecasters often fall short in predicting a country's growth path, particularly around turning points in economic activity. And now that emerging markets are playing a larger role in driving global growth, forecasting growth has become even more difficult.

Tracking errors

The contribution of the Group of Seven (G-7) major industrial economies to global growth has declined—from about 50 percent in 1990 to 20 percent last year. Meanwhile, the seven largest emerging economies (the EM-7) have seen their contribution to global growth rise from 25 percent in 1990 to approaching 50 percent. This development poses a challenge for forecasters, who have much more experience with forecasting G-7 economies.

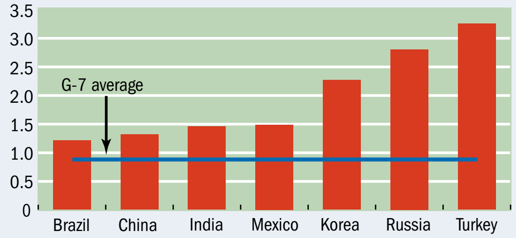
The contribution of emerging market economies to growth has doubled since 1990.

(contribution to real world GDP, percent)



Forecasting errors are larger for the EM-7 economies.

(average forecast errors, percent)



Growth in the G-7 economies has been only half as volatile as in the EM-7 economies, and data for the G-7 are more reliable and timely. So how have forecasters fared in tracking growth in the EM-7 economies? Evidence from a group of private sector forecasters shows that errors made in forecasting growth in these economies over the past decade have been larger than those for the G-7 economies. This year the task of predicting global growth has been even more perilous as many economies may be at turning points.

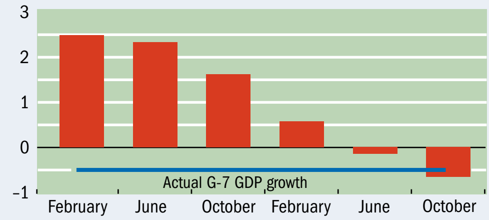
Prepared by Prakash Loungani and Jair Rodriguez (International Monetary Fund). Some of the charts and text are based on "Economic Forecasts: Too Smooth by Far," World Economics, *2008, Vol. 9, No. 2 (April–June), pp. 1–12.*

Recessions vs. reality

For the G-7 economies, on average, forecasters had no inkling of recessions a year ahead, although they suspected a slowdown by October. Only in June of the year in which the recession occurred was a decline in economic activity forecast, but it underestimated the eventual decline. As the year was ending, around October, forecasts of recessions caught up with reality.

For the G-7 countries, forecasters predict recessions in the year in which they start.

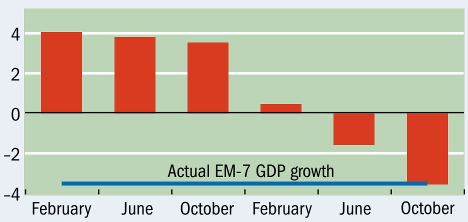
(G-7 average GDP forecasts in the run-up to recessions, percent)



Note: The first three forecasts shown are made in the year preceding the recession; the other three are made in the year of the recession.

The same pattern is true for forecasts of recessions in the EM-7 countries.

(EM-7 average GDP forecasts in the run-up to recessions, percent)



Note: The first three forecasts shown are made in the year preceding the recession; the other three are made in the year of the recession.

Forecasts of recessions in the EM-7 economies show the same pattern as for the G-7 economies. Forecasts made in February of the year of the recession sense trouble, but it is only in June that there is a serious marking-down of forecasts, followed by a catch-up with reality by October.

The task of forecasters is made more difficult because data on growth are prone to revisions. In addition, forecasts are conditional on policies and key prices (for example, oil prices), which can be difficult to predict. Such challenges might explain why, in the United States, the National Bureau of Economic Research often decides on the official start date of a recession well after the recession has ended.

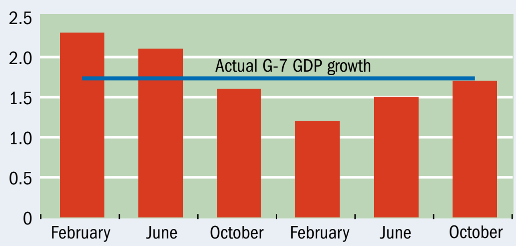
Anticipating recoveries

Although forecasters—including those from the official sector—are often off target in predicting recessions, their record of predicting recoveries is somewhat better.

For the G-7 countries, on average, private sector forecasts of growth for the following year tend to be marked down a bit once a recession is fully recognized. The gloom carries over into the start of the year but dissipates by the summer; by October, the forecasts of recovery match what actually transpires.

Once a recession is under way, predicting its end in the G-7 countries is easier.

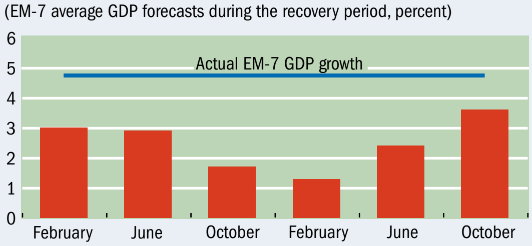
(G-7 average GDP forecasts during the recovery period, percent)



Note: The first three forecasts shown are made in the year preceding the recovery; the other three are made in the year of the recovery.

But forecasters have been more pessimistic about the extent of recoveries in the EM-7 countries.

(EM-7 average GDP forecasts during the recovery period, percent)



Note: The first three forecasts shown are made in the year preceding the recovery; the other three are made in the year of the recovery.

For the EM-7 economies, the pattern is similar, except that forecasters have been more pessimistic than warranted about the extent of the recovery—the forecasts made in October of the year of the recovery are still quite a bit below the actual outcomes.

Using forecasts correctly

This does not mean that forecasts of economic growth have no value. Without them, policymakers would be operating "without radar." But it does suggest that users of forecasts might be better served by paying greater attention to the description of the outlook and the associated risks than to the central forecast itself. Reassuringly, it is becoming more common to show how much uncertainty there is about whether the central forecast will come true. It is particularly useful to be explicit about the downside risks to a growth forecast because it can provide a wake-up call for policies and actions needed to keep those risks from materializing. ■

Mobilizing Revenue

Strengthening domestic revenue bases is key to creating fiscal space for Africa's developmental needs

Sanjeev Gupta and Shamsuddin Tareq

FINANCIAL flows to sub-Saharan Africa have increased sharply since 1980. Between 1980 and 2006, net aid (including debt relief) increased fivefold, remittances ninefold, and foreign direct investment fiftyfold. Increased resource flows into the region and the associated high growth rates have enabled these countries to scale up public spending, including on social sectors. As a result, education and health spending increased in the region's oil-importing countries, in relation to both GDP and total spending (see Chart 1).

While these increases in spending are welcome, they are insufficient to meet the vast needs of the region's population in a sustainable manner. It is therefore essential that donors live up to their commitments of increasing aid to these countries. But aid-receiving countries in the region could also do more to generate resources internally—and to ensure that both new and existing resources are used efficiently.

In this article, we propose expanding the tax base in these countries by capturing activities not adequately taxed because of policy or administrative weaknesses. Such a step—together with strengthened fiscal institutions—would hasten the progress of African countries toward achieving the Millennium Development Goals (MDGs) and produce an array of other benefits. This does not mean that tax rates should be increased. In fact, high tax rates in some countries in the region, particularly on mobile production factors (such as skilled labor and capital), may be hindering economic growth. An effective broadening of the revenue base may enable these countries to lower the tax rates while raising more revenue to finance pressing developmental needs.

The case for domestic resources

The average tax-to-GDP ratio in sub-Saharan Africa increased from less than 15 percent of GDP in 1980 to more than 18 percent in 2005. But virtually the entire increase in tax revenue in the region came from natural resource taxes, such as income from production sharing, royalties, and corporate income tax on oil and mining companies. Nonresource-related revenue increased by less than 1 percent of GDP over 25 years. Even in resource-rich countries, nonresource-related revenue has essentially been stagnant (Keen and Mansour, 2008).

