REPORT ON THE NEW FACE OF THE IMF

Center for Economic Analyses (CEA)

Skopje
November, 2007

Disclaimer: Opinions expressed in this report are those of the Center for Economic Analyses and do not represent the opinion of the USAID or any other concerned institutions.
It is the responsibility of other authors to cite this report when it has informed their research and publications.

Center for Economic Analyses

Table of Contents

CEA
Center for Economic Analyses

General information about CEA

Logo:

CEA
Center for Economic Analyses

Address:

CENTER FOR ECONOMIC ANALYSES (CEA)
Bul. Jane Sandanski 63/3,
1000 Skopje Macedonia

Tel: + 389 (0)2 24 44 766
Mob: + 389 70 834 636

TIN: 4030003479278
Reg. 5763061

Account number:

Stopanska Banka AD Skopje
Account number: 200000856268559

Web page and e-mail:

www.cea.org.mk

www.lsg-data.org.mk

info@cea.org.mk

EXECUTIVE SUMMARY

The idea for this report was the seminar for civil society organizations organized by the IMF at the JVI in cooperation with the Stability Pact for South Eastern Europe took place in Vienna at October 31 – November 2, 2007. Mr. Mico Apostolov attended the seminar as a CEA member and he has prepared a report upon which this report to USAID was prepared.

The seminar was organized on the bases of the constant effort of IMF to introduce as much as possible transparency into its work with the wider sector of the civil society. The Civil Society Organizations (CSOs) are in the core and in fact shape the civil society. Thus, it is a perfect target group for transmission of the already achieved, the present engagements and the future projects and intentions of IMF.

The quality of presented / learned was at the highest level, knowing that all of the presenters are key decision-makers and policy-creators for IMF and the region of Southeast Europe. Hence, the output was of importance, setting up the foundations of the current macroeconomic policies and giving indicators that are important milestones for national governments and CSOs in their day-to-day work.

In a conclusion, it is evident that the overall macroeconomic parameters of the Southeast Europe show that this region is in phase of rapid convergence and the national economies will continue to grow rapidly, as expected, in the years to follow. Although second-generation (structural and institutional) reforms are underway in Southeastern European economies, the unprecedented levels and large variations of external imbalances occupy relatively high positions on the policymakers agenda. Widening external imbalances reflect either rapid capital formation or private consumption booms, but there are country-specific thresholds beyond which market participants are unwilling to finance these deficits.

Even if the growth potential of these economies justifies the large and persistent deficits, in case of sudden shift in the market sentiment, the inevitable adjustment could have devastating macroeconomic implications. The ensuing reduction of current account deficits could lead to a slowdown in medium term growth and reduction of long run per capita income. Hence, despite the strengthened macroeconomic management, SEE economies must continue their cooperation with the Fund, particularly in terms of regular surveillance of macroeconomic and financial market developments.

This report was prepared under the contract provisions signed between CEA and USAID for nonexclusive services to USAID as part of a grant agreement.

This document will be published on the CEA web site 10 working days after submission to USAID (http://www.cea.org.mk).

The report has been prepared by Mico Apostolov – CEA member, Marjan Nikolov President of CEA, and Aleksandar Stojkov Board Member of CEA.

BACKGROUND

IMF is an organization established 1945 and its mission is to keep the health of the world economy through a global institutional framework and to promote global economic growth and economic stability. It is an organization with a bit less than 3000 employees from around 140 countries.

On the bases of constant efforts to reach and further develop positive relationships with civil society organizations (CSOs), the IMF organized this seminar on macroeconomic policy. Thus, it was the goal of IMF to offer a framework of experience and expertise for these organizations i.e. to improve the understanding of macroeconomic policies that the countries introduce in close cooperation with the IMF.

The usual critics to the IMF are that it is non democratic institution. Out of 183 member countries, 159 countries[1] are developing countries and only 24 (15%) are developed countries and in accordance with the quota system the developed countries have inproportionately higher voting power.

