

BP/11/06

## **Review of the IMF's *Regional Economic Outlook* Reports, 2003–09**

Peter J. Montiel

May 20, 2011

**IEO Background Paper**  
Independent Evaluation Office  
of the International Monetary Fund

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**Abstract**

This study evaluates the technical quality of the *Regional Economic Outlooks*. It covers all 44 outlooks issued between 2003 and 2009. It found the policy analysis contained in the publications to be uneven. Many of the analytical chapters were satisfactory, but some were weak. A common weakness in all *REOs* is that they fail to articulate the common features of the countries being analyzed (beyond being covered by the same administrative unit at the Fund) that justifies a “regional” approach as having value added over the global and country analysis. They were undermined by a tendency to advocate very specific, highly prescriptive policies rather than identifying policy options and the trade-offs often involved in conflicting economic objectives. Some prescribe specific policies without substantive explanations. Many of the instances of vagueness, unsubstantiated claims, missing analysis, incoherent analysis, and incorrect analysis found by the evaluation seem to arise from an uncritical acceptance of conventional wisdom. Exposing these documents to outside review before they are issued might help to address this problem.

The views expressed in this Background Paper are those of the author and do not necessarily represent those of the IEO, the IMF or IMF policy. Background Papers report analyses related to the work of the IEO and are published to elicit comments and to further debate.

JEL Classification Numbers: E0, F3, F5

Keywords: IMF Research, multilateral surveillance, *Regional Economic Outlook*, quality comparison, research evaluation

Author's E-Mail Address: Peter.J.Montiel@williams.edu

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## ABBREVIATIONS

AFR	African Department
AHF	Asian-focused hedge funds
APD	Asia and Pacific Department
ASEAN-4	Indonesia, Malaysia, Philippines, and Thailand
ASEAN-5	Indonesia, Malaysia, Philippines, Thailand, and Vietnam
CCA	Caucasus and Central Asia
CPI	consumer price index
EAC	East African Community
EU	European Union
EUR	European Department
GCC	Gulf Cooperation Council
GDP	gross domestic product
GIMF	Global Integrated Monetary and Fiscal Model
GVAR	global vector autoregressive model
HP	Hodrick-Prescott
ICR	interest coverage ratio
IEO	Independent Evaluation Office (IMF)
IT	inflation targeting
LAC	Latin America and Caribbean
LAC-7	Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela
LIC	low-income country
MCD	Middle East and Central Asia Department
MENAP	Middle East, North Africa, Afghanistan, and Pakistan
NIE	newly industrialized economy
OECD	Organization of Economic Cooperation and Development
PPP	purchasing power parity
<i>REO</i>	<i>Regional Economic Outlook</i>
SSA	Sub-Saharan Africa
TFP	total factor productivity
<i>WEO</i>	<i>World Economic Outlook</i>
WHD	Western Hemisphere Department



## I. INTRODUCTION

1. This background paper evaluates the 44 *Regional Economic Outlooks (REOs)* issued by the Fund's five area departments from 2003 to 2009 (Table 1 identifies the authoring departments and dates of the relevant *REOs*). Since 2003, the IMF's area departments have been publishing *REOs* to complement the *World Economic Outlook (WEO)*, the Fund's flagship publication.<sup>1</sup> *REOs* provide regional perspectives on the general macroeconomic outlook for the region covered by each department as well as on specific economic issues that emerge as particularly important at the regional level. Preparation of the *REOs* has grown to absorb significant resources, including the creation of units within each area department dedicated mainly to the production of the *REO*. Accordingly, an outside evaluation of these reports seems timely and appropriate.

Table 1. *Regional Economic Outlook Reports Covered in this Review*

	Asia-Pacific (9)	Europe (5)	Middle East and Central Asia (9)	Sub-Saharan Africa (13)	Western Hemisphere (8)
2003					
Spring				X	
2004					
Spring				X	
Fall				X	
2005					
Spring				X	
Fall	X		X	X	
2006					
Spring	X		X	X	X
Fall	X		X	X	X
2007					
Spring	X		X	X	X
Fall	X	X	X	X	X
2008					
Spring	X	X	X	X	X
Fall	X	X	X	X	X
2009					
Spring	X	X	X	X	X
Fall	X	X	X	X	X

2. *REOs* have several functions, including to serve as a platform to engage authorities and other stakeholders in discussions on the IMF's global and regional outlook and to

<sup>1</sup> The *WEO* is published twice yearly by the Research Department of the Fund.

disseminate research studies focused on the region. The focus of this paper is on the technical quality of the regional outlook and studies. It also discusses presentational aspects that are important to allow country authorities and other stakeholders to assess whether the analysis and the recommendations are relevant for their own circumstances. The aim of this evaluation is to draw lessons to improve *REOs*, in particular as a tool for policy dialogue with country authorities in the different regions. Accordingly, while I note areas of strength in the documents reviewed, the focus is on areas in which I believe that there is room for improvement.

### **A. Evaluation Criteria**

3. The reports' technical quality is assessed based on two main dimensions: general analytical quality and broad expositional principles. The general analytical quality was judged by the following criteria:

- The analysis should be clear and unambiguous in content.
- It should avoid making unsubstantiated claims.
- It should be thorough (avoiding loose ends) as well as internally consistent.
- It should have been thoroughly vetted to avoid obvious analytical errors.

4. The broad expositional principles are the following:

- The reader of these documents should be given enough information to form an independent opinion on the issues considered by the staff.
- The adoption of a regional perspective should be accompanied in each case by a description of how the region does or does not function as an economic unit.
- The economic analysis contained in these documents should be well grounded in the professional literature, with appropriate references to that literature.

5. Following these criteria, I present below an evaluation of the *REOs* produced by each of the Fund's five regional departments. I recorded a summary evaluation of each document reviewed in a ledger such as that presented below. Ratings ranged from 1 to 5, with U = "unsatisfactory" being 1, and S = "superior" being 5. Intermediate ratings were BA = "below average," A = "average," and AA = "above average" (Table 2). I used an absolute scale, e.g., the benchmark for "average" was based on my expectation of what would constitute adequacy under each criterion, rather than on a comparison across reports.

Table 2. Research Quality Indicator Form

Criteria	Ratings				
	S	AA	A	BA	U
I. Adequacy of information to form an independent opinion					
II. Provision of a regional framework					
III. General analytical quality					
IV. Grounding of analytics in the relevant literature					

### B. Quantitative Indicators

6. Table 3 shows the summary of the ratings for all 44 regional economic reports evaluated, broken down by department and evaluation criteria category. The average rating across all departments was 2.0, which corresponds to the rating of “below average.” This low rating reflects deficiencies in the reports on one or more criteria.

Table 3. Summary of *REO* Scores by Department and Category<sup>1</sup>

Department	Category				Average
	I	II	III	IV	
Africa	1.5	1.2	2.2	1.8	<b>1.7</b>
Asia and Pacific	2.0	3.1	2.3	1.4	<b>2.2</b>
Europe	2.0	1.4	2.0	1.6	<b>1.8</b>
Middle East and Central Asia	1.8	1.7	1.8	1.0	<b>1.6</b>
Western Hemisphere	2.0	4.0	2.9	3.1	<b>3.0</b>
<b>Average</b>	<b>1.8</b>	<b>2.3</b>	<b>2.2</b>	<b>1.8</b>	<b>2.0</b>

<sup>1</sup> Based on a scale of S = 5 and U = 1.

7. A closer look at the indicators reveals a great deal of unevenness in quality. The reports from the Western Hemisphere Department were rated the highest but only received an “average or acceptable” rating of 3.0. The reports from the African, European, and Middle and Central Asian Departments were rated below 2.0, pointing to the general weakness of the reports. However, the African and Middle Eastern reports in particular improved over time, so the low ratings received were pulled down by the earlier reports. One area of weakness revealed in many of the reports, especially from the European Department and early African and Middle Eastern reports, was that they did not provide a description of how the region functioned as an economic unit. Another common weakness, excluding Western Hemisphere, was that the reports frequently lack grounding in relevant professional literature. The later African and Middle Eastern reports provided more of a regional framework than did the early reports.

### C. Outline of the Evaluation

8. The structure of this review is based on the criteria described above. In the next section, I evaluate the extent to which the *REO* documents as a group comply with my broad expositional principles. Sections III-VII evaluate the analytical quality of the *REO* documents produced by each of the Fund's area departments. Each of these sections describes the structure of the department's reports and comments on their analytical perspective as well as briefly on their general tone, before highlighting specific analytical strengths and weaknesses. Section VIII concludes the review by providing a critical discussion of the role of policy advice in *REOs*, and by identifying a set of research topics that could fruitfully be pursued at the Fund for the purpose of improving the analytical quality of future *REOs*.

## II. BROAD EXPOSITIONAL PRINCIPLES

9. Do the *REOs* comply with the three broad expositional principles set out above? This section addresses this question from the perspective of the *REOs* as a group, leaving the evaluation of individual area department *REOs* for the five sections that follow.