Also, in many of Africa's low-income oil importers, domestic revenue mobilization has not kept pace with rising public spending. As a result, a growing share of current spending is financed by aid. For example, from 1997–99 to 2004–06, the share of current spending financed by aid increased from 16 percent to 36 percent in Ghana, from 22 percent to 40 percent in Tanzania, and from 60 percent to 70 percent in Uganda (see Chart 2).

It is not inappropriate for low-income countries to finance a rising share of their recurrent outlays from aid, one might argue. After all, these countries have pressing needs at this stage of their development, and increasing expenditures for infrastructure and human development would only promote growth over time. Although this argument has some merit, policymakers in these countries still need to take into account a number of other considerations.

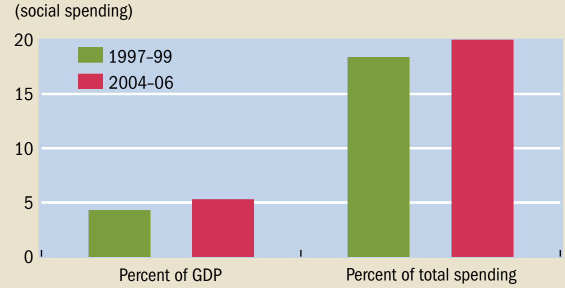
First, ***aid-financed projects give rise to additional spending, such as on operations and maintenance, which will need to be covered at least partly, if not wholly, from domestic resources.*** The country must generate sufficient revenue to finance these expenditures, or the productivity of aid-financed projects and assets will suffer.

Second, ***strengthened revenue mobilization contributes to economic stability, particularly in countries dependent on external financial flows.*** Rising domestic revenue not only creates additional fiscal space for supporting high-priority spending, it also allows a country to maintain spending con-

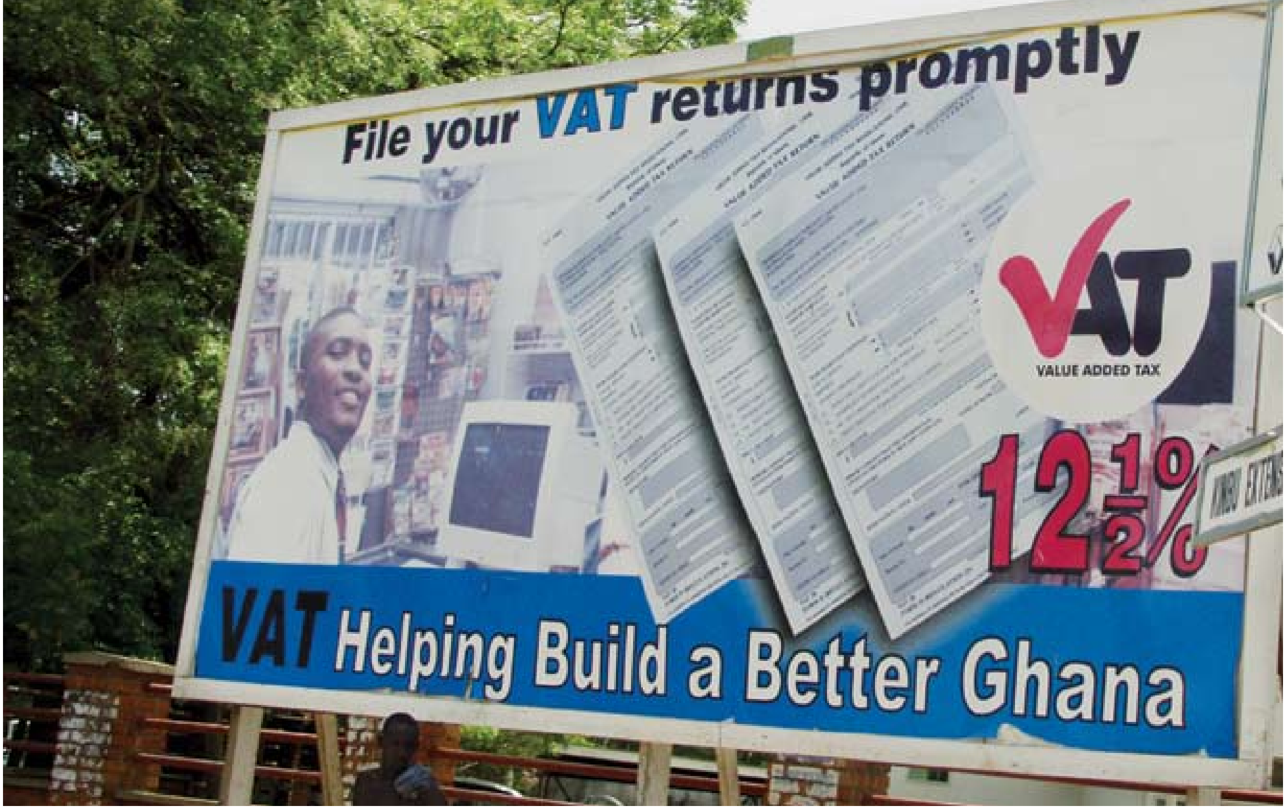
Chart 1

Higher social spending

With increased resource flows to Africa, governments have been able to ratchet up spending on education and health.



Source: IMF staff calculations.
Note: Data refer to simple averages of education and health spending at the central government level in 25 low-income oil importers.



Billboard in Accra, Ghana: A value-added tax has been introduced in virtually all countries in sub-Saharan Africa.

sistent with its policy priorities when aid is phased out. Ghana, Malawi, Rwanda, Tanzania, and Uganda all successfully created fiscal space through higher domestic revenue mobilization during 2000–06, demonstrating that it is feasible. Moreover, as low-income countries in sub-Saharan Africa develop into emerging market countries, they will need to strengthen their revenue collection accordingly (see Chart 3).

Increased domestic revenue can also help countries mitigate the adverse impact of volatility and uncertainty in aid flows, which can complicate budgetary management. Aid flows are more volatile than domestic revenue and significantly more so than remittances, and this volatility has increased over time. For example, Bulír and Hamann (2007) find that, even for countries that have benefited from the IMF's Heavily Indebted Poor Countries (HIPC) Initiative, the relative volatility of aid with respect to revenue (when variables are expressed as a share of GDP) has increased to 62 in 2000–03, compared with only 25 during 1997–98.

Third, ***expanding domestic revenue could also help Africa address the challenges arising from globalization.*** These countries are feeling the pressure to further liberalize their trading regimes, because their average tariff rate is higher than in other regions. Also, tariff rates in sub-Saharan Africa are expected to fall as a result of the formation of free trade areas and customs unions within the region as well as with other regional trading blocks, including the European Union. Currently, about a third of nonresource tax revenue in the region comes from trade taxes—about 4 percent of GDP—indicating that revenue loss from further trade liberalization would be significant. Strengthening the domestic revenue base could help recoup at least some losses from trade taxes.

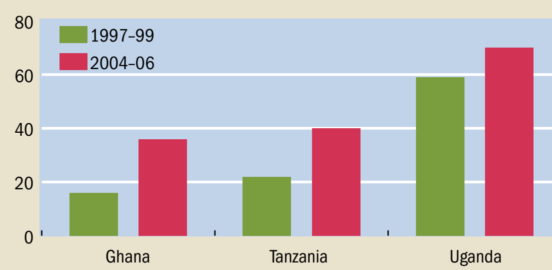
African countries are also confronted with increasing tax competition on corporate income tax (CIT), as countries compete more aggressively to attract foreign invest-

Chart 2

Worrisome trend

In many countries, a growing share of current spending is now financed by aid.

(share of current spending financed by aid, percent)



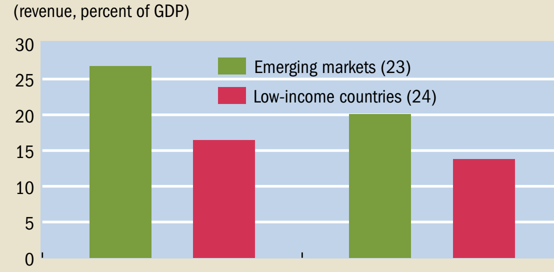
Source: IMF staff calculations.

Chart 3

Time to catch up

Tax collection levels of emerging market countries are significantly higher than those of low-income countries.