Through this seminar the IMF gave the overall scope of its activity and focused closely on the aims of the IMF when supporting with CSOs. Firstly, an accent was given to public outreach, then to policy inputs i.e. the information generated form the nongovernmental sources. Therefore, it was important for IMF to aim at political viability, which is important to measure *pro et contra* IMF-supported policies. And finally, the last aim was to mobilize political support and national ownership of IMF-supported adjustment programs.

Furthermore, the course concentrated on the so-called ‘Government-IMF-CSO Triangle’. Hence, the transparency of IMF (as it is accountable to the member governments) is crucial in building the relationships and making them work. There are several steps needed to achieve such commitment:

- Keep the initiative with government, whose responsibility it is to engage CSOs;
- Handle links with CSOs in ways that do not alienate government;
- If a government raises objections to IMF-CSO relations, explain the rationale in terms of the aims identified above;
- Where a government is sensitive about IMF engagement with CSOs, a closer dialogue with the government and CSOs is needed.

OVERVIEW OF THE IMF AND ITS OPERATIONS

Jenny Bisping,
IMF External Relations Department

The conference commenced with a presentation delivered by Ms. Jenny Bisping coming from the IMF External Relations Department, with the introduction of the IMF’s creation, mandate and structure. Consequently, a short outlook was given to the

[1] 2002 data.

IMF's main activities, such as, surveillance, technical assistance, lending and assistance to low-income countries. The presenter gave more meaning to the so-called accountability and the possible ways of spreading it through transparency of the overall IMF structure and stuff.

Some important figures about the IMF's work were presented, but the most significant were the IMF lending positions in the world. The key features that determine the IMF's landing are as fallows: 1. general, temporary - balance of payments supports; 2. access limits – depending on size of quota and crisis; 3. conditionality - safeguards of fund resources; 4. charges - rate of charge - market-related.

INSIDE THE IMF: DECISION MAKING AND TRANSPARENCY AT THE IMF

Age F.P. Bakker,

Executive Director for Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Macedonia, Moldova, Netherlands, Romania, and Ukraine

It was an excellent occasion to have the Executive Director that represents Macedonia [with the other countries in the group of Netherlands] in the Board of IMF and to closely get to know the possible ways that shape the decision-making process within the core structure of the IMF.

His presentation was comprised of few decisive points that explained the composition of the Board of Executive Directors of IMF, as well as, the main roles of the Execuitive Director while representing the group. In addition, he explained the quota based participation in the capital of the IMF, the voting powers and the ways to swing the decision-making process. In fact, the quota is determined by a formula that shows the function of a country's GDP, foreign reserves, trade openness, and export variability.

However, Mr. Age F.P. Bakker underlined that at the present time the Fund considers introduction of new formula in order to increase the representation of fast growing economies, many of which are emerging market economies, and low-income countries. Thus, a needed consensus of this issue has to be achieved within the internal negotiation process of the Board.

According to Mr. Age F.P. Bakker's presentation the core mandate and operations of IMF and hence objectives are:

1. To promote international monetary cooperation, exchange stability, and orderly exchange arrangements;
2. Foster economic growth and high levels of employment;
3. Provide temporary financial assistance to countries to help ease balance of payments adjustment.

Nonetheless, the IMF through all these years of existence has managed to preserve these objectives, cunningly adopting itself to the newly aroused satiations, solutions and problems.