### A. Informing the Reader

10. A simple reading of the *REOs* suggests that the main intended audience consists of policymakers in the region, or the financial press, i.e., people who already familiar with the region's economy, because the reports provide very little background on the countries that comprise the region and also because they are highly prescriptive in tone. An additional role for these reports could be to engage academics and other stakeholders to think about and conduct independent research on regional economic issues that fall within the Fund's policy purview. This could better be achieved by providing more information—either within each report or in some background overview section/document—on relevant features of the individual economies and the region that could help to inform the analysis in the report. A reader who comes to these reports without this basic background information would find it difficult to form an independent view on the policy analysis provided in the *REOs* and thus to be a useful contributor to the policy conversation.<sup>2</sup>

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<sup>2</sup> Even for individuals engaged in policy within each region the exposition in these documents could be much improved. While the *REOs* do not contain mathematics, some of the supporting empirical analysis is somewhat technical and (I suspect) not readily accessible to high-level policymakers and financial reporters. Probably for that reason, the reports often do not go into great detail on empirical methodologies, or provide the types of caveats that one would expect in more academic exercises. At times this makes for an awkward blend, especially when the supporting empirical analysis is described in the text, rather than in boxes or appendices. For the purposes of the policy world, I would suggest adopting a clear and consistently accessible tone in the text, while placing supporting evidence and empirical analysis in boxes and appendices (as indeed several reports do), where the methodologies employed can be described and evaluated in greater depth.

## **B. Implicit Regional Model**

11. In addition to information on the characteristics of specific countries in each region, such as those listed above, it would be extremely helpful to offer readers a clear notion of how the staff perceives each region functioning (or not) as an economic unit—in other words, to clearly articulate the staff’s implicit regional macroeconomic model up front.

12. If a region is just a collection of individual countries that are located close to each other but do not interact as an economic unit, then there is little justification for separate regional economic outlook exercises, other than spreading among the Fund’s staff the task of bringing the *WEO*’s global analysis down to a more local level. But in many cases there are important regional real and/or financial links among countries in a geographic area that indeed make the region a meaningful unit of economic analysis (e.g., trade and capital flows between North and South America in the Western Hemisphere, vertical integration of production between China and East and Southeast Asia, flows of bank lending between advanced and emerging European countries). At present these links, and the functioning of regional economies, emerge indirectly and almost incidentally in the *REOs*, leaving the reader to do most of the work in inferring how the region functions as an economic unit.

13. A more explicit description of the staff’s perspective on this issue would help the staff sharpen its own regional analysis as well as make the *REOs* more transparent and analytically satisfying to their audience.

## **C. Links to the Professional Literature**

14. The reports that I read often cite the professional literature on specific issues that they consider. Providing links to the literature is important for several reasons: to convey to the reader that the staff’s analysis is professionally well grounded, to provide outside analytical and empirical support for some of the staff’s specific views, and to provide further elaboration of the staff’s analysis where that seems to be called for.

15. Unfortunately, however, the links between these reports and the professional literature tend to be deficient in three ways:

- In several cases, analysis is supported by simple made-to-order empirical exercises conducted by the staff even where more sophisticated work has already been done on the topic either inside or outside the Fund.
- References to the professional literature are not common enough. *REOs* should reflect state-of-the-art thinking by the profession on the issues being discussed by the staff. To make the reports more authoritative, references to current professional opinion and/or research done outside the Fund should be included whenever possible. I found many instances where such references were not provided (some of these instances are described in what follows).

- Some of the references that are made to the literature do not do justice to the diversity of professional opinion on a particular issue. Wherever possible, reference should be made to survey pieces that summarize the state of the art, rather than to individual pieces of research espousing a view that may have been challenged by others.

### III. ASIA-PACIFIC

16. I read nine *Regional Economic Outlook* reports prepared by the Asia-Pacific Department (APD), covering the period October 2005 to October 2009.

#### A. Structure

17. These reports have a uniform structure: each focuses on a general theme (e.g., “Building a Sustained Recovery” in the October 2009 report) that guides the discussion in an overview chapter and motivates the topics chosen for inclusion in two or more “analytical” chapters. Most of the analytical chapters are well motivated and relevant to the general theme; for example, Chapter 2 of the May 2009 report, on the lessons from past recessions, is pertinent, well executed, and timely.

18. Some chapters are not particularly illuminating, not necessarily topical, or not obviously relevant. Examples follow:

- Chapter 3 of the April 2007 report discuss housing prices in Asia and resource-rich countries in the Asia-Pacific region. It is textbookish in tone and not particularly informative or insightful.
- In a report issued in the midst of an international crisis (November 2008) it seems odd to have devoted the analytical chapters to developments such as the implications of commodity prices for inflation and of population aging. Undoubtedly these are important recurring issues for the region, but one suspects that the topics were chosen well before Lehman Brothers collapsed in September of that year.
- Similarly, the discussion of the Japanese “lost decade” experience in the May and October 2009 *REOs*, while useful and illuminating from the perspective of the countries at ground zero in the Great Recession, is not nearly as useful for the purpose of analyzing events within the Asia-Pacific region, where financial sector problems have not been at the heart of recent events.

19. The earlier APD reports share the problem, mentioned above, of the absence of a description of the region as an economic unit—that is, the implicit regional “model” that underpins the analysis in the overview chapter. The reports refer to many analytical country

groups,<sup>3</sup> which seem to be organized by common features that these economies share, rather than by an implicit regional model. In some ways this may be a sensible approach, given that the structure of economic relationships among countries in the Asia-Pacific region is quite different from that in, say, the Western Hemisphere, where the emerging-market and low-income countries (LICs) depend heavily on trade and financial flows with the two large industrial countries in the region (the United States and Canada). By contrast, Asian economies, while highly open, tend to concentrate their exports outside the region, and also interact extensively outside the region through financial flows.

20. The later Asia-Pacific *REOs*—starting with the September 2006 report, which describes well the increased role of China as an engine for regional growth—approach closer to a coherent analytical view of how the region fits together as an economic entity. Adopting this more coherent view enables these reports to make some intelligent, not-so-obvious, points that illustrate the value of underpinning the analysis with some sort of regional model. For example, based on its view of economic interactions within the region, APD takes a reasonable (and ex post correct) view of the limited prospects for “decoupling” that existed within the region when the international crisis broke out. It is also able to interpret the severe depth of the contraction in Asia, as well as the role played by exports and inventory cycles in the West in driving the especially strong recovery that subsequently emerged in Asia.

21. The progression from seemingly ad hoc country groupings to a unified view of the regional economy in the APD reports, and the insights that emerge from the latter, support the view that each *REO* should be buttressed by a vision of how the regional economy works.

22. A shortcoming of the structure of the APD reports is that they pay relatively little attention to the role of LICs in the region. Though these countries are mentioned in every report, including in some boxes that address issues specific to them, their overall role in the reports is very minor. The reports give more detailed treatment of emerging economies in the region than of either advanced or low-income countries (see, for example, the rather sketchy discussion of Australia and New Zealand in Box 2 of the May 2006 report).

## **B. Analytical Perspective**

23. In some of the early APD reports the discussion in the first (“developments”) chapters lacks much of an analytical framework. Some statements simply reproduce accounting identities: an example is the statement in the September 2005 report (p. 9) that reserves went up more than the current account surplus, because of capital inflows. Others are ambiguous: for example, “capital inflows have slowed considerably, because of a strengthening of the

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<sup>3</sup> Industrial Asia, emerging Asia (subdivided into newly industrialized economies (NIEs) and the ASEAN-4/5, depending on whether Vietnam is included), and low-income countries (LICs).

U.S. dollar” (ibid.)—have they slowed because the dollar was expected to strengthen, or did the dollar strengthen because capital inflows to Asia slowed?

24. The analysis becomes more sophisticated in the later reports. By and large, I found the analytical approaches adopted in the later reports up to date and very satisfying—basically offering good solid applied macroeconomics. For example, they acknowledge the role that aggregate demand contractions have played in creating output gaps, they take appropriate account of the role of intertemporal considerations and expectations, they attempt to quantify relationships where appropriate with cross-country empirical work, and they show an awareness of the relevant professional literature. All in all, this is just the kind of work that one would hope to see from the Fund.

25. Moreover, in a number of instances these reports give a fresh and well-documented perspective on the situation in Asia. Such useful insights are provided from the earliest reports onward. Some examples follow:

- The September 2005 report points to the role of an “investment drought” rather than a “savings glut” in driving current account surpluses in emerging Asia (p. 22). Overall, the discussion of saving and investment in Asia in that report (p. 25) is well motivated, reasonable, and insightful.
- The surprising rise in income inequality in Asia is well documented in Chapter 6 of the September 2006 report, with interesting and policy-relevant patterns identified.
- Chapter 2 of the October 2007 report, on what Asia learned from the 1997–98 crisis, predicts the region’s resiliency in the face of future crises, which has indeed turned out to be the case.
- The estimation of current account determinants in the November 2008 report is interesting and innovative, and gives plausible results. I consider it a very useful contribution.
- Another useful contribution is the construction of indicators such as the Financial Conditions Index, introduced in the November 2009 report (p. 17).
- The use of the Global Integrated Monetary and Fiscal Model (GIMF) (May 2009 report, p. 25) to assess the growth impact of sustained fiscal stimulus (instead of premature retrenchment) is a laudable piece of sound quantitative policy analysis. Indeed, the May 2009 report contains several good uses of quantitative indicators, including of the interest coverage ratios in Chapter 3 (p. 44) on corporate vulnerability.