(revenue, percent of GDP)



Source: IMF staff calculations.
Note: Simple averages for the period 2004–06, with sample sizes in parentheses. Tax revenue for low-income countries refers to the 2004–05 average.

ment. Although statutory CIT rates in the region fell markedly in the 1990s, CIT revenue as a share of GDP has remained broadly unchanged, suggesting that the impact of rate reductions on revenue has been mitigated by other factors (Keen and Mansour, 2008). Nevertheless, the trend worldwide is toward lower statutory CIT rates, and rates in sub-Saharan African countries are still relatively high. This implies that these countries remain under pressure to further reduce CIT rates, which in turn means that the tax base should be broadened in order to minimize the impact on tax revenue.

Fourth, ***greater reliance on domestic revenues reduces the risk of Dutch disease***, which occurs when the exchange rate appreciates as a result of capital inflows, making the country's exports less competitive. A key challenge in managing scaled-up external inflows is the potential impact on the real exchange rate, exports, and competitiveness (Gupta, Powell, and Yang, 2006). Increasing domestic revenue means that there is less risk of being affected by Dutch disease.

Fifth, ***taxation increases incentives for public participation in the political process and creates pressure for more accountability, better governance, and improved efficiency of government spending***. It fosters awareness to limit rent seeking (that is, lobbying for tax breaks or protection from foreign competition) in public policy by interest groups. Taxation also creates incentives for governments to upgrade their institutions for tax collection and administration and to provide more public services (Moore, 2007).

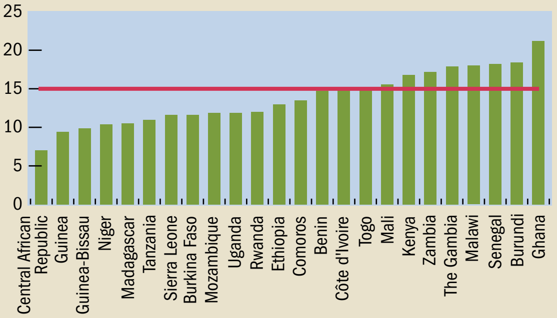
Sixth, ***domestic revenue mobilization can help strengthen fiscal institutions***. Stable and predictable revenue facilitates medium-term fiscal planning, which can help ensure that resources are allocated to priority sectors and that these allocations are effectively translated into outcomes. In fact, the efficiency of social spending has a strong positive correlation with the quality of fiscal institutions (Gupta et al., 2008).

Chart 4

Raising the bar

Many oil-importing countries in Africa have a strikingly low tax-to-GDP ratio, but a target of at least 15 percent is desirable.

(tax revenue, percent of GDP)



Source: IMF staff calculations.
Note: Data refer to simple averages in each country for 2004–05.

Revenue-raising potential

What is the potential for strengthening domestic revenue bases in sub-Saharan African countries? The revenue performance across oil exporters in the region varies; many countries have relatively high revenue-to-GDP ratios. These countries need to improve the efficiency of their tax systems to promote investment in nonresource sectors, which would help diversify their tax base. Countries that have low revenue-to-GDP ratios should strive to boost domestic tax revenue over the medium term.

In low-income African countries, domestic revenue remains low, at about 16.5 percent of GDP. Tax revenue is about 14 percent of GDP on average. A tax-to-GDP ratio of at least 15 percent is considered a reasonable target for most low-income countries (Keen and Simone, 2004). Many low-income African countries that are not rich in resources have a tax-to-GDP ratio well below 15 percent of GDP (see Chart 4).

Several studies indicate that developing countries have the potential for greater domestic revenue mobilization. The United Nations Millennium Project (2005) estimated that these countries could increase their domestic revenue by about 4 percent of GDP over the next 10 years. Similarly, the Commission on Macroeconomics and Health (World Health Organization, 2002) concluded that most countries could raise an additional 1–2 percent of GDP for financing additional health spending.

What it will take

Direct taxation, in the form of corporate or personal income tax, exists in all countries, but its potential has not yet been fully exploited. There are many large taxpayers who are benefiting from rising commodity prices, but they are not paying taxes commensurate with their income. Fine-tuning the policy and the administration governing the taxation of these taxpayers' incomes would help a number of countries raise additional revenue. However, the high share of agriculture and the informal sector in the economies of many countries is an important constraint in raising more revenue from direct taxation.

A value-added tax (VAT) has been introduced in virtually all countries in sub-Saharan Africa. To maximize revenue from VAT, countries need to ensure that the tax base is as broad as possible and the rate structure simple. Excise taxes are levied on products such as alcohol, tobacco, petroleum products, vehicles, and spare parts, but their yield in some countries has eroded because of rising prices. During 2007–08, many African countries reduced taxes (both import duties and consumption taxes) on fuel and food in response to higher international prices of these commodities. This has helped mitigate the impact of rising prices, particularly on the poor. But eventually, these countries would need to recoup some of the resulting revenue losses through rationalization of domestic taxation.

Rationalizing tax incentives can also generate substantial revenue (without negating the role of such incentives in improving the investment climate). Tax incentives in sub-Saharan Africa are now used more widely than in the 1980s, with more than two-thirds of the countries in the region providing tax holidays to attract investment. The number of countries using free zones that offer tax holidays has also dramatically increased. Moreover, low-income countries in the region use such incentives more extensively than do middle-income countries—yet foreign direct investment in sub-Saharan Africa, other than in the resource sector, has increased very little over the past two decades.

Such incentives not only shrink the tax base but also complicate tax administration and are a major source of revenue loss and leakage from the taxed economy. Because investment decisions depend on a host of factors that often carry more weight than tax incentives, these countries need to improve the business climate while keeping the tax considerations as neutral as possible for investors.

Countries should also take steps to strengthen tax administration, because weak administrative capacity and poor governance are important constraints to raising revenue in many countries. Policies should focus on strengthening the technical capacity and organization of revenue authorities through computerization and improved operating procedures. Stricter enforcement mechanisms as well as improved tax audits and inspections could also contribute to increased taxpayer compliance. Tanzania and Uganda, for instance, have succeeded in improving domestic revenue performance by strengthening tax administration.

Effective resource use

Achieving the MDGs will require not only higher spending but also more efficient spending. Improving budget systems of African countries is therefore critical. Weaknesses in these systems can undermine budgetary planning, execution, and reporting, and result in the squandering of scarce public resources. Expenditure-tracking surveys have pointed to substantial leakage of public funds in some countries—revealing, for example, that during 1991–95, less than 15 percent of the nonwage budgetary allocation for education in the central government budget actually reached the schools in Uganda. Similarly, other surveys point to leakage of about 60 percent in education spending in Zambia in 2002 and in Tanzania in 1999. In response, countries are taking strong action to address these weaknesses. By 2001, leakage of education funds in Uganda was reduced to only 18 percent. Nevertheless, public financial management systems remain weak in many low-income countries.

Countries can take a number of steps to strengthen their public financial management systems, such as ***putting in place an adequate and coherent accounting framework*** for tracking spending, enforcing accountability, and meeting fiduciary requirements; ***regular and timely fiscal reporting; and establishing a sound system of internal control*** to ensure that public expenditure is executed in accordance with the approved budget and the established regulatory framework.

Many countries also urgently need to ***develop effective audit procedures***. In addition, budget planning in many countries lacks a medium-term focus; only a few countries in sub-Saharan Africa have fully developed medium-term frameworks. And even in countries where such frameworks exist, they are often not well integrated with the budget or used for analytical purposes. These problems reflect both the complexity of developing these frameworks and the lack of adequate capacity, particularly in the line ministries. Countries should strive to ***develop medium-term frameworks in a phased manner consistent with improvements in local capacity***.

Maximizing the benefits

Domestic revenue levels in most sub-Saharan African countries remain low by international standards. Countries should intensify efforts to raise the tax-to-GDP ratios to at least 15 percent. Given the current levels of tax rates and increasing tax competition, however, further increases in tax rates—particularly on mobile production factors—are neither feasible nor desirable. Instead, broadening the tax base—including through bringing the informal sector into the tax net—is a more effective way of generating domestic revenue and has the advantage of improving the perceived equity of the tax system, which is a key consideration in many countries. These reforms should be complemented by measures to strengthen revenue administration.