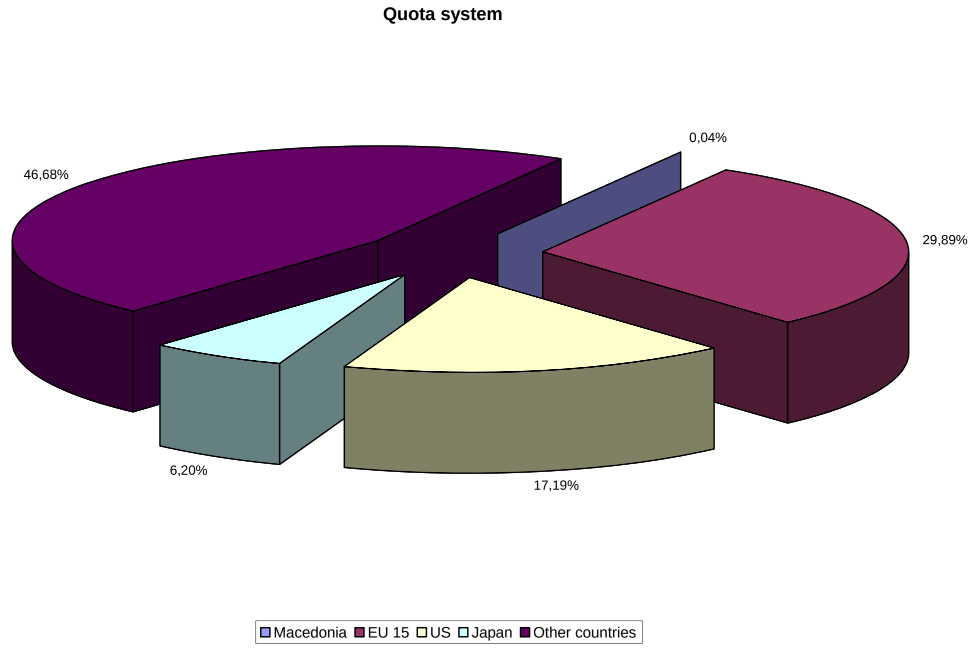


Figure 1. IMF quota system

CEA comment: The IMF is not transparent in choosing its President and there is no procedure for that as well.

ECONOMIC OUTLOOK FOR EMERGING EUROPE: DELIVERING THE PROMISE OF CONVERGENCE

Luc Everaert
Division Chief, Regional Studies Division
European Department, IMF

According to the findings of Mr. Luc Everaert the growth of Southeastern Europe has been rapid, reflecting real convergence with the Western advanced economies. The inflation has been put under control. However, the most important challenge is the continuity of this high growth and convergence, as well as, creating new jobs and benefits.

The biggest concerns fell on the external account imbalances with high external debt which are unsustainable. Yet, the region’s outlook remains favorable.

The following chart shows some essential parameters, with prediction for the years 2007 and 2008:

SEE Selected economic indicators, 2006-08

	Real GDP growth			CPI inflation			Current Account Balance/GDP			General Government Balance/GDP		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
Europe	3.8	**3.6**	**3.1**	3.5	**3.3**	**3.1**	0.4	**-0.1**	**-0.5**	-0.4	**-0.2**	**-0.5**
Advanced European economies	2.9	**2.7**	**2.2**	2.2	**2.0**	**2.0**	0.5	**0.2**	**0.0**	-1.2	**-0.8**	**-0.8**
Emerging European economies	6.6	**6.3**	**5.7**	7.2	**6.8**	**6.0**	0.1	**-1.9**	**-2.9**	2.0	**1.2**	**0.6**
Albania	5.0	**6.0**	**6.0**	2.4	**2.5**	**3.3**	-5.9	**-7.4**	**-6.5**	-3.2	**-3.9**	**-3.9**
Bosnia & Herzegovina	6.0	**5.8**	**6.5**	7.5	**2.5**	**1.9**	-11.5	**-15.3**	**-15.0**	3.0	**-0.5**	**-0.9**
Bulgaria	6.1	**6.0**	**5.9**	7.3	**8.2**	**7.9**	-15.8	**-20.3**	**-19.0**	3.5	**3.0**	**2.5**
Croatia	4.8	**5.6**	**4.7**	3.2	**2.3**	**2.8**	-7.8	**-8.4**	**-8.8**	-3.0	**-2.6**	**-2.3**
Macedonia, FYR	3.0	**5.0**	**5.0**	3.2	**2.0**	**3.0**	-0.4	**-2.8**	**-5.9**	-0.5	**-1.0**	**-1.5**
Romania	7.7	**6.3**	**6.0**	6.6	**4.3**	**4.8**	-10.3	**-13.8**	**-13.2**	-1.7	**-2.8**	**-2.1**
Serbia	5.4	**5.0**	**5.5**	12.7	**4.7**	**6.1**	-12.3	**-9.9**	**-8.9**	-1.5	**2.9**	**3.0**
Slovenia	5.7	**5.4**	**3.8**	2.5	**3.2**	**3.1**	-2.5	**-3.4**	**-3.1**	-0.8	**-0.9**	**-1.1**

Source: IMF, *World Economic Outlook*.