26. My one reservation regarding the analytical perspective in the APD reports is the discussion of financial issues in some chapters of the earlier *REOs*. These read too much like

the financial press or financial newsletters, in that they are somewhat divorced from the underlying macroeconomic analysis and contain unnecessary jargon that tends to obscure the analysis for a general macroeconomic audience. An example is the reference to a “not unexpected” equity market correction in the September 2006 report (p. 16). The claim that stock market corrections can be widely anticipated strikes a macroeconomist as strange, and gives this writing too much the flavor of financial reporting. Box 2.1 on Asian-focused hedge funds in the same report uses too much jargon; terms such as “long-short and market neutral securities” and “family offices” should be defined for this audience. Similarly, the April 2007 report (p. 16) refers to “markets where trades had become crowded” and to “‘real money’ investors.” The section on recent financial developments in the October 2007 report also has too much of the flavor of financial reporting for its own sake. Is it really very useful to know how Asian-focused hedge funds have fared? It may be, but the links with macro developments in the region are not established in the report.

### C. Boxes

27. Most of the topics treated in boxes in the APD reports seem extremely well chosen. In the September 2005 report, clearly relevant boxes (on electronics exports, the impact of oil prices, and the effects of the removal of textile quotas) are not integrated into the text, but appear at the end of the document. The incorporation of boxes into the body of the text, beginning with the September 2006 report, provides more continuity for the reader. Particularly useful boxes in subsequent reports include:

- Empirical analysis of the trade-creating or diverting effects of Asian regional trade agreements, based on gravity models (May 2006 report, Box 9).
- An informative discussion of sovereign wealth funds in Asia (October 2007 report, Box 1.3).
- Discussions of the differential impact of the crisis on LICs, of estimating the impact of countercyclical fiscal policies on growth, and of whether policy rates have been passed through to lending rates (October 2009 report, Boxes 1.1–1.3).
- A discussion of saving in China that is timely in view of the need to stimulate domestic sources of demand (October 2009 report, Box 3.2).

### D. Tone

28. I did not find the Asia-Pacific *REOs* to be excessively prescriptive in tone, unlike some of those from other regions.

29. But what comes through clearly from the Asia-Pacific *REOs* is the extent to which the Fund’s policy recommendations for countries in the region are based on a *global* perspective, rather than the *single-country* or *regional* perspective that the authorities in the region are

themselves more likely to adopt. Much of the advice offered to regional economies in these documents is clearly intended to support the Fund's particular perspective on the "global imbalances" issue—a desire for Asia (especially China) to reduce its current account surpluses by increasing domestic consumption, and for these countries to adopt more flexible exchange rate arrangements (see, for example, the October 2007 report, p. 21), and allow their currencies to appreciate relative to the U.S. dollar. Advice to improve social safety nets, pursue financial liberalization, and improve corporate governance is overtly motivated by the goal of increasing household consumption and reducing corporate saving in Asia.

30. Framing its policy recommendations from a global perspective may be unavoidable, given that the Fund is a global institution. But to the extent that APD believes that these policy objectives are appropriate even from the narrow self-interest of the Asian countries themselves, the *REO* reports provide a unique opportunity to make this case. From my perspective, they did not sufficiently capitalize on this opportunity.

### **E. Links to the Professional Literature**

31. *REOs* should be well grounded in the professional literature. At times, some of the APD reports appear to try to reinvent the wheel. For example, Chapter 5 of the May 2006 report contains a very comprehensive analysis of why China's household saving rate is so high, but it contains very few references to the professional literature on this issue. Has there been so little work on this topic outside of the Fund? If not, the absence of links with the professional literature is a serious drawback on this important topic. Box 1.4 of the September 2006 report, on remittances, is very appropriate but seems to be drawn mainly from one paper; it does not begin to do justice to the literature on remittances, and does not sufficiently identify what we still need to learn about the phenomenon. In the October 2007 report (p. 30), the claim that China's real exchange rate is undervalued is an extremely controversial one, and should have been backed with evidence and extensive references to the professional literature.

### **F. Analytical Strengths**

32. These documents occasionally offer insightful and novel perspectives that I have not seen elsewhere, on important issues of substantial policy relevance. For example, Chapter IV of the October 2007 report, on trade patterns in Asia, is very informative, especially as regards its analyses of "decoupling" in Asia and of the impact of the crisis on economic activity in the region; it also sheds useful insight on the impacts of exchange rate changes on Chinese export prices (p. 52). The indexes of export similarity and export overlap in the same report are innovative and informative constructs, at least for someone (like myself) who is not a trade economist.<sup>4</sup>

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<sup>4</sup> My one quibble here would be with the identification of "high-tech" with "high valued added" (p. 46).

## **G. Analytical Weaknesses**

33. The APD reports have many positive features but they also have some analytical deficiencies. These are discussed below under the headings of vagueness, unsubstantiated claims, missing analysis, incoherent analysis, and (in my view) incorrect analysis.

### **Vagueness**

34. A recurring problem in these reports is that, while reference is often made to a “baseline scenario,” there is no explanation of how this baseline was compiled (see, for example, the April 2008 report). This makes it difficult for the reader to judge how much confidence to place in the baseline scenario.

35. Vagueness also characterizes some rather important judgments that have policy implications. For example, the claim in the October 2007 report that Asia remains “too dependent” on exports as an engine of growth is hard to interpret. The origin would appear to be an agenda based on “global imbalances,” but the report provides no metric by which to judge “excessive” dependence. Moreover, a judgment like this seems to run counter to the Fund’s past advocacy of outward-oriented growth, but this apparent contradiction is neither acknowledged nor explained.

36. A third problem is that the methodology applied in some of the underlying empirical work is left murky. Chapter 3 of the April 2008 report, on de-linking in Asia, for example, is well executed and was quite topical at the time. However, the recession scenario (run with the general equilibrium model), which combines a slowdown in U.S. activity with a decline in confidence, is artificial and not well explained. It is unclear how the scenario was constructed, or how the general-equilibrium effects of a decline in confidence were specified and quantified. It would have been preferable to describe the alternative scenario as it was actually operationalized and then claim that this is intended to capture a decline in confidence. Similarly, as I will argue in Section VII below, the use of “fiscal space” indicators is an extremely important background research issue for all of the *REOs*, and the May 2009 APD report uses such an indicator (p. 26), but leaves its construction unexplained.

### **Unsubstantiated claims**

37. Unsubstantiated claims should be avoided, since they undermine the credibility of the policy advice offered in these reports. They are more frequent than one would like. Some examples:

- In the May 2006 report, the slowing of capital inflows into the region over the period preceding the report is attributed to narrowing interest rate spreads and waning expectations of renminbi revaluation (p. 12). The report explains the latter, in turn, by the nominal renminbi revaluation that had taken place on July 21 2005, as well as tighter monetary policy in the United States. This is a very plausible explanation of an

endogenous outcome in terms of exogenous variables, but it is not backed up by evidence. Since changes in capital flows can potentially be driven by a wide range of factors, singling out any specific cause requires some justification.

- Statements about the stance of fiscal policy should always be backed up with data using a widely accepted indicator of the fiscal stance. This is not always done in these reports. For example, in the September 2006 report (p. 28) the statement that fiscal policy is broadly neutral is not backed up by data on indicators such as fiscal impulses.
- It is commendable that the April 2008 report (p. 25) acknowledges that most countries in the region have fiscal space for countercyclical policies. (Past Fund orthodoxy on this issue stressed fiscal sustainability at the expense of short-run stabilization objectives.) But the report does not indicate the basis for this conclusion.

### Missing analysis

38. Probably the single most important shortcoming of the APD reports is a lack of complete or in-depth analysis of the issues discussed. Several examples will illustrate what I mean:

- The Asia-Pacific *REOs* frequently state that countries in the region should increase domestic demand in order to address world imbalances, but invariably stress that these increases need to be achieved without activist stabilization policies—that is, that they should happen through “structural reforms.” It is easy to agree that such reforms (e.g., improved safety nets, financial reform, reforms in corporate governance) are likely to help, but over what time horizon? This issue is not addressed. Is the problem of global imbalances not so pressing, so that these reforms can be given time to have their effects on household spending in Asia? Or, if they are pressing, what other measures can be taken to rebalance demand? This discussion is missing.
- In accounting for the evolution of debt ratios in the region (e.g., in the May 2006 report, p. 23), decompositions of debt accumulation—into the contributions of primary deficits, real interest payments, inflation, valuation changes arising from exchange rate movements, etc.—would have been very useful in helping to understand the sources of changes in debt/GDP ratios.
- The analysis of the investment decline in ASEAN-4 countries in Box 5.1 of the September 2006 report interprets the decline as the result of credit constraints on the nontraded goods sector. But it is unconvincing, since it does not address whether the reduction of credit flows to the nontraded goods sector is the result of supply or demand contraction. The post-crisis real exchange rate depreciation that these countries experienced suggests a role for the latter, but again, this needs more investigation.