Resources must also be managed efficiently so that the people of sub-Saharan Africa receive the maximum benefit. To this end, these countries must further strengthen institutions, in particular public financial management systems, which will cut down on waste and reduce the incidence of fund misappropriation by promoting transparency and enhancing governance. Countries should also develop appropriately sequenced reform plans for strengthening these systems, taking into account the local capacity to undertake the reforms. ■

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BACK TO **BASICS**

What Is Securitization?

Andreas Jobst

THE SUBPRIME mortgage crisis that began in 2007 has given the decades-old concept of securitization a bad name. Securitization is the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities.

Securitization got its start in the 1970s, when home mortgages were pooled by U.S. government-backed agencies. Starting in the 1980s, other income-producing assets began to be securitized, and in recent years the market has grown dramatically. In some markets, such as those for securities backed by risky subprime mortgages in the United States, the unexpected deterioration in the quality of some of the underlying assets undermined investor confidence. Both the scale and persistence of the attendant credit crisis seem to suggest that securitization—together with poor credit origination, inadequate valuation methods, and insufficient regulatory oversight—could severely hurt financial stability.

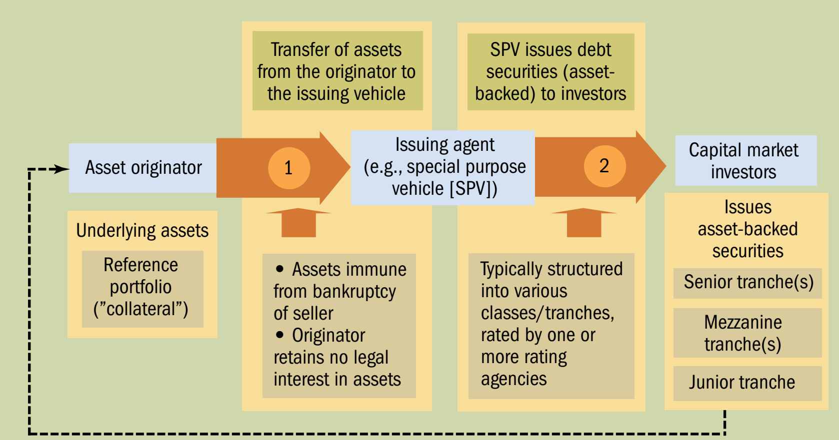
Increasing numbers of financial institutions employ securitization to transfer the credit risk of the assets they originate from their balance sheets to those of other financial institutions, such as banks, insurance companies, and hedge funds. They do it for a variety reasons. It is often cheaper to raise money through securitization, and securitized assets were then less costly for banks to hold because financial regulators had different standards for them than for the assets that underpinned them. In principle, this "originate and distribute" approach brought broad economic benefits too—spreading out credit exposures, thereby diffusing risk concentrations and reducing systemic vulnerabilities.

Until the subprime crisis unfolded, the impact of securitization appeared largely to be positive and benign. But securitization also has been indicted by some for compromising the incentives for originators to ensure minimum standards of prudent lending, risk management, and investment, at a time when low returns on conventional debt products, default rates below the historical experience, and the wide availability of hedging tools were encouraging investors to take more risk to achieve a higher yield. Many of the loans were not kept on the balance sheets of those who securitized them, perhaps encouraging originators to cut back on screening and monitoring borrowers, resulting possibly in a systematic deterioration of lending and collateral standards.

The securitization process

In its most basic form, the process involves two steps (see chart). In step one, a company with loans or other income-producing assets—the originator—identifies the assets it wants to remove from its balance sheet and pools them into what is called the reference portfolio. It then sells this asset pool to an issuer, such as a special purpose vehicle (SPV)—an entity set up, usually by a financial institution, specifically to purchase the assets and realize their off-balance-sheet treatment for legal and accounting purposes. In step two, the issuer finances the acquisition of the pooled assets by issuing tradable, interest-bearing securities that are sold to capital market investors. The investors receive fixed or floating rate payments from a trustee account funded by the cash flows generated by the reference portfolio. In most cases, the originator services the loans in the portfolio, collects payments from the original borrowers, and passes them on—less a servicing fee—directly to the SPV or the trustee. In essence,

How securitization works



securitization represents an alternative and diversified source of finance based on the transfer of credit risk (and possibly also interest rate and currency risk) from issuers to investors.

In a more recent refinement, the reference portfolio is divided into several slices, called tranches, each of which has a different level of risk associated with it and is sold separately. Both investment return (principal and interest repayment) and losses are allocated among the various tranches according to their seniority. The least risky tranche, for example, has first call on the income generated by the underlying assets, while the riskiest has last claim on that income. The conventional securitization structure assumes a three-tier security design—junior, mezzanine, and senior tranches. This structure concentrates expected portfolio losses in the junior, or first loss position, which is usually the smallest of the tranches but the one that bears most of the credit exposure and receives the highest return. There is little expectation of portfolio losses in senior tranches, which, because investors often finance their purchase by borrowing, are very sensitive to changes in underlying asset quality. It was this sensitivity that was the initial source of the problems in the subprime mortgage market last year. When repayment issues surfaced in the riskiest tranches, lack of confidence spread to holders of more senior tranches—causing panic among investors and a flight into safer assets, resulting in a fire sale of securitized debt.

Securitization was initially used to finance simple, self-liquidating assets such as mortgages. But any type of asset with a stable cash flow can in principle be structured into a reference portfolio that supports securitized debt. Securities can be backed not only by mortgages but by corporate and sovereign loans, consumer credit, project finance, lease/trade receivables, and individualized lending agreements. The generic name for such instruments is asset-backed securities (ABS), although securitization transactions backed by mortgage loans (residential or commercial) are called mortgage-backed securities. A variant is the collateralized debt obligation, which uses the same structuring technology as an ABS but includes a wider and more diverse range of assets.

The allure of securitizing

Securitization started as a way for financial institutions and corporations to find new sources of funding—either by moving assets off their balance sheets or by borrowing against them to refinance their origination at a fair market rate. It reduced their borrowing costs and, in the case of banks, lowered regulatory minimum capital requirements.

For example, suppose a leasing company needed to raise cash. Under standard procedures, the company would take out a loan or sell bonds. Its ability to do so, and the cost, would depend on its overall financial health and credit rating. If it could find buyers, it could sell some of the leases directly, effectively converting a future income stream to cash. The problem is that there is virtually no secondary market for individual leases. But by pooling those leases, the company can raise cash by selling the package to an issuer, which in turn converts the pool of leases into a tradable security.

Moreover, the assets are detached from the originator's balance sheet (and its credit rating), allowing issuers to raise funds to finance the purchase of assets more cheaply than would be possible on the strength of the originator's balance sheet alone. For instance, a company with an overall "B" rating with "AAA"-rated assets on its books might be able to raise funds at an "AAA" rather than "B" rating by securitizing those assets. Unlike conventional debt, securitization does not inflate a company's liabilities. Instead it produces funds for future investment without balance sheet growth.

Investors benefit from more than just a greater range of investible assets made available through securitization. The flexibility of securitization transactions also helps issuers tailor the risk-return properties of tranches to the risk tolerance of investors. For instance, pension funds and other collective investment schemes require a diverse range of highly rated long-term fixed-income investments beyond what the public debt issuance by governments can provide. If securitized debt is traded, investors can quickly adjust their individual exposure to credit-sensitive assets in response to changes in personal risk sensitivity, market sentiment, and consumption preferences at low transaction cost.

Sometimes the originators do not sell the securities outright to the issuer (called "true sale securitization") but instead sell only the credit risk associated with the assets without the transfer of legal title ("synthetic securitization"). Synthetic securitization helps issuers exploit price differences between the acquired (and often illiquid) assets and the price investors are willing to pay for them (if diversified in a greater pool of assets).