In contrast to the world and European economic growth which is expected to weaken, the growth of the SEE region will likely further ahead. Thus, the policymakers will need to ensure continued convergence through some useful mechanisms[2]:

1. Tighten monetary and fiscal policies to deal with excess demand and provide safety margins for vulnerabilities;
2. Implement very strong banking supervision and further reforms to strengthen the financial system;
3. Broaden structural reforms to improve investment climate, flexibility of markets, and reap benefits from international economic integration.

According to this presentation it was evident that a strong banking sector will crucially attribute to stability against turbulence.

MACEDONIA AND THE IMF

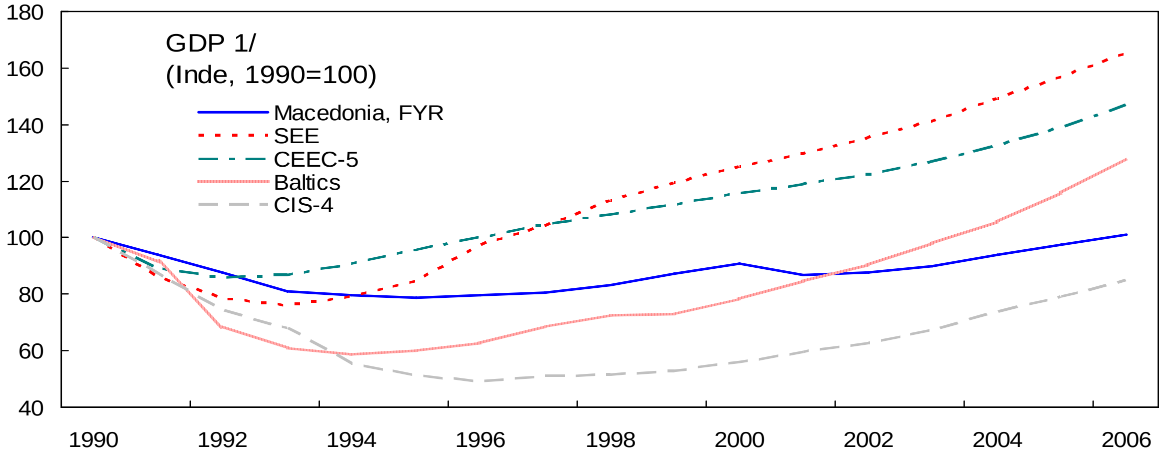
Bert van Selm, IMF Resident Representative in Macedonia

The resident representative of IMF to Macedonia expressed his views on the overall macroeconomic situation and gave some pointers towards future developments.

Mr. Bert van Selm gave solid information on the macroeconomic stability of the country explaining that the inflation is low, the exchange rate is stable, the interest rates are decreasing and the current account deficit is decreasing. He was positive on the fact that Macedonia has managed to reduce the external debt [examples: London Club buy-back, Jan 2006 (US$163 million); Paris Club buy-back, Jan 2007 (US$104 million) and IMF repayment, May 23, 2007 (US$44 million)] and managed to further increase the reserves.