- Chapter 3 of the October 2007 report gives a clear explanation of sterilized intervention and a good survey, based on the literature, of where we stand on the effectiveness of sterilized intervention. But the tests conducted in this chapter for the effectiveness of intervention are very simple, and the reader is not told whether more sophisticated techniques are available and, if so, why they were not used here. Most importantly, while the chapter appropriately concludes with reservations about the simple methodology it employs, it gives no indication of how seriously one should take the results in light of those reservations. This is important, because if intervention is ineffective, then Asian countries would be misguided in conducting intervention policy with the objective of achieving a real exchange rate target. It is disappointing that this important implication is not brought out in the document.
- In the April 2008 report, which offers sensible projections for other variables, there is no recognition of the effects that weaker remittance flows will have on the Philippines (p. 22)—an important remittance recipient.
- Box 1.3 in the November 2008 report (p. 33), on headline and core inflation, is very useful in the context of the report, but the analysis is incomplete: the fact that households care about headline inflation does *not* call into question the usefulness of core inflation as the primary or implicit operational target. The volatility of headline relative to core inflation would require introducing more volatility into real output if monetary policy were to stabilize headline inflation, and volatility in real output is something else that households care about. This trade-off is not explicitly mentioned.
- The November 2008 report repeats the standard policy prescription for China. This is certainly understandable from a “global imbalances” perspective, but the case should instead be made that it is good for China itself, if the staff indeed believes this to be true. The fact that demographics will otherwise continue to put upward pressure on China’s current account surplus, as suggested in this chapter, does not make that case, because there is no reason to believe that the resulting current account surplus would not be an optimal one.
- By contrast, the advocacy of a boost in Chinese domestic consumption in the May 2009 report is easy to justify in China’s own interest, in light of the crisis-induced collapse in external demand. But here the report makes the mistake of advocating real exchange rate appreciation independently of what would be implied by stronger domestic demand—in fact such appreciation would in and of itself *discourage* consumption of domestic goods.
- The May 2009 report (p. 68) may be right that the Bank of Japan’s approach to quantitative easing (buying government bonds) should use channels of influence similar to those of the U.S. Federal Reserve Board (intervening in markets that appear stressed), but it is not obviously so, and there is much confusion about exactly how

these policies are supposed to work. The point deserves more consideration than it receives.

### **Incoherent analysis**

39. In some of the reports the analysis at times lacks internal consistency, though I did not detect a particular pattern or particular area of analysis in which this problem was especially evident. Some examples follow:

- The statement (September 2005 report, p. 40) that local financial markets have not been able to keep foreign savings within the region—implying some shortcomings in these markets—is based on the view that without these shortcomings, capital inflows into the region would have resulted in larger current account deficits (or smaller surpluses). The idea seems to be that Asia is perceived as an attractive place to invest, but because Asia’s financial markets are poorly developed, capital inflows into Asian countries tend to flow back out again, so they are not absorbed via current account deficits. This reasoning does not make sense to me. The region’s financial markets may indeed have shortcomings, but the reason why capital inflows have not had larger impacts on current account deficits is exchange rate policy decisions (specifically, intervention in foreign exchange markets), rather than financial market performance. In the absence of reserve accumulation, those inflows would have resulted in faster real exchange rate appreciation and larger trade deficits or smaller surpluses.
- The September 2007 report provides another example of strange reasoning. It claims that “overheating and credit-fueled asset price rises remain a concern, and the scope for easing monetary policy if growth falters is much more limited” (p. 25). But if growth falters, that implies the *absence* of overheating, so overheating cannot be used to rule out expansionary policy in the event of faltering growth. This type of reasoning appears again in the April 2008 report (p. 24), regarding the scope for monetary accommodation in the event of an imported slowdown. The claim is that several countries would have little room for monetary accommodation because of rising concerns with inflation. But if slower activity is indeed imported from the world slowdown, core inflation should fall, and that should alleviate the concerns alluded to before. The statement in the same report that China would have limited room to ease in the event of an imported slowdown, because of its concern with booming investment, is similar: if the imported slowdown materializes, booming investment should certainly become less of a concern.
- The October 2007 report (p. 20) claims that a depreciation of the exchange rate would result in a loosening of monetary conditions, which may preclude countercyclical policies in response to a slowdown. I do not understand either step in that causal chain.

- The November 2008 report (p. 37) states that the emergence of high energy prices when wages are showing little indication of excess demand pressure may mean that energy prices are a better indicator of the output gap than wages are. This claim seems strange at best. After all, different sectors may reach full capacity at different times, and, as they do, one would expect to observe relative price changes. Increases in some subset of prices may thus provide a poorer indication of the economy-wide extent of excess capacity than an aggregate wage index.
- The suggestion in the May 2009 report (p. 23) that Asian central banks may have to turn to “quantitative easing” (expansion of their balance sheets) in light of policy rates being close to zero, is puzzling, since there appears to be no breakdown in domestic Asian credit markets that would suggest a need for Asian central banks to step in to provide the financial intermediation that private institutions are unable to perform. How else is quantitative easing supposed to work?
- The October 2009 report (p. 4) makes some odd statements about the consequences for Asia of lower consumption growth in the West. Specifically:
  - The need for the region to live with smaller current account surpluses is by no means an obvious consequence, since effects on the saving-investment balance are not clear.
  - The need to live with more flexible exchange rates is also not obvious, but if it is true, probably suggests more *depreciated* exchange rates—which is probably not the message the report intends to send.

### **Incorrect analysis**

40. Some topics appear to be incorrectly analyzed in more than one instance and in more than one area department’s *REO*. Examples of these in the APD reports concern the effects of exchange rate depreciation on inflation and a confusion between inflation and relative price changes:

- The May 2006 report (p. 20) expresses the fear that the depreciation of regional currencies could lead to an uptick in inflation. This is a recurring theme in many *REOs*. But this fear is not justified in the text and seems entirely unwarranted in the context at hand, especially since core inflation had not previously responded to changes in other relative prices (such as those for food and energy) in APD countries. Why should changes in import prices arising from exchange rate changes have different effects?
- Although they do this less than the *REOs* of some other regions, the APD reports occasionally confuse inflation with relative price changes (as in the November 2008

report, p. 13). The welfare effects of sharp increases in food prices stem mainly from changes in relative prices, not from an increase in the aggregate price level.

41. Other instances of incorrect analysis are more *sui generis*. Here are two examples:
- In the September 2006 report, Chapter 5 on private consumption usefully employs a cross-country regression model to gain perspective on consumption behavior in Asia, but the implementation is deficient in several respects. For example, the finding that positive terms of trade shocks tend to reduce consumption cannot be explained by consumption smoothing in the face of transitory shocks, as suggested (p. 57), since transitory shocks would tend to leave consumption unchanged. Also, the inclusion of country dummies makes the deviation of actual from fitted values uninformative about whether the fundamentals explain consumption behavior in the region; it would have been much more informative to report the country dummies for Asian countries. The report concludes that the transitory (one-year) decrease in private consumption that took place in some countries after the Asian crisis means that countries should do more to reduce the uncertainty faced by households (p. 61). This conclusion may be right, but the evidence given provides weak if any support for it. Indeed, none of the policy conclusions on p. 61 is supported by the results, and it is hard to understand why, if real exchange rate appreciation is expected to boost private consumption, that variable was not included in the regressions.
  - The November 2008 report (p. 44) claims that capital should flow from slow-growing countries to fast-growing ones. This is incorrect—capital should flow from countries with a low marginal product of capital to those with a high one. This is an issue that concerns *levels*, not growth rates.

#### IV. EUROPEAN DEPARTMENT

42. I read five *Regional Economic Outlook* reports prepared by the European Department (EUR), covering the period from October 2007 to October 2009.

##### A. Structure

43. As for other regions, what is needed is some sense of how the regional economy works. Like the APD reports, the *REO* documents prepared by EUR do not open with a description of how the region functions as an economic unit, and do not refer to background material on that issue. This background information—especially about intraregional real and financial links—would have been particularly useful in the European case, given the role of the euro in the region and the aspiration of many European countries to euro accession, with associated implications for macro institutions and policy regimes.

44. Also like the APD reports, the European reports feature a “recent developments and outlook” chapter, and one or more analytical chapters focusing on an issue of topical

importance for the region. Some of these chapters are well argued and relevant and some are not. The November 2007 report contains an analytical chapter focusing on financial systems in Europe; in view of the U.S. subprime crisis that was ongoing at the time, and the rapid credit growth in emerging Europe, that focus seems very appropriate. The October 2008 report, by contrast, has analytical chapters focusing on coping with high commodity prices, on diverging credit cycles in Europe, and on cross-border labor flows. In light of what was happening in the world economy at the time, this choice of topics seems a little artificial and probably illustrates how events can sometimes get ahead of the planning for the content of the analytical chapters.

45. The October 2009 report, which contains three analytical chapters (on the effect of crisis on potential output, on the effects of changes in potential output on macro policies, and on emerging economies), illustrates a somewhat different problem: the topics of these chapters may be relevant for policy but there is simply not enough to say about them to warrant full chapter treatment, as discussed further below.

### **B. Analytical Perspective**

46. Overall, the EUR reports are much more doctrinaire than are those of other regions about the priority that countries in the region should give to reducing inflation at the expense of other objectives, and about the role of tight macroeconomic policies as the cure for many ailments, and they give relatively little solid analysis to support these views. This perspective tended to dominate in these reports until the true dimensions of the current international crisis became evident, even after the initial slowdown in both the United States and Europe. It is possible that the evident overheating problem that existed in several European countries accounts for the dominance of this perspective, or the perspective may simply represent a departmental “fixed effect”—that is, a longstanding departmental orientation.

### **C. Boxes**

47. Some of the boxes included in EUR reports are very illuminating and others leave much to be desired, either for reasons of relevance or quality. The better boxes include:

- Box 2 of the November 2007 report, on intra-European integration (p. 14), which estimates the growth benefits derived from intra-European trade.
- Boxes 9 and 10 of the November 2007 report, which provide specific examples of financial development in Hungary, and of its shortcomings in Ukraine. The contrast is revealing. Particularly useful is the diagnosis in Box 10 of what needs to be done to foster additional financial deepening in Ukraine.
- Box 8 of the April 2008 report (p. 44), which contains estimates of potential growth rates in Europe. While these estimates may be crude, something like them belongs where this box was placed.