Growth of securitization

The landscape of securitization has changed dramatically in the last decade. No longer is it wed to traditional assets with specific terms such as mortgages, bank loans, or consumer loans (called self-liquidating assets). Improved modeling and risk quantification as well as greater data availability have encouraged issuers to consider a wider variety of asset types, including home equity loans, lease receivables, and small business loans, to name a few. Although most issuance is concentrated in mature markets, securitization has also registered significant growth in emerging markets, where large and highly rated corporate entities and banks have used securitization to turn future cash flow from hard-currency export receivables or remittances into current cash.

In the future, securitized products are likely to become simpler. After years of posting virtually no capital reserves against highly rated securitized debt, issuers will soon be faced with regulatory changes that will require higher capital charges and more comprehensive valuation. Reviving securitization transactions and restoring investor confidence might also require issuers to retain interest in the performance of securitized assets at each level of seniority, not just the junior tranche. ■

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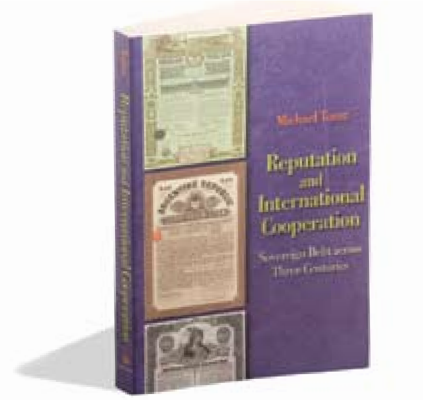
Debt default and history



Michael Tomz

Reputation and International Cooperation

Sovereign Debt across Three Centuries

Princeton University Press, 2007, 328 pp., $22.95 (paper).

READERS interested in gaining a better long-run appreciation of the history of sovereign debt default are sure to learn a great deal from Michael Tomz's *Reputation and International Cooperation.*

The first chapter provides an overview of different ways of thinking about the vexing problems of sovereign debt—why countries default, why some default repeatedly, and what leads debtors to repay. Chapter 2 lays out the basics of what Tomz calls a dynamic reputation model, which, he argues, helps to explain the behavior of both debtors and creditors. In his model, which is largely descriptive rather than mathematical, governments have heterogeneous preferences and types of borrowers are not fully revealed to market participants. Hence, creditors form beliefs about borrowers, update these beliefs over time, and use a borrower's reputation to discern whether they should lend and at what rate they should lend. He provides a convenient way of describing the reputation of borrowers at a given point in time—as "stalwarts" (those who always pay), "fair-weather" (those who pay in good times but not always in bad times), and "lemons" (those who don't pay in bad times and sometimes default in good times as well)—and uses this classification to understand the predictions of his model versus other models.

The rest of the book carries out a variety of empirical tests using some impressive, new historical data sets to convince readers that the author's dynamic model of reputation fits the data from three centuries of sovereign lending and borrowing. For a book that focuses mostly on the past rather than on the present, it is somewhat surprising that the narrative, at times, lacks historical nuance. The book paints a picture of history that is stark and always consistent with reputational theory. As a result, it sometimes ignores or understates the importance of historical evidence and data that don't fit the model's predictions and perhaps better fit other models.

These weaknesses are most visible in Chapter 6. Tomz argues that government interventions on behalf of creditors were rare during 1820–1913 and thus not important for regulating debt default. First, he only considers militarized interventions. Turkey (Ottoman Empire), Greece, Egypt, Tunis, Serbia, and Liberia are examples of 19th-century sovereign borrowers that ceded fiscal authority (and hence autonomy) to governments of unhappy creditors after they defaulted on their debt. These interventions—a type of heavy-handed sanctions—were available to creditor governments during the late 19th and early 20th centuries. By omitting these, Tomz understates the overall use of interventions, giving readers the impression that sanctions were too infrequent to have been useful for regulating debt default in the 19th century, and that the timing of default does not coincide with the use of sanctions.

Second, by including the period 1820–69 in his analysis of militarized interventions, Tomz underestimates the effectiveness of sanctions as an enforcement mechanism. Sovereign borrowing during the early part of the 19th century was rife with informational problems, making it difficult to assess why countries defaulted. Governments were likely unwilling to carry out militarized interventions or other forms of heavy-handed sanctions because they were unable to assess why countries went into default; it was simply too politically costly to "go gunning" without sufficient information. However, by the second half of the 19th century, the political economy of international finance had changed considerably. During this age of high imperialism, governments began a race to acquire new colonies and mark certain areas of the world as under their "stewardship." One consequence of this was that finance during this period became linked to strategic considerations. It might not be surprising, then, to find evidence that heavy-handed sanctions were widely used when countries went into default during 1870–1913; indeed, there was a roughly one-in-three chance that a foreign power would impose heavy-handed sanctions.

Finally, in his analysis, Tomz defines militarized interventions as episodes during which a country used force, displayed force, or directly threatened another country. By this definition, Tomz's analysis underestimates the true effect of sanctions on debtor behavior because it excludes the effects of *perceived* threats of force on sovereign debtors. Historical evidence suggests that sovereign borrowers avoided default or taking on more debt for fear of reprisal by creditor governments. For example, during the Baring Crisis of the 1890s (the largest debt default of the 19th century), the threat of foreign intervention entered into Argentina's decision to settle with creditors, and Brazil opted to reschedule its debts during this period partly because it feared that, if it did not repay, its sovereignty would be in serious jeopardy. Brazil's behavior also suggests that the perceived threat of heavy-handed

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sanctions led many countries to avoid default even when times were tough. It is thus entirely plausible that the other parts of Tomz's study, which seeks to bolster the reputational theory by comparing the performance of debt repayment of sovereigns in good times and bad times, suffer from an observational equivalence problem. Tomz argues countries continue to pay "even in bad times" in order to improve their reputation, but Brazil's response during the Baring Crisis suggests that some countries might have repaid in "bad times" out of fear of being sanctioned.

Perhaps an even clearer example of why creditors repaid in earlier periods is the response of Central American borrowers to the U.S. government's announcement of the Roosevelt Corollary to the Monroe Doctrine in 1904. According to this pronouncement, if a nation in the Western hemisphere maintained its financial obligations, it need not have feared U.S. intervention, but if did not live up to its financial obligations, the United States would enforce claims by acting as an "international police power."

The U.S. government lent credibility to this policy pronouncement by sending gunboats to Santo Domingo in 1905 and taking over customs collection to pay foreign creditors after Santo Domingo defaulted on its external debt and European powers threatened to intervene. Creditors believed the United States might intervene elsewhere and, in response, bid up sovereign debt prices for Central American and the Caribbean countries by 74 percent in the London market in the year following the announcement of the new policy. The effects of U.S. intervention in Santo Domingo had a profound effect on debtor behavior. Countries in the region, which collectively had been in default for 140 combined years until this point, reached agreements with bondholders and were able to issue new debt on European capital markets.

As policymakers and historians are well aware, the world of sovereign lending is messy: why countries default and then choose whether to repay is likely a function of many factors. As this book makes clear, reputation surely matters; but other factors, such as sanctions, have played an important and perhaps leading role during certain periods of history. In arguing for the primacy of reputational theory to explain sovereign borrowing over the past three centuries and dismissing the possibility that particular periods of history may be better explained by alternative models, Tomz undercuts his otherwise careful historical analysis.

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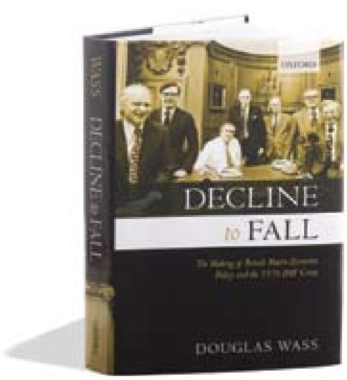
Santa Clara University and National Bureau of Economic Research

Unhappy memories



Douglas Wass

Decline to Fall

The Making of British Macro-Economic Policy and the 1976 IMF Crisis

Oxford University Press, 2008, 399 pp., £55 (cloth).

THE IMF's 1977 Stand-By Arrangement with the United Kingdom was a big deal, for the IMF as well as for Britain. For the IMF, the loan that it made available to the United Kingdom—still then the country with the second-largest quota—stood for some years as its largest. The arrangement was also one of the IMF's last with an industrial country. For the United Kingdom, as argued in *Decline to Fall*, the IMF—through the arrangement—"played a crucial role" in the resolution of the crisis that had erupted in 1976.