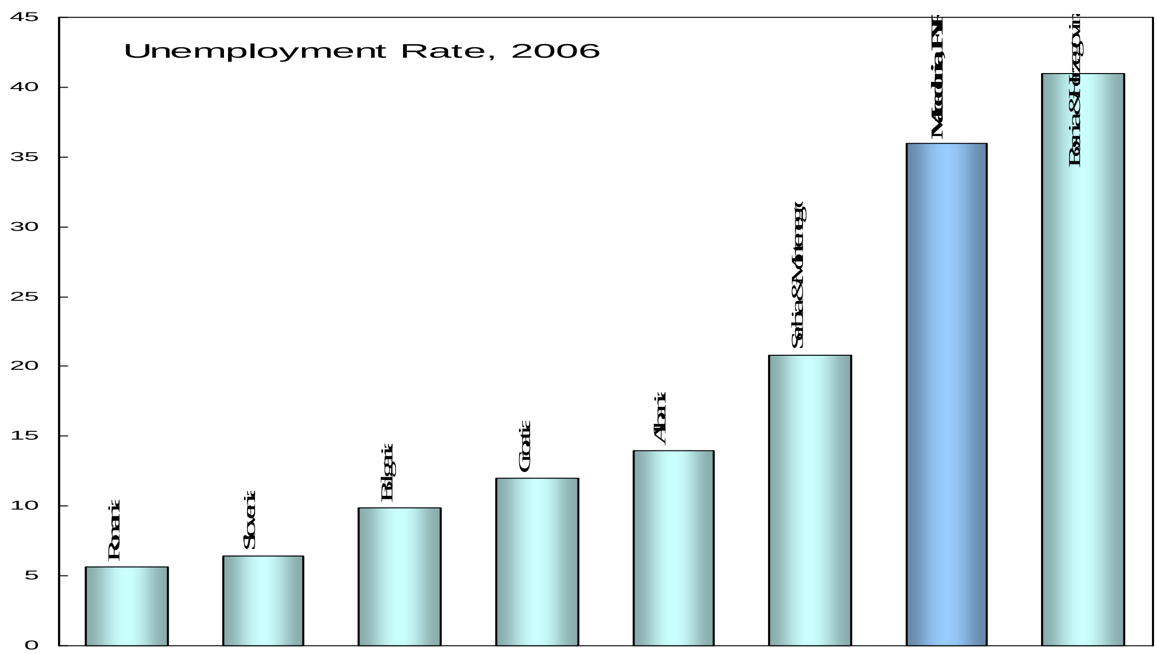
[2] Source: Mr. Luc Everaert's presentation

However, he made a clear case that the growth still remains sluggish[3], or al least that something is happening or to happen.



Sources: IMF, World Economic Outlook. 1/ SEE refers to: Albania, Bosnia & Herzegovina, Bulgaria, Croatia, Macedonia, Romania. CEEC-5: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia. Baltics: Estonia, Latvia, Lithuania. CIS-4: Belarus, Moldova, Russia, Ukraine.

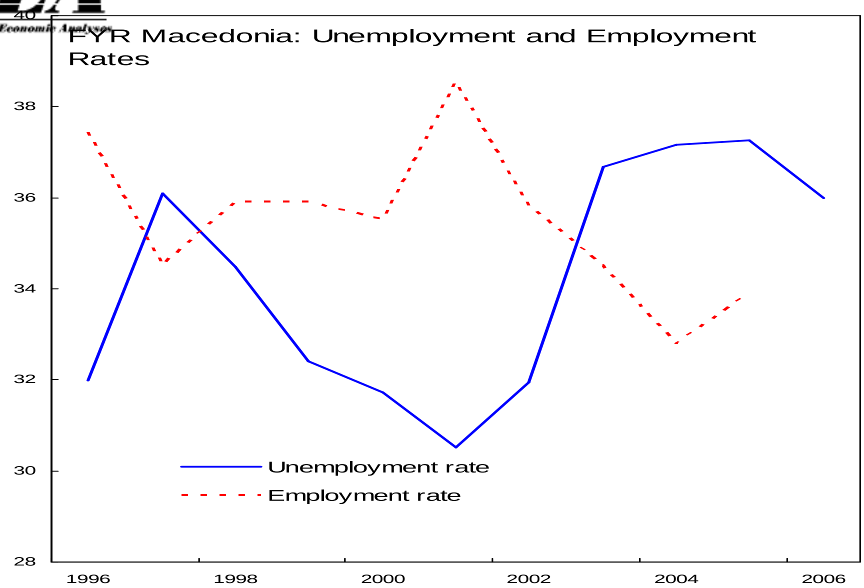
Also, one of the most negative factors that disturb the overall positive picture of the Macedonian economy is the fact that at "35%, the unemployment remains very high"[4]:



---

[3] Mr. Bert van Selm's presentation

[4] Mr. Bert van Selm's presentation and discussion with the participants



Sources: IMF, World Economic Outlook.