48. Boxes that, in my opinion, fall short include:

- Box 6 of the November 2007 report, which argues that Latvia's small size and limited workforce have impeded the establishment of large export-oriented manufacturing projects, but at the same time that Latvia needs to shift to higher value-added products. What are these products, if not manufacturing for export? The box does not say.
- Boxes 6 and 7 of the April 2008 report, which address the real effects of financial shocks in emerging Europe. The exercise described in Box 6 is a little too mechanical, and the model simulated in Box 7 too stylized, to yield credible quantitative estimates.

#### **D. Tone**

49. These reports put almost an uncompromising emphasis on tight macroeconomic policies and they occasionally lapse into somewhat empty formalism.

50. Illustrating the first of these problems, the October 2008 report (p. 10) states that "in the current circumstances, discretionary loosening [of fiscal policy] is unlikely to be effective" in Europe. This conclusion is not explicitly justified. The emphasis on tighter policies in response to the crisis in emerging Europe (p. 16) is also surprising, given that no evidence is presented to suggest dangers to fiscal solvency in those countries. Similarly, tight monetary policy and accompanying real appreciation are also advocated, to contain second-round effects of food and energy price shocks and to reduce external imbalances. This seems completely unrealistic in the face of the projected contraction in real activity. Along the same lines, the focus in Chapter 2 of the same report (p. 19) on the risks to inflation from higher commodity prices seems highly inappropriate for October 2008. This is especially so since all of the empirical findings reported (p. 22) suggest little reason to fear pressures on core inflation in the advanced countries.

51. The October 2008 report (p. 78) provides the results of a simulation model exploring the effects of labor mobility, but all the simulated effects seem quite intuitively obvious; the model results seem to add formalism but not new understanding.

#### **E. Links to the Professional Literature**

52. While I particularly liked the treatment of financial sector issues in the EUR reports, the links to the professional literature about this topic were often weak. The November 2007 report (p. 28), for example, presents evidence on the benefits of financial development but the arguments in this section do not distinguish between domestic financial development and international financial integration. There is strong evidence on the benefits of the former, but very ambiguous evidence on those of the latter. This problem is still present in the October 2008 report, in which Box 11 (p. 61) gives a very misleading picture of the evidence on financial integration and growth. The box reads as if the verdict on integration and growth is

unambiguously positive, while the bulk of the evidence—including some prominent work done at the Fund—tends to find very ambiguous effects.

53. Along the same lines, there is a large professional literature based on international experience concerning the factors that are conducive to financial development, but this literature is barely referenced where these issues are discussed in the November 2007 report (p. 62). The analysis there relies heavily on correlates of financial development in emerging Europe, based on background work done for this chapter. Why reinvent the wheel on this heavily-researched issue? And if the answer is that a specific focus on emerging Europe is perceived as desirable, why not ground the interpretation on the international experience (to see where emerging European countries fit in) rather than restricting the sample to emerging Europe?

54. A separate instance of the same problem concerns the crisis in emerging Europe. The soft landing for emerging Europe that was projected in the April 2008 report (p. 12) contrasts sharply with what actually happened. Hindsight is, of course, 20/20, but the risks inherent in the evolution of these economies, particularly those in the Baltics, would perhaps have been more evident if the report had taken a broader international perspective and applied the lessons from crises elsewhere. A general problem is that these reports are too Euro-centric.

## **F. Analytical Strengths**

55. The EUR *REOs* provide particularly good analysis of financial sector issues. The perspective taken in the chapters on finance in the November 2007 report, for example—that financial innovation is extremely valuable, but can get ahead of regulatory mechanisms—seems exactly right; the idea should be not to stifle financial innovation, but to ensure that it does not outpace the effectiveness of regulation. And while the advice on macro policies often tends to be more doctrinaire in the European reports than in others, this is not always true; for example, the advice given in the April 2008 report (p. 8) regarding monetary, fiscal, and financial sector policies is sensible and sufficiently nuanced.

56. The many examples of useful and high quality analysis include:

- The use of the National Institute Global Economic model to estimate the real output effects of financial market shocks (April 2008 report, p. 31).
- A valid and well-placed criticism of reduced gasoline taxes (October 2008 report, Box 6, on p. 30)—recall the discussion of this issue in the U.S. presidential contest at the time.
- A useful summary of what went wrong with securitization (October 2008 report, Box 9, on p. 40).

- The use of the global vector autoregression exercise to measure financial interdependence in Europe (October 2008 report, p. 59).
- A plausible and important argument that fiscal multipliers may have increased in size in the current crisis environment (May 2009 report, p. 31).
- The use of the GIMF model to simulate the effects of the crisis on fiscal multipliers, as well as to illustrate the potential benefits from coordinated fiscal expansions in the euro area (May 2009 report, p. 32).
- A very useful discussion of the role of the Stability and Growth Pact in allowing discretionary fiscal responses while ensuring medium-term sustainability (May 2009 report, p. 42). Overall, Chapter 2 of the May 2009 report, on fiscal issues in response to the crisis, is excellent. Chapter 3, on the crisis experience of emerging Europe, is also quite good, in particular on the determinants of bond spreads in these countries (Table 12).
- A revealing comparison of crisis dynamics in Germany, the United Kingdom, and Spain (October 2009 report, Box 1).

## **G. Analytical Weaknesses**

### **Vagueness**

57. Like the APD reports, the *REOs* prepared by EUR are sometimes vague on important issues. The October 2008 and October 2009 reports provide two notable examples.

58. The October 2008 report claims (p. vii) that to safeguard long-term fiscal sustainability in the region requires deficits to be kept within the limits of fiscal rules. But what does this mean? Does it mean that contingency clauses in these rules should not be activated under present circumstances, or that the fiscal response should respect those clauses? It would have been useful to clearly describe the constraints that the Stability and Growth Pact places on the policy response to the crisis, and to discuss whether those constraints allow for an adequate fiscal response. As mentioned above, a good discussion of these issues is indeed provided in the May 2009 report.

59. The October 2009 report leaves rather vague the impact of the crisis on potential output in Europe. The chapter devoted to this issue (Chapter 2) does not offer a convincing single methodology to assess the effects of the crisis on potential output, or even a convincing range of plausible estimates of these effects. It describes several approaches (growth regressions, HP filters, sectoral decompositions) but makes no attempt to reconcile them with each other, leaving any conclusions about the size of the impact rather vague. It is not clear how policymakers could have applied this material to inform themselves about likely quantitative impacts of the crisis on capacity growth.

### Unsubstantiated claims

60. Much too often, these reports make claims that are stated as fact but are not supported by evidence. A partial list of examples follows:

- A claim that labor market reforms in advanced countries have been responsible for increased employment rates there (November 2007 report, p. 16). This is quite plausible, of course, but where is the evidence? Are there no other possible explanations for increased employment rates?
- A statement that lower productivity growth in the financial sector accounted for half of the economy-wide productivity growth gap between Europe and the United States during 1996–2003 (November 2007 report, p. 24); no reference is provided to the studies documenting this fact.
- How was it judged that “reforms in some parts of the region have not progressed enough to sustain current growth rates” (April 2008 report, p. 38)?
- It is not at all clear that the appreciation of the euro in 2008 was caused by “insufficient progress in resolving global current account imbalances” (October 2008 report, p. 1). A more likely explanation, in my view, was a short-run safe-haven effect. How did the authors select one cause rather than the other?
- Similarly, the statement is made that commodity price shocks played an important role in slowing economic activity in Europe (October 2008 report, p. 1). This may be so, but what is the basis for this claim? Is there supporting empirical work documenting the effects of terms of trade shocks on real economic activity in Europe?
- The October 2008 report also prescribes policy objectives that are not supported analytically. For example, on p. 80 it suggests that new member states should seek to improve labor force participation rates. Why should they do so? What are the distortions that are keeping participation rates suboptimally low? These are not explained. On p. 81 it suggests that countries should adopt policies to encourage return migration. Why? Why does the market not already produce the optimal amount of return migration? Again, the source of the problem is not identified.
- A reference to “depreciations beyond levels required to bring real effective exchange rates in line with fundamentals” (May 2009 report, p. 1) presupposes more knowledge than we really have about what the fundamental levels of real exchange rates may be.

### Missing analysis

61. These reports contain many instances where one would have liked to see more analysis. The November 2007 report contains several examples:

- Why have some countries in Europe been experiencing much more rapid housing price increases than others (p. 8)? Is this related to developments in the mortgage market?
- Exactly which tax-induced distortions have contributed to the high rate of credit growth (p. 12)? This is discussed much later, but there is no suggestion here that such a discussion is forthcoming.
- The statement that high tax burdens in emerging economies imply that spending reforms are the only option for fiscal consolidation (p. 12) may be right, but it assumes that the marginal social cost of additional taxation exceeds the marginal social benefit from current expenditure programs. This case has not been made, and cannot be made solely on the basis of the size of the tax burden.
- Why have policies had limited success at slowing the pace of credit growth (p. 35)? What has been tried, and why didn't it work? There is some discussion of this later in the report (p. 44), but not nearly enough.
- Reference is made to a "blistering" rate of financial deepening (credit growth) (p. 35). But how fast is too fast? There is a curious disregard here of the experience of emerging economies outside Europe that have suffered crises because of inappropriate domestic financial regulation (e.g., Chile in the early 1980s, East Asia in 1997). Why not draw the obvious comparisons? Why not use the empirical literature on the determinants of banking crises to evaluate the prospects for problems in emerging Europe? Similarly, how does the behavior of the ratio of private credit to GDP in Table 4 (p. 38) compare to that in countries that have previously undergone rapid financial deepening? Why not see what banking crisis prediction equations say about the vulnerability of these countries to such crises?
- The report does not explain why greater flexibility in labor and capital markets implies a higher "speed limit" (p. 40). I presume that the reason must be that relative price (real exchange rate) adjustments are smoother and less costly.
- The macro effect of overheating (p. 41) is the least of the problems associated with excessively rapid financial market expansion (over-borrowing). I would judge that an even more serious problem may be the misallocation of resources by a poorly regulated financial sector. This possibility is not pursued.
- Why are there such large cross-country differences in the share of foreign-currency-denominated loans among emerging European economies (Figure 29, on p. 41)? This needs to be explained, since there are probably inferences to be drawn here about the quality of financial regulation in these countries.