The story of the United Kingdom's 1977 IMF-supported program has been told before, including in the IMF's official history and British ministers' memoirs. The main novelty of this book is that it is based largely on recently released official British documents. And who better to have as a guide to those documents than Sir Douglas Wass who, as Permanent Secretary to H.M. Treasury, was the leading British official in the negotiations with the IMF? (He had earlier been the United Kingdom's Alternate Executive Director at the IMF, in the period leading up to the country's 1967 IMF-supported program.)

Wass uses the documents now available to provide a detailed history of the making of U.K. macroeconomic policy in the period 1974–76 that led up to the IMF-backed arrangement. He tells the story year by year, under the headings of the major policy issues (public expenditure, the exchange rate, and so on), and he tells it memorandum by memorandum and meeting by meeting. This account alone will make the book essential for students of this episode. But the study is also interesting for its review of the conduct and evolution of U.K. macroeconomic policy in the mid-1970s, and for the author's thoughtful and critical assessment of policymaking then, and especially of the work of the Treasury.

In the early 1970s, the United Kingdom's policy framework was unlike it is today. Fiscal policy was the main tool used to regulate demand, with the principal aim of maintaining full employment, and monetary policy was supplementary to fiscal policy. Inflation was seen mainly as a cost-push process: dampening it through demand measures, certainly from the 10 percent a year level it had reached in early 1974, "would take a very long time and require substantial unemployment," which was judged unacceptable. The main instrument to combat inflation was wages policy. Wass observes, strikingly, that the Bank of England was therefore not much involved in controlling inflation. The central bank was not independent, and changes in official interest rates were constrained politically as well as by concerns about financial fragility. The pound sterling had been floating, in a managed way, only since 1972.

In late 1973 and early 1974, this framework, already strained by inflationary pressure, was subjected to two traumas—the first oil shock, and the collapse of the incomes policy of the Conservative government as a result of strikes and an election that brought a new (Labour) government to power. Wass sees the origins of the 1976 crisis here, and in the commitments and policies of the new administration.

In 1974 and early 1975, with incomes policy having been delegated to the trade unions, wages accelerated and annual price inflation rose to about 25 percent. The fiscal deficit burgeoned, partly owing to indirect tax cuts intended to reduce inflation by promoting wage restraint, but also because public spending was planned on the basis of "wildly optimistic" assumptions about economic growth. Wass views these assumptions as a major failing of the Treasury in the run-up to the crisis, though at the time disappointing growth performance was hardly unique to the United Kingdom. Externally, official borrowing, facilitated by the increased surpluses of the oil producers, contributed to relative stability of the exchange rate while the current account deficit widened and international competitiveness deteriorated. There was here a "confusion of attitudes" toward exchange rate policy among officials—another Treasury failing.

Wass describes how, during 1975, important policy corrections were made. With the fiscal deficit rising toward 10 percent of GDP, increased attention was paid to its financial implications. Wass sees here a turning point in the conduct of U.K. fiscal policy: conventional "Keynesian" demand effects "no longer held centre-stage," and action was taken to reduce the deficit even in the face of a weak economy. There were also important reforms to the system of budgetary control, which were to begin bearing fruit in 1976. In addition, in mid-1975, the trade unions began to enforce a "norm" for pay increases that was below recent price inflation. Wass describes this as a "watershed" in the control of inflation, albeit with a significant cost in the leverage it gave the trade unions over other elements of policy.

In early 1976, the outlook was not entirely gloomy. With regard to external financing, a Treasury memo advised that "we ought to be able to get through 1976 very comfortably." This proved far too optimistic. Already in 1975 there had been bouts of pressure on sterling; and late that year, the United Kingdom had drawn on the IMF to the extent that it could without substantial conditionality. During 1976, the pressure increased as official holders of sterling balances diversified their portfolios. Fiscal measures failed to stem the tide, and at the end of September, the United Kingdom applied to the IMF for a new Stand-By Arrangement, which would involve more demanding conditionality. Dramatically, this was amid renewed pressure on sterling that stopped the Chancellor of the Exchequer from flying to the IMF–World Bank Annual Meetings in Manila.

In the subsequent discussions between U.K. and IMF officials, the main issues were fiscal adjustment and the exchange rate. Particularly on fiscal adjustment, according to Wass, it became clear in the technical discussions that "there could be no meeting of minds on the logic," because the British officials viewed the IMF's financial programming approach as inapplicable to their economy. The officials were skeptical about the basis for targets for monetary growth, and about the assumed links between the fiscal balance and domestic credit expansion in an economy with an advanced financial system. However, the IMF had more of a meeting of minds with Chancellor Denis Healey, who agreed that monetary expansion on existing fiscal policies was likely to fuel inflation, although he disputed the scale of the adjustment that the IMF sought. Differences were eventually narrowed, partly by the IMF's agreeing to the authorities' commitment to fiscal measures to be taken only if growth in the second year of the program exceeded a certain rate.

Wass describes the agreement as a "huge personal achievement" for Healey and also for Alan Whittome, the leader of the IMF team. Announcement of the agreement quickly had an "extraordinarily favorable" effect on sterling, permitting the reserves to be replenished and interest rates to be reduced. The United Kingdom needed to make only two drawings on the IMF, out of the eight allowed, and it soon began repaying. Wass observes that the crisis was resolved before any of the measures agreed with the IMF had taken effect: the turnaround was a matter of confidence. Subsequent data showed that public spending had been contained, thanks to earlier measures, especially the 1975 reforms, and that the program's public spending cuts amounted, inadvertently, to "overkill." They were largely cancelled during 1977, without damage to the U.K.'s overall fiscal commitments under the program. In Wass's view, therefore, the spending cuts agreed in the program were important mainly as "totemic gestures" to the markets whose sentiment they transformed.

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Argentina: A Tanzi chronicle

Vito Tanzi

Argentina: An Economic Chronicle

How One of the Richest Countries in the World Lost Its Wealth

Jorge Pinto Books, New York, 2007, 164 pp., $19.95 (paper).

VITO TANZI, the former longtime Director of the IMF's Fiscal Affairs Department, knows Argentina well. Over the past four decades, he traveled to Argentina about thirty times and lived there for a combined period of more than one year. This book is a history of Argentina from the perspective of his periodic visits and contacts. Although Tanzi focuses on the economic and fiscal problems of Argentina, the span of his book is broad.

Argentina: An Economic Chronicle is a thoroughly enjoyable memoir, with stories of encounters with presidents and ministers, artists and intellectuals, politicians and journalists, and taxi drivers and Italian immigrants. It collects the impressions—over four decades—of a European visitor to Argentina, as he tries to decipher the national culture and history, reflects on the fate of the many Italian immigrants to that land, describes places of stunning natural beauty (it was not all work and no fun after all), and relates the (inevitable) experiences of the frequent international traveler, including strikes, scary flights, and food poisoning.

Tanzi must also be fond of Argentina because it served to inspire the "Tanzi effect." (In Argentina, this is often called the "Olivera effect," in honor of Professor Julio Olivera of the Universidad de Buenos Aires, who also wrote about fiscal lags at about the same time.) The Tanzi effect explains that the real value of tax revenues falls in high inflation, as a consequence of the usual time lags in the collection of taxes—for example, between the moment when income is earned and when income tax is paid. With high inflation, this lag implies that by the time the government receives the money, its purchasing power has already depreciated, and the money will not go as far in purchasing goods or paying salaries (that often become indexed to inflation faster than taxes). At moderate rates of inflation, the Tanzi effect is negligible; at triple-digit rates and higher, it can be devastating. Argentina has, unfortunately, been the perfect subject for Tanzi's observations and estimates of the fiscal lags' effect.