Macedonia introduced Tax reform in 2006 introducing flat PIT rate of 12% and as of the beginning of the fallowing year it should be lowered to 10%. In addition, there is 0 taxation on re-inverted profits, but on the other hand VAT remains on the previous level.

The resident representative of IMF to Macedonia estimated that there are positive overall developments due to the newly introduced strategy “Invest in Macedonia”, but at the same time specific characteristics of the campaign were questioned.

Here are some of the indicators presented by Mr. Bert van Selm, IMF Resident Representative in Macedonia:

I. 2007 budget

- Slight increase in the deficit to 1 percent of GDP
- Used to finance a number of important reforms: harmonized social security bases, higher investment, lower tariffs, lower income taxes
- Budget remains in surplus in year to date
- For 2008 government targets deficit in the 1 to 1½ percent range

II. Macro-economy looks OK—but markets do not

III. Strengthening the financial sector

- Credit to the private sector increased rapidly in 2006 (at 30 percent) but credit to GDP remains modest (at around 30 percent)
- Spread between lending and deposit rates remain high (at around 6 percentage points)
- New banking law strengthens the powers of the supervisor
- Need for more effective competition and foreign expertise
- New banking law allows for foreign bank branching

IV. Improving the labor market

- Tax wedge is 67.2 percent of net wages, compared to OECD average of 57 percent (FAD calculations)
- Improving tax administration to reduce compliance costs: creation of harmonized basis for social security contributions and PIT, in two stages
- Minimum contributions discriminate against low-wage sectors
- Health care contributions discriminate against part-time labor

V. Imperfect product markets :
- Telecommunications
- Air Transportation
- Energy

IMF'S VIEW OF GOVERNMENT POLICY

- **Consensus view: higher growth by maintaining macro-stability while making markets work better**
- **Many of the '100 steps' go in the right direction: more competition, market liberalization, clearer property rights...**
- **…but in the view of the IMF, a level playing field needs to be maintained, and safeguards are needed to protect government revenue, Macedonian depositors, etc.**
- **examples: Banking Law, Free Economic Zones Law, Energy Law.**

THE BALKANS: TURNING THE CORNER

Promoting Investment and Growth through Structural Reforms
Vladimir Gligorov, Vienna Institute for International Economic Studies

The presentation of Mr. Vladimir Gligorov mainly focused on three topics. The first one was on growth and a present / possible imbalance, the second was on regional trade liberalization and the third was on the existing political risks.

The growth of the economies in Southeast Europe is estimated to be positive and will continue to grow as influx of FDI is expected to renew the existing industrial capacities and to create new production sights.

Imbalances: reality or myth? It is estimated that the inflation should not be a problem, but as an exception of this argument is stated Serbia [when it comes to wage inflation]. Indeed, the current account deficits are sustainable because of the continuous growth of exports, increase in remittances and increased saving. Even though the balances seem to be sustainable, the foreign debt development may present problems due to mostly fixed exchange rate regimes and thus it is not clear what the level of debt tolerance for these countries really is.

The imbalances on the labour markets are indeed pronounced, but what strikes the most is that the job creation in the private sector is *still very limited* {Macedonia and Serbia are obvious examples].

The overall growth perspectives of the Southeast Europe remain positive and should accelerate on medium and long run over the crucial 5% benchmark as a regional average. In addition, the investments should take over the consumption, and exports should continue to grow by double digits.