62. The problem of missing analysis is not confined to the November 2007 report. The April 2008 report (p. 38) offers a growth decomposition for emerging Europe showing that growth has been driven by productivity improvements rather than by accumulation. It would have been more useful, however, to have provided a much more careful interpretation of this outcome than represented by Table 8.<sup>5</sup> The October 2008 report (p. 57) measures the effects of changes in the Financial Conditions Index on real output growth, but leaves the results difficult to interpret. The share of output variability explained by the three financial variables seems too high to be a plausible measure of the effects of exogenous financial shocks on real activity. Instead, it seems more likely that the exercise reflects a combination of transmission through financial variables of more primitive real shocks as well as of exogenous real shocks. The text does not offer this interpretation.

### Incoherent analysis

63. There are multiple examples of analysis that I found incoherent, though, as in the APD reports, with no discernible pattern suggesting specific analytical gaps or biases:

- If the exchange rate has truly been playing a larger role in the transmission of monetary policy in emerging Europe, why has that helped these countries to weather external financial market turbulence relatively well?<sup>6</sup> These statements (November 2007 report, p. 7) seem contradictory.
- There is some ambiguity of language concerning monetary policy in the April 2008 report (p. 5), which claims that monetary conditions have been tightened but credit growth remains high. One interpretation would be that extensive foreign exchange market intervention has been undertaken in a context of high capital mobility, rendering tight monetary policy ineffective. Yet the subsequent narrative continually refers to monetary *loosening*, and even uses a Taylor rule (which describes the behavior of a *policy* rate) as a point of reference to judge the monetary stance.
- Why should the fact that global demand factors played an important role in the run-up of commodity prices imply that some emerging economies may need to adopt a tighter-than-usual monetary stance (October 2008 report, p. viii)? Are not these prices

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<sup>5</sup> Does the strong total factor productivity (TFP) growth in emerging Europe suggest that the financial sector has actually been relatively efficient in allocating resources there? It would have been useful to tie the TFP findings to the extensive analysis of the financial sector elsewhere in the European *REOs*. It is also useful to note that productive capacity has grown faster in the nontraded than in the traded goods sector. But why has this been so, in the absence of real appreciation to drive resources to that sector?

<sup>6</sup> It is not clear to me why the particular channels through which monetary transmission works should have anything to do with how a country weathers external shocks. I suspect that the reason has to do with the advantages of exchange rate flexibility, rather than with the channels of monetary transmission. But if this is true, why have peggers been less affected than floaters?

exogenous to these economies? Why should the reasons for their increase affect how these economies should respond? This makes no sense if the report is looking at this issue from the perspective of the individual country, rather than that of the global economy.

- The October 2008 report (p. 31) states that energy price increases would tend to slow the growth rate of potential output in Europe, over some time horizon. This is undoubtedly true, but given the range of uncertainty that surrounds estimates of potential output, the estimated effect of the energy price increase on the *level* of potential output is so small that it seems hard to draw particular operational consequences for the conduct of monetary policy. The estimate seems like a flimsy basis for drawing such consequences, and makes the inferences about monetary policy on this page seem rather artificial.
- The methodology described in the October 2008 report (p. 39) for gauging the contribution of credit to growth in European economies—that is, by looking at household and corporate financial deficits—seems too crude to be useful. By definition, is this deficit not equal simply to the sum of the government’s and the rest of the world’s financial surpluses? What do we learn from splitting up financial deficits in this way?
- The October 2008 report takes some trouble to debunk the view that labor emigration produces overheating (see, for example, p. 76). Is this a paper tiger? If this view has serious proponents it would have been useful to document it and explain its analytical justification. Is it simply based on a contraction of potential output as the result of a contraction in the size of the labor force? How large can this effect be? And are there no offsetting demand-side effects?
- The description of the bank lending channel in the May 2009 report (Box 1, on p. 9) is confusing. It claims the supply of credit is changed “not only by changing interest rates but also by changing the supply of base money.” Does the report consider these to be independent?<sup>7</sup>

### **Incorrect analysis**

64. Unlike the instances of analysis that I found incoherent, many of the instances of incorrect analysis seem to have a systematic component, apparently being influenced by the direction in which the reports seem to be trying to influence policy.

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<sup>7</sup> This said, I actually found the box very useful, documenting as it does the dislocations of the monetary transmission mechanism in Europe caused by the financial crisis.

65. As already indicated, the EUR reports show a particular orientation toward tight macroeconomic policies. Their analysis is sometimes led astray by the advocacy of such policies. For example, the April 2008 report (p. 16) advises emerging European economies with flexible exchange rates to adopt tight monetary policy to prevent wage growth that would erode competitiveness. But of course, the real exchange rate appreciation that would result from monetary tightening would itself produce just such a loss of competitiveness. This contradiction is not acknowledged. Page 54 of the same report uses a cyclically-balanced budget as a point of reference for fiscal policy. But this choice seems completely arbitrary. As acknowledged by the Sustainability and Growth Pact, sustainable deficits do not have to be zero over the cycle, and there may be good (optimality) reasons for a government to run deficits or surpluses over the cycle.

66. A particular concern with low inflation and wage restraint also produces some analytical glitches. There is some odd analysis in the October 2008 report (p. 30), for example, of the effects of an increase in energy prices on factor remuneration. An increase in energy prices is perceived as reducing the marginal product of labor, thus requiring a reduction in the real wage (correct), but not in the real return to capital (odd). To keep the profit rate constant, firms are advised to increase productivity (it is not clear why they would not have already done that, if they could), but somehow this increase in productivity does not feed back to increase real wages. Wage restraint is the clear message here. On p. 79 of the same report, wage inflation is said to be a consequence of international labor mobility—presumably in source rather than host countries. But it is not wage inflation (an increase in the nominal wage) that should be associated with emigration, but rather an increase in the real wage. This may or may not be associated with nominal wage inflation. Again, a concern with wage inflation distorts the analysis. On the same page, it is claimed that emigration limits the scope for keeping wage growth in line with productivity growth. Why should this be? If the domestic labor force shrinks, that would indeed be expected to increase the real wage, but it should increase labor productivity commensurately.

67. In general, the EUR reports see inflationary dangers too often. As one example, based on a calibrated model the October 2008 report (p. 32) concludes that rising energy prices driven by improved productivity in emerging economies should trigger higher inflation in Europe. But this relationship is not at all clear *ex ante*, since European import prices should fall in this case. I realize that the calibration could indeed produce the claimed result, but one would then want to know how sensitive the outcome is to the specific calibration. The text does not hint at possible alternative outcomes, so the resulting conclusion about monetary policy is not very convincing.

68. Not all the apparent errors in analysis stem from what I perceive as an excessive concern with the policy bottom line. For example, some of the statements in Box 9 of the April 2008 report (p. 48) are rather puzzling: since emerging Europe's current account deficits are significantly larger than those predicted by the empirical model used in this box (at least, according to the figure included in the box), in what sense can the report interpret

these deficits as “justified by fundamentals?” Also, if the deficits are larger than predicted by the model, how can they be explained on the basis of demographics and net foreign asset positions?

## V. MIDDLE EAST AND CENTRAL ASIA

69. I read nine *Regional Economic Outlook* reports prepared by the Middle East and Central Asia Department (MCD), covering the period from October 2005 to October 2009.

### A. Structure

70. Before 2009, the MCD reports had a different structure from those of the other regions. They tended to consist of a single chapter—containing sections on recent developments, the economic outlook and risks, and policy issues—supplemented by a lengthy statistical appendix. The analytical country classifications were based on the role of oil, with countries classified as oil-exporting or oil-importing.

71. New sub-regions were introduced in the May 2009 report, presumably to facilitate analysis of the effects of the crisis, and subsequent MCD reports have subdivided countries into Middle Eastern oil exporters, Middle Eastern oil importers, and the Caucasus and Central Asia, and devoted one chapter to each group.

### B. Analytical Perspective

72. As is true for other regions, the MCD reports leave unclear where the baseline scenario and outlook come from. The narrative in the early reports has an up-and-down character without much apparent coherence, and much of what is described is country-specific. While the narrative description in the “recent developments and outlook” section improves in later reports, the same failure to describe the implicit regional model that characterized the APD and EUR reports also weakens the analytical clarity of the MCD reports. Everything seems to be driven by oil prices and commodity prices, with some mention of remittances but little mention of other types of trade (say, with Russia and China). Developments in regional stock markets are described, but without an explanation of the role they play in these economies (see, e.g., the October 2007 report, p. 18). Frequent reference is made to capital inflows, but with little indication of the degrees to which different economies in the region are linked with international financial markets. Finally, while some countries are classified as emerging markets, this seems to make little difference in the way they are analyzed in the reports.