Although the book is not technical, and does not contain charts or equations, Tanzi makes a serious attempt to explain the inexplicable secular economic decline of Argentina. One hundred years ago, he notes, Argentina's exports accounted for 7 percent of world exports, and its per capita GDP was higher than France's and twice as large as Italy's. The economic history of Argentina is a history of un-development. What caused this economic tragedy? Fiscal mismanagement, pure and simple, is Tanzi's answer. Since the Peronist regime started to create an overextended welfare state in the 1940s, the country became unable to balance the fiscal accounts ever again. This resulted in decades of persistent inflation, punctuated by devastating hyperinflation episodes, because the central bank was the ultimate source of finance for the fiscal disequilibrium. When, in 1991, Argentina adopted a currency regime that precluded central bank financing of the government deficit and effectively eliminated inflation, the fiscal imbalance resulted in an explosive accumulation of government debt, which ended in a notorious sovereign bond default by end-2001. This is where the book may prove especially controversial. Tanzi thinks that the IMF lending to Argentina during the 1990s was largely responsible for the debt accumulation that resulted in the financial crisis. Whatever one thinks of the IMF's advice to Argentina at the time, which in fact was much more nuanced than commonly thought, this does not change the fact that global private markets were anxious to lend almost unlimited amounts to Argentina at the time. Granted that markets charged a higher interest rate than the IMF, but would this detail have stopped the borrowing and spending?

But what has been the ultimate cause of the secular impossibility to balance the books of the state? Many have blamed a famously abysmal taxpayer compliance. Taking off from the joke that "Argentines are Italians who speak Spanish and think that they are British," Rudi Dornbusch commented that the "problem of Argentina is that the unions are British but the taxpayers are Italian." But culture alone does not explain poor taxpayer compliance. A system with huge tax rates and almost no compliance enforcement can destroy taxpayer culture, even in Finland. In fact, tax revenues have increased significantly over time, and at least part of the credit goes to the recommendations of an IMF mission that Tanzi headed in 1989, along with the 1990s' high growth rates and falling inflation (the other side of the coin of the Tanzi effect). Unfortunately, government spending grew more or less in line with tax revenues, and the fiscal disequilibrium did not close. Tanzi says that Argentina is "a society that over the long run wanted a level of public spending larger than what it was prepared or able to finance (through taxes or other ordinary revenues)." But why? Argentina's inexplicable decline is still unexplained.

Eduardo Borensztein
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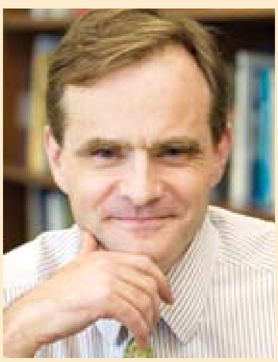
STRAIGHT TALK

Emerging Markets Emerge

Emerging markets are now a key determinant of global growth. This is good news—and a potential problem



Simon Johnson is the outgoing Economic Counsellor and Director of the IMF's Research Department.

TWENTY years ago, "emerging markets" was the label for countries that were just starting to interest a broader class of investors worldwide. These countries were perceived as having strong (but unrealized) prospects while being somewhat peripheral to the main functioning of the global economy. Ten years ago, many of these emerging markets faced major crises. They had clearly become big enough to shake the financial world, at least in some disturbing moments in 1997–98. The label "emerging markets" meant instability, or at least some form of volatility.

Today, emerging markets—or, perhaps more descriptively, middle-income countries—have emerged as a major determinant of global prosperity. Over the past five years, these countries have accounted for between one-quarter and one-half of global growth (depending on how it is measured). They have also weathered the recent global financial disturbance well and, through growing financial and trade linkages, have helped keep advanced economies from slowing down. And, now, the way emerging markets handle the latest round of inflation challenges will have profound effects on growth and inflation around the world.

How did emerging markets become so economically influential? What are the implications? And—from a global macroeconomic perspective—are there potential future costs, as well as benefits?

What happened?

Remember that there have always been a lot of people living outside what we call the developed countries. Of today's roughly 6 and a half billion people, only about 1 billion live in relatively rich countries. But for a long time, for various reasons (related to colonialism, communism, and common policy mistakes) most of the world's poor countries experienced relatively little economic growth.

This began to change in the 1960s as a range of developing countries put in place economic policies that produced growth, and the world economy experienced a sustained boom. Many fast-growing developing countries experienced serious bumps, or even the derailing of growth, in the 1970s and 1980s; in fact, this is when the IMF seriously entered the business of lending to emerging markets. The 1980s were for some countries—particularly in Latin America—a "lost decade," with little growth.

Relatively few countries have sustained high rates of growth since the early 1960s—probably no more than a dozen. But by the early to mid-1990s, many more governments had figured out how to run their economies with sustainable budget deficits (or even surpluses), moderate inflation, and avoid overvaluation of their exchange rates. Also, some countries moved to adopt better institutions, either bringing more political stability or a better environment for investment, or both.

The last crisis

Just when things seemed finally to be going well for emerging markets, many or even most of them were hit by a major crisis in the late 1990s. Some of the most affected countries were in Asia, which had escaped the problems of the earlier decades; as well as some countries in Latin America, which had experienced repeated problems since 1980. More broadly, any emerging market that had borrowed capital (for the private or the public sector) was vulnerable.

This time there was a rapid bounceback, sound economic policies quickly prevailed, and existing debt levels turned out not to put a brake on growth. Again, emerging market policymakers learned some important lessons. Many of them took the view that their countries should carry more foreign exchange reserves, particularly as they opened up to financial flows of all kinds. It is increasingly hard to avoid substantial financial flows when things go well, and this was an understandable view to take.

Some policymakers also took the view that exchange rates should err more on the side of being undervalued. Whether this was ultimately such a good idea remains to be seen, but there is no question that it contributed to at least half a decade of strong growth across a wide range of emerging markets.

Role reversal

Emerging markets have grown fast during the past 10 years. They have sustained this growth, in the face of substantial financial turbulence in advanced economies during the past 12 months, for three main reasons.

First, although emerging markets are highly connected to the world in terms of goods flows, they are not (yet) fully connected in terms of financial flows. The banks in emerging market countries perhaps became more cautious after the problems of the 1990s. Or perhaps they just had better opportunities at home. In any case, emerging markets were generally not exposed to any significant degree to the problems in U.S. subprime mortgages or associated financial instruments.

Second, emerging markets have continued to maintain sound economic polices. Unlike during some previous booms, they did not throw fiscal caution to the wind. And problematic behaviors, such as various forms of rent-seeking or corruption, seem to have been controlled much more effectively in this boom compared with past booms.

Third, global trade remains strong and so-called south-south trade (not involving advanced economies) has proved resilient. Countries understand that throwing up trade barriers should be avoided at all costs. The global trading rules have held up so far under considerable pressure. This has been of great benefit to emerging markets.

As a result, over the past year, it is emerging markets that have played a relatively stabilizing role, helping to offset repeated waves of financial concern (and even capital flight from entire classes of securities) in advanced economies. This is a reversal of the usual roles; it is also the first time in recorded history that emerging markets have played such a role.

For whom the bell tolls

No good deed goes unpunished, and the same is true for economic policies. It is precisely the resilience of emerging markets that now underpins high commodity prices, including for energy, food, and industrial inputs. This adds an inflationary shock to the mix facing all countries.

This inflationary shock comes at the same time as, and in spite of, a slowdown in the United States and in some other advanced economies. Again, this is a great reversal compared with the past 20 years, during which time low prices for manufactured goods helped keep down inflation in developed countries. Now the effect of emerging market prosperity is to increase prices in advanced economies, rather than decrease them. Also, energy intensity has declined, and food comprises a relatively small share of consumer expenditures in advanced economies.

Avoiding stagflation

There are many good reasons to believe that developed countries can avoid the slowdown in growth and acceleration of inflation that plagued the 1970s. Their economies (and real wages) have become more flexible, and they are able to adjust in the face of higher energy prices. Monetary policy has established greater credibility, and central banks are more focused on controlling inflation, communicating their intentions, and moderating expectations. Exchange rate flexibility, though sometimes a mixed blessing, in general makes it easier to manage the macroeconomy of rich countries.

On all these dimensions, emerging markets are more vulnerable. They may not face stagflation per se—this will depend on their policy responses. But they are certainly at risk of higher inflation. Price expectations in many of these countries are not well measured, and this means it is hard to know if they are still, in central bank parlance, "anchored."