It is clear that further structural reforms need to be reinforced in each country separately restructuring the economy, introducing more competition and adjusting the labour markets. Hence, this will give serious impetus to increasing SEE export shares and will enable shifting from low to medium skills industry exports.
The competitive advantage of SEE is still based on products that contain low-added value even though the development in recent years tend to show that there is specialization more in medium-skills-white-collar and even in high-skills industry exports.

Mr. Vladimir Gligorov gave the fallowing conclusions:

Tentative Conclusions

- Recent development of export shares and RCA's suggest a general skills upgrading in SEE export industries;
- Stronger SEE regional diversification in trade specialization and labour skills might hint at first structural effects of the regional Free Trade Agreements in recent years.

THE RECENT SPATE OF FLAT TAXES IN EASTERN EUROPE

Alexander Klemm, Economist, Fiscal Affairs Department, IMF

In this course was presented the overall development of the 'flat tax revolution'**.** It was quite interesting to hear the analyses of the IMF for a phenomenon that is still shaping. The early examples of introduction of the flat tax (in the text further on marked as FT) have received little attention. However, the second wave was initiated by the outstanding economic performance of the Baltic countries while introducing flat taxes. Then, there are the newest examples of Macedonia and Mongolia in 2006, and the latest discussion i.e. thinking of introducing FT in countries like Bulgaria, Germany, Greece, Mexico, Slovenia, etc.

Table 1: Recent Flat Tax Reforms

	Year	Tax rates (%) before	Tax rates (%) after	Allowances (US$) /1 before	Allowances (US$) /1 after		Change in revenue to GDP ratio (p.p.)
Estonia	1994	16-33	26	184.7	277.1		-0.4
Lithuania	1994	10-33	33	105.7	347.2		0.4
Latvia	1997	10-25	25	464.8	433.9		0.2
Russia	2001	12-30	13	108.6	164.5		0.5
Slovakia	2004	10-38	19	1203.8	2505.9		-0.7
Ukraine	2004	10-40	13	38.4	138.7	/2	-1.3
Georgia	2005	12-20	12	59.6	0.0		-0.2
Romania	2005	18-40	16	823.7	1029.6		-0.7
Iceland	2007	36.72-38.72	35.73	.	.		.
Kazakhstan	2007	5-20	10	.	.		.
Kygyzstan	2007	10-20	10	.	.		.
Macedonia	2007	15-24	12	.	.		.
Mongolia	2007	10-30	10	.	.		.
Montenegro	2007	16-24	15	.	.		.

Sources: Keen et al. (2006), IMF country reports, EIU.
Notes:
1/ Value per annum, ignoring any family element. Pre- and post-reform allowance converted at the rate of the reform year to abstract from currency fluctuations.
2/ Only individuals earning up to 1.4 times the subsistence level after the reform are entitled.

The different waves of tax reform in the counties differ in many ways. Mainly the differences are because of the particular nature of the country in question, as well as, the timing of FT introduction and targets that are intended to be achieved.

Though, there are also similarities. There is almost always increase in basic allowances and many of the second wave countries have involved cut in social contributions. The introduction of FT was closely tied to administration reforms. Another similarity is that the capital income often was taxed at reduced flat rates.

The effects of introducing FT are on work incentives, equality, simplicity and automatic stabilization. When it comes to practical evidence it is a broad consensus in the literature that the effects of tax changes remain modest.

Here are the conclusions of this particular course:

- Rhetoric increasingly based on evidence—but still need more!
- Diversity of FTs and accompanying reforms preclude simple generalizations
- Interaction with social security often ignored
- No presumption that movement to FT is associated with reduction of the progressive system
- Impact of FTs on work incentives is not clear-cut
- Simplification, but important only if no threshold
- FT as signal to rest of the world
- Opportunity to clean-out and widen base may be a key (political economy) benefit
- Sustainability of the FT remains unclear (political economy considerations point to schedules that tend to benefit middle income earners)

CASE STUDY BOSNIA AND HERZEGOVINA

Graham Slack, IMF Resident Representative in Bosnia and Herzegovina

The study on Bosnia and Herzegovina presented the current challenges that this country faces. The presentation included the basic data on the economic record. as well as, the current and possible economic outlook.