73. The implicit structure of the regional model becomes more apparent in later reports. The October 2008 report (p. 14), for example, notes that foreign direct investment and remittances from the Gulf Cooperation Council (GCC) countries have helped sustain demand in the oil-importing countries of the region. This kind of observation provides a useful insight into regional economic interactions, which are not as evident in these reports as a reader

might like.<sup>8</sup> Similarly, the May 2009 report (Box 3) gives a very useful summary of the economic relationships between the GCC and the Middle Eastern oil importers. And, for the first time in these reports, p. 26 of the May 2009 report emphasizes the important impact that developments in Russia have on the Caucasus and Central Asia (CCA). The October 2009 report contains a useful box (Box 3.2) on the role of remittances from Russia in crisis transmission. Why were these regional interactions not covered in prior reports?

74. The MCD reports frequently advocate fiscal expansion rather than real appreciation as a tool to reduce current account surpluses in oil exporting countries (e.g., the October 2007 report, p. 28). But as in the APD reports, this advocacy takes too much of a “global imbalances” perspective. Whether these countries (many of which are very poor) should try to reduce surpluses or not should depend on the investment opportunities they have at home, not on what they can contribute to reducing global imbalances.

### **C. Boxes**

75. By and large, the MCD reports contain appropriate boxes. The May 2006 report, for example, contains boxes on the disposition of oil revenue in oil-exporting countries, the pass-through of higher oil prices in the oil importers, and developments in regional equity markets, which boomed at the time. More so than those of other regions, these reports also contain informative boxes on recent developments in specific countries. For example, the October 2007 report contains boxes on Kazakhstan (Box 4), and Armenia (Box 5). The inclusion of boxes with country capsules illustrating particular development strategies or policy frameworks is an excellent idea.

76. All is not perfect, however. For example, in the May 2008 report, which singles out Kazakhstan as the only country directly affected through its financial sector by the international financial crisis, it would have been appropriate to have included a box on events in that country, but none is provided.

### **D. Tone**

77. Like the *REOs* produced by other area departments, the MCD reports are highly prescriptive. Box 1.1 of the October 2007 report, on the Maghreb countries, provides a good illustration.

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<sup>8</sup> This report is notable for citing research—a practice less common in the MCD reports than in the *REOs* of APD and EUR.

### **E. Links to the Professional Literature**

78. The MCD reports stand out from the others for their relatively scarce references to the professional literature. There are many places where such references would have been appropriate. For example:

- In the September 2005 report, the presentation in Box 3.1 gives a misleading impression of rigor. Estimating real exchange rate undervaluation for the CCA countries based on regressions of the price level on per capita incomes is both desirable—because it imposes some discipline on judgments about undervaluation—and undesirable, because it is a very crude and approximate procedure. The literature offers much more sophisticated ways to estimate misalignment.
- In the September 2006 report, Box 3.1 on remittances is an important addition, since remittances are very important for many countries in the region. But the box makes a number of assertions about the macroeconomic effects of remittances that are not backed up by evidence or references to the rather large professional literature on this subject.
- In the May 2008 report, Box 7 on the factors driving high oil prices (fundamentals or speculation) is very appropriate, since this issue was hotly debated at the time. But the box makes no reference to outside work on the topic. By comparing the price of oil to that of gold, it concludes that speculation contributed to the run-up in oil prices in 2007. It does not consider other types of evidence—for example, evidence of oil hoarding—that might bear on this question.

### **F. Analytical Strengths**

79. By and large, I found the analysis in these reports very reasonable, and more flexible in drawing implications for policy than reports prepared by the EUR, for example. While appropriate analytical tools are not always used (see below), I found many positive features.

For example:

- The executive summary of the May 2008 report mentions the possible need to live with inflation, at least for a while, in the oil-exporting countries with dollar pegs; the need to make an exchange rate regime choice for the proposed GCC monetary union; and the urgent need to overhaul educational systems in the region.
- The October 2009 report (p. 19) usefully observes that the limited engagement of Middle Eastern oil importers in advanced manufacturing has helped insulate them from the crisis.

- To assess the appropriateness of the fiscal response to the oil boom in oil-exporting countries, it is correct to use the non-oil fiscal stance, rather than the overall fiscal outcome (September 2005 report, p. 20), but using the non-oil fiscal impulse would have been better. The October 2009 report (p. 24) uses fiscal impulses, rather than actual fiscal deficits, to assess changes in the fiscal policy stance (specifically, fiscal responses to the crisis). In the same report, I particularly liked the decomposition of the change in the primary deficit into the fiscal impulse and the effect of automatic stabilizers in Figure 3.6 (p. 35).
- Table 1 of the May 2009 report (p. 8) gives a very useful summary of the policy response of Middle Eastern oil exporters to the crisis, and this is repeated for the other groups.

## **G. Analytical Weaknesses**

### **Vagueness**

80. As in the reports of APD and EUR reviewed above, vagueness in some of the policy prescriptions in the MCD reports sometimes reduces these prescriptions to the level of platitudes. For example, in the September 2005 report (p. 2), the advocacy of spending in oil-exporting countries to reduce global imbalances is appropriately qualified to refer only to “quality” spending but without, unfortunately, suggesting how to recognize “quality” spending or how much “quality” spending there is to be done. Similarly, in the same report, advocacy of exchange rate appreciation to contain inflation is appropriately qualified with the need to promote productivity to preserve competitiveness, but again without indicating how, how quickly, or how effectively this can be done. The October 2008 report makes continued calls for structural reforms that could boost competitiveness in the non-oil sectors. But what exactly are these reforms? Overall, the policy advice at the end of the October 2008 report is vague and somewhat textbookish. More concreteness would have been useful here.

81. In other cases, the language leaves unclear what is exogenous and what is endogenous. For example, p. 10 of the October 2008 report contains the statement: “wages have been increased in more than half of MCD countries... .” This seems to suggest an exogenous policy decision. But what does it refer to exactly? To public sector wages? To minimum wages? Other wages would presumably be endogenous. Only later does the report make clear that the reference is indeed to wages that are set by policy.

### **Unsubstantiated claims**

82. Some of the unsubstantiated claims in the MCD reports seem to reflect a particular policy bias or perspective. Among the instances that seem systematic to me are those that clearly reflect the Fund’s view on certain issues. The September 2005 report (p. 36), for example, claims that the virtues of the Fund’s preference for nominal appreciation to combat inflation in the face of capital inflows are well documented, but it neither explains nor

documents them. In the same vein, the October 2009 report (p. 27) states that “creating an environment more conducive to private business” should be the key to reducing unemployment, but it leaves unclear why this should be so. Where is the research that backs up this statement?

83. In other cases, the deficiencies in this regard appear to be more innocent:

- The September 2005 report (p. 38) claims that remittances are priced in local currency, but gives no supporting references.
- Box 1 of the October 2008 report contains very informative maps on the contributions of food and fuel prices to headline inflation. It claims that higher food and fuel prices feed through into core inflation, depending on a country’s inflationary history. While this may be true, no evidence is presented and no references are given.
- The October 2009 report (p. 36) claims that there is extensive financial dollarization in the CCA countries, but provides no data to support this.

### **Missing analysis**

84. Unfortunately some of the missing analysis in these reports concerns issues that are central to the region: poverty, income distribution, unemployment, and domestic debt markets. For example, though the earlier MCD reports repeatedly point to the persistence of poverty in the face of rapid growth in the region, not until the May 2007 report (p. 27) is it acknowledged that a failure to reduce poverty even in the face of high growth means that income distribution needs to be improved in these countries. This issue deserves much more prominence than it receives in these reports. There is considerable and appropriate concern in the MCD reports with unemployment in the region (e.g., the end of Chapter 1 in the September 2005 report), but unemployment is consistently interpreted as a growth problem. In fact, the analysis needs to recognize that a substantial part of the unemployment in the region may be structural, requiring microeconomic rather than macroeconomic policies to address it. The September 2006 report (p. 19) refers to the fact that rapid growth has not made a large dent in unemployment, not acknowledging the possibility that the natural rate of unemployment is high in many MCD countries. There is also a recurrent theme concerning the need for the Middle Eastern oil exporters to develop domestic debt markets, as well as some discussion of why this may be useful (see, for example, the concluding suggestion on p. 16 of the October 2009 report), but no identification of what constraints might limit the development of these markets.

85. Aside from such region-specific issues, analysis is also missing on more traditional fiscal, exchange rate, and financial sector policies that are the Fund’s bread and butter. Regarding fiscal matters, a recurring theme in all of the MCD reports (see, for example the September 2005 report, p. 10) is that of fiscal space. Though the May 2009 report makes frequent (and appropriate) reference to the role of fiscal space in determining the fiscal

response to the downturn, it gives no indication of how the availability of fiscal space can be determined, except at the very end of the October 2009 report (and see below for a criticism of that analysis). Similarly, the advocacy of fiscal measures to put debt/GDP ratios on a declining path in several countries (p. 29 of the October 2007 report) does not seem to be based on any notion of what a desirable debt/GDP ratio should be in those countries. And while it is appropriate to point out that debt reduction achieved through privatization *may* not improve the public sector's net worth (September 2005 report, p. 10), it would have been useful to explain the conditions under which it *would* do so and to have taken a position on whether it *has* in fact done so in the countries under review.