Some emerging market countries have adopted forms of inflation targeting, in which they explicitly say what they want inflation to be and then back that up by tightening monetary policy as needed—preferably moving early and decisively, rather than waiting until inflation is higher and bigger interest rate moves are required. At the very least, the latest round of commodity price increases is a test for central banks in emerging markets. Many of these banks have become independent over the past two decades. But how much of a difference this will make, we are about to find out.

And then there is exchange rate policy. This is an Achilles' heel for some emerging markets: if you tie your exchange rate to the U.S. dollar (the most common form of peg) and you are reasonably open to capital flows, then your interest rates will be roughly those of the United States. Think this through: the U.S. Federal Reserve has cut interest rates substantially over the past year, to help the U.S. economy as it struggles with problems in the housing market, and the U.S. policy rate is now at 2 percent. But this is also the interest rate in emerging markets whose currencies are pegged to the dollar. In other words, these emerging markets have eased their monetary policies at the same time as their economies have continued to grow fast—for oil producers, actually faster. This is not a good idea.

The crisis next time?

The emerging market crises of the 1980s were about high levels of public external debt, unsustainable budget deficits, and, in some instances, borderline hyperinflation. The crises of the 1990s and early 2000s were more about private sector borrowing and vulnerabilities created through large current account deficits. Of course, there can always be a crisis of an "old" type; for example, through financing a current account deficit with private capital inflows, and then finding out suddenly that the private investors want to go home. But if there is a new kind of potential crisis lurking for emerging markets, what would that look like?

Most likely it would be centered again on a failure to control inflation, except through raising interest rates late and in dramatic fashion. This might coincide with a broader global slowdown that would affect trade. The danger is that emerging markets could now be perfectly positioned for negative experiences very much akin to those seen in richer countries during the 1970s. Luckily, drastic negative outcomes are avoidable, particularly if key emerging markets act quickly to slow down their economies and—most important—move to allow more exchange flexibility, which will allow them to run independent monetary policies appropriate for their own conditions. ■

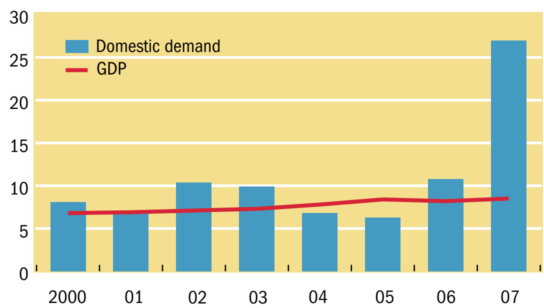
COUNTRY FOCUS

Vietnam

Greater integration with the global economy enabled Vietnam to grow rapidly, but also brought massive capital inflows, which fueled a credit boom that has led to overheating of the economy.

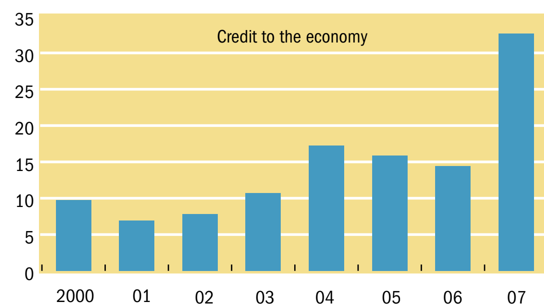
Vietnam's economic development has been impressive, but domestic demand has begun to outpace real GDP growth by a wide margin.

(1994 prices, percent change)



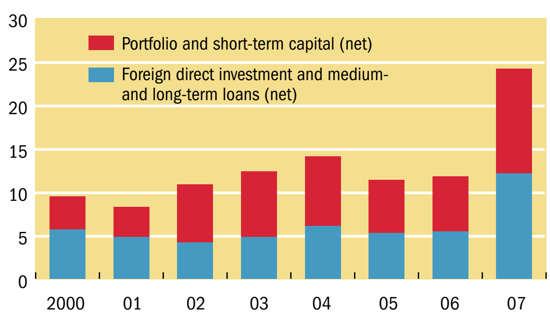
Domestic demand was fueled by a rapid increase in credit to the economy . . .

(percent of GDP)



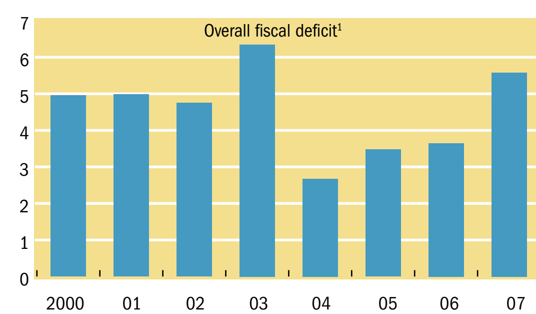
. . . which stemmed from unprecedented capital inflows—notably portfolio investments.

(percent of GDP)



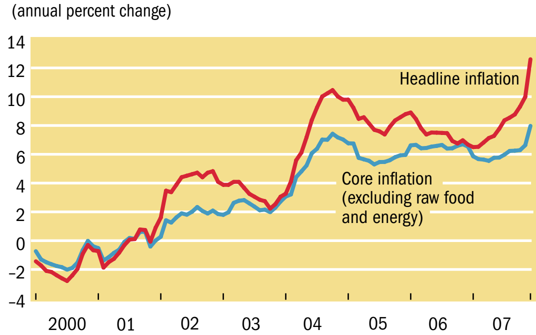
The growing fiscal deficit also added to domestic demand pressures.

(percent of GDP)



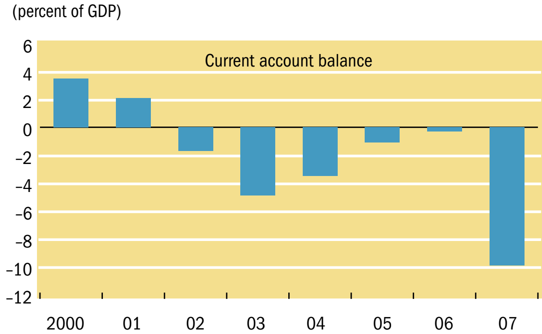
Inflation rose sharply due to the combination of rising commodity prices and domestic demand pressures.

(annual percent change)



The current account deficit has widened significantly because of rapid import growth.

(percent of GDP)



Sources: Vietnamese authorities; and IMF staff estimates.
[1]Includes off-budget operations.

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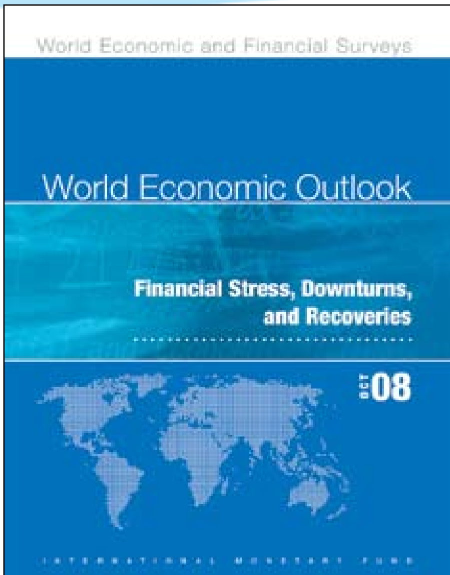

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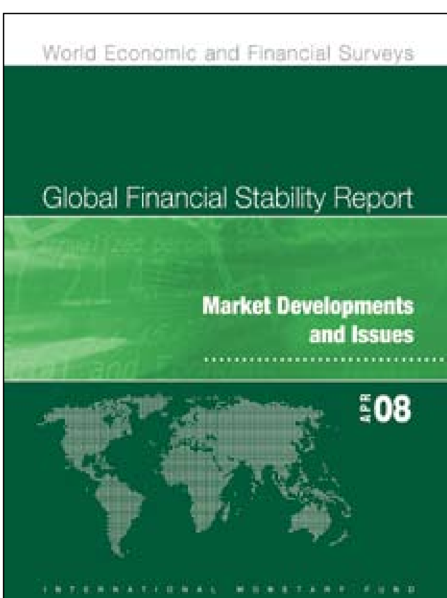

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