First, the economic record was based on indicators such as: growth, investments, external position, financial sector and fiscal policy.

Second, the indicators on the economic outlook showed that the public finances need to be put under control. Thus, strengthen financial stability and improve business environment. Indeed, the GDP growth is and will probably remain strong. On the other hand, the current account will widen, unemployment is ought to remain high, and is expected possible sharp deterioration in government balance. All in all, the economic situation will improve.

MACEDONIAN EXPERIENCE WITH THE IMF

CEA comments

Without further elaboration we present the CEA view on the results from the 15 years of IMF – Macedonia cooperation. Since its independence and membership renewal, Macedonia has undergone 124 months (or roughly 10 years) in formal arrangements with the Fund. Initial stabilization programs (the Structural Transformation Facility and the Stand-by Arrangement) in the mid 1990s have been sucessfully completed and resulted in rather stable macroeconomic environment. Unfortunately, the subsequent adjustment programs (Enhanced Structural Adjustment Facility and the Poverty Reduction Growth Facility) have had mixed record.

There are a number of reasons on both sides for the insufficient progress in the implementation of second-generation reforms:

- (i) the Fund has insisted on very detailed matrices of measures and performance indicators which sometimes were not crucial for the success of the program;
- (ii) lack of national ownership of the IMF-supported programs, as seen by the weak commitment and implementation capacity by the Macedonian authorities
- (iii) very weak institutional capacity for preparation of macroeconomic adjustment programs and insufficient political support for the painful, but needed reforms (treatment of the Fund as alibi for the implementation of politically unpopular reforms).

There are indications that during election years the establishment in Macedonia was not really keeping to the agreed with the IMF arrangements. Election-driven expenses have frequently led to serious incompliance with the structural benchmarks and performance criteria, undermining the Fund's confidence in the Government commitment. Unfortunately, this has led to much harsher measures in the postelection periods. Such stop-and-go policies have resulted into sluggish economic growth and undermined credibility.

Achievements:

- Macroeconomic and financial stabilization
- Medium-term current account sustainability
- Knowledge transfer and institutional capacity building
- Fiscal and public debt sustainability
- Substantial mobilization of donor support
- Improved fiscal transparency

Failures:

- Continuation of the soft budget constraints (SBC) practices
- Severe fiscal swings and insufficient financial consolidation of the extra-budgetary funds (particularly, the Health Insurance Fund)
- Lack of ownership of reform agenda
- Imported IMF credibility for "Domestic Government programs".
- Moral hazard of having IMF programs

Table: Main characteristic of IMF programs within Macedonia (yellow highlight shows parliamentary election year).

	IMF	**Stabilization component**	**Adjustment component**	**GDP**	**SDR from IMF in mln $ USD (241)**	**Parliamentary Elections**	**Budget deficit**
1994	STF	IMF supported inflation fight success after the government failed to succeed in their program		-1,8	40	1	-2,9
1995	SBA	Gross foreign reserves	Loss making companies (25)	-1,1	35		-1,2
1996	SBA			1,2			-0,5

1997	ESAF		Treasury, VAT, deficit instead of surplus in the budget, flexibility of the labor market, program not fulfilled	1,4	75		-0,4
1998	ESAF		Treasury, VAT, deficit instead of surplus in the budget, flexibility of the labor market, program not fulfilled	3,4		1	-1,7
1999	CCFF	Kosovo		4,3	19		0
2000	PRGF13/EFF30		The tax burden relief on the direct taxes, public administration reform	4,5			2,5
2001				-4,5	44		-6,3
2002	SMP		TAT moral hazard, program not fulfilled	0,9		1	-5,6
2003	SBA		Flexibility of labor market	3,4	28		-1,7
2004	SBA			2,5			-0,9
2005	Three-year SBA			4,1*			3,8*
2006	Three-year SBA			4,0*		1	3,2*
2007	Three-year SBA			5,5*			

*Estimate.