86. Turning to exchange rate policy, the advocacy in the October 2007 report (p. 29) of real appreciation in the CCA countries, to control inflation and avoid its harmful effects on growth, does not factor in the potential deleterious effects of real appreciation on growth. This issue is more complicated than the report supposes.

87. Analysis is also missing with regard to some financial sector issues. For example, the use of a financial stress indicator in Box 2.1 of the October 2009 report is informative, but the box does not explain what statistical procedure permits it to conclude that financial sector stress had a small effect on growth in the Middle East, North Africa, Afghanistan and Pakistan region. This issue is too important in the current context to leave the analysis incomplete.

### **Incoherent analysis**

88. Like the cases of missing analysis, instances of incoherent analysis involve some aspects that are region-specific and others that involve areas of particular Fund competence. A recurrent region-specific issue concerns the role of so-called “flexible” labor markets in contributing to price stability in the context of a large expansionary shock in aggregate demand in oil-exporting countries, such as one arising from an oil boom. This is brought up, for example, in the September 2005 report (p. 23), and there are other references to “flexible labor markets” keeping inflation under control in the May 2006 report (p. 14) and the September 2006 report (p. 11). But why should we expect a “flexible” labor market to imply less inflation in response to an expansionary aggregate demand shock? The issue is, of course, what precisely is meant by a “flexible” labor market. I can understand the effect of trade openness in limiting inflation (under a fixed exchange rate), but the “flexible” labor market argument has to be based on labor supply elasticity rather than on wage flexibility or intersectoral labor mobility. This distinction is finally made on p. 15 of the September 2006 report, with a reference to “open product and factor market.” Should this be interpreted to mean an elastic supply of labor because of migrant workers? Not until Box 2 of the May 2007 report is a clear explanation finally presented of why the real exchange rate in oil-exporting countries has not appreciated as one might have expected, and the answer is indeed not labor market “flexibility” as such, but rather labor market *openness* (i.e., the role of migrant labor).

89. There are also problems of incoherence regarding exchange rate and monetary policies. It is hard to see what real exchange rate appreciation means in the oil-importing countries—for example, whether it simply reflects an increase in inflation as the result of pass-through of higher imported oil prices (October 2007 report, p. 17). If oil prices are rising throughout the world, the direct impacts on national price levels will depend simply on the extent to which these increases are passed through to the domestic economy. There also seems to be general confusion in these reports about monetary policy in countries with managed exchange rates.

90. Regarding monetary policy, there is a contradiction in the October 2008 report (p. 16), where it is stated that oil-exporting countries with fixed exchange rates have had to follow the expansionary monetary policies of the United States at a time when their cyclical conditions call for the opposite, but also that they have undertaken open market operations to mop up liquidity. If these countries truly have no monetary autonomy, and need to follow U.S. monetary policy, they cannot effectively “mop up” liquidity. And on p. 30 of the same report it is claimed that raising interest rates in such countries would attract capital inflows, which fuel inflationary pressures. But if interest rates are successfully increased, that should reduce aggregate demand whether more capital inflows are attracted or not. Finally, an analysis of the factors contributing to the recent slowdown in credit growth in the region (October 2009 report, p. 8) is not very informative; it is basically an accounting exercise on banks’ balance sheets without providing any way to tell what is driving what.

### **Incorrect analysis**

91. Examples of weak or incorrect analysis in the MCD reports include the following:

- The region’s reports typically express reserve adequacy in terms of months of import cover. This indicator is anachronistic, except perhaps for countries with no access to international capital markets. More useful in countries that are more closely linked with international capital markets are the ratios of reserves to short-term external debt or to some domestic monetary aggregate.
- The suggestion that CCA countries should move to more flexible exchange rate regimes to improve competitiveness (October 2009 report, p. 29) only works when capital is tending to flow out. When it is tending to flow in, the effect on competitiveness is just the opposite.
- The appendix on fiscal space in the October 2009 report is weak, defining fiscal space as existing only when public debt and interest rates on public debt are low, without specifying what “low” means or how these two components can be traded off for each other in assessing fiscal space. The rationale offered in the appendix for taking debt interest rates into account in this calculation is incorrect.

## VI. SUB-SAHARAN AFRICA

92. The African Department (AFR) produced the earliest regional economic reports, beginning in September 2003. I read 13 *Regional Economic Outlook* reports prepared by AFR on Sub-Saharan Africa (SSA), covering the period from October 2003 to October 2009.

### A. Structure

93. The structure of the SSA reports has changed dramatically over time, revealing the experimental nature of the earlier reports. The initial reports consisted of a foreword, an overview, a review of recent economic developments, a section on economic policies, and a section on prospects for the region. Later reports are more similar in structure to their contemporaries from other regions, featuring an overview chapter and usually two or three analytical chapters. Like the MCD reports, the SSA reports have consistently contained lengthy statistical appendices. Such appendices seem more useful for this region than most others, since macro data for countries in SSA are less likely to be familiar to most readers from outside the region.

94. SSA reports' analytical chapters are not always well motivated. The May 2006 report, for example, contains chapters on aid, financial sector development, and decentralization. The latter two topics did not receive much attention in earlier reports from the region, so it is unclear why they merit entire chapters in May 2006. Since these issues did not suddenly become important in 2006, they either did not receive sufficient attention in earlier reports or they receive excessive attention in the May 2006 report. I believe that these issues have been of long-standing importance for the region, and should have been more prominent in earlier reports. The point to be made here, though, is that these analytical chapters are not well connected to the ongoing narrative for the region.

95. The audience for this region's reports seems to be a little different from that of the reports from other regions, in that it includes in a very self-conscious way the international community at large (presumably policymakers, aid organizations, and civil society in industrial countries). These reports quite often call for policy action by industrial countries on behalf of countries in SSA (e.g., trade liberalization, the removal of agricultural subsidies, and additional donor assistance in fulfilling the 2005 Gleneagles accords).

### B. Analytical Perspective

96. Like the *REOs* reviewed so far, the SSA reports do not explicitly provide a view of how their region functions as an economic unit—that is, of an implicit regional economic model. But Box 2.3 in the September 2006 report, on South Africa's economic links with the rest of SSA, is very appropriate and should have been in earlier reports, to give the reader some indication of the extent of intraregional economic relations, at least in Southern Africa.

97. Like the reports on other regions, the early SSA reports contain little systematic institutional or structural background on the countries in the region (e.g., on their exchange rate regimes, the nature of their links with international capital markets, the composition of their exports, their main trading partners, and so on) or on the most salient aspects of their current economic situation. For example, it would have been beneficial to inform the reader much earlier than on p. 20 of the April 2008 report that real per capita income in SSA now is about the same as in the mid-1970s, and that the poverty rate is 41 percent! The writing in the early reports is monotone and tedious, with too much emphasis on and discussion of international agreements and organizations, and the use of many acronyms.

98. The initial SSA reports also contain no analytical country groupings, but instead a hodgepodge of country-specific results. A new classification of countries was introduced in the September 2006 report: countries are classified as resource-rich (oil exporters and importers) and non-resource-rich (coastal and landlocked). This became the standard classification for most subsequent reports, and seems useful.<sup>9</sup>

99. A surprising aspect of the SSA reports, given the number of LICs in this region, is that little attention is paid to the development strategies being pursued—or that should be pursued—by these countries. The April 2007 report takes up the issue of development strategy for the first time, arguing that removing structural impediments to value-added industries linked to agriculture and commodities is the key to stimulating growth (p. 2).

### C. Boxes

100. The first SSA report (September 2003) contains very few boxes, and its graphs are very crude. Such boxes as are included in the initial report are so vague as not to be very useful; that on p. 24, for example, is mainly anecdotal. Matters improve in successive reports, but gradually. The May 2004 report contains several boxes, but these and the figures are very poorly integrated with the text and many are deficient. Box 2, for example (p. 7), on causes and remedies for civil wars, is suitable for inclusion given the SSA context as well as the extensive amount of outside research on these issues for SSA, and it appropriately discusses some of the relevant literature, but the “findings” it discusses are primarily platitudes. Box 3 (on famine and drought) is also appropriate, but would have been more useful had it provided some evidence on incidence, severity, and impacts.

101. As is true for other regions, there are boxes that suggest themselves but are not included in the early reports. For example, the May 2004 report (p. 35) cites Benin, Burkina Faso, Cape Verde, Mozambique, Tanzania, and Uganda as countries that have implemented the “sound policies and structural and institutional reforms” that the report repeatedly calls

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<sup>9</sup> The October 2009 report (p. 7), however, describes four groupings as “traditional” for the Sub-Saharan Africa *REOs*: oil exporters, MICs, LICs, and fragile countries.

for. Why not include extended boxes on these countries explaining what exactly they did, and how? This would offer an opportunity to take the policy recommendations beyond platitudes. In the September 2006 report, it would have been useful to add a box on how Madagascar managed to sustain its textile exports to the EU after textile quotas were phased out, in contrast to other SSA countries (p. 6). A box discussing Zimbabwe and its impact on the region is conspicuously absent from these reports until October 2007, and even that box contains no discussion of spillovers to other countries in Southern Africa. I presume the topic must be politically sensitive. Another opportunity is missed in Chapter 3 of the April 2008 report (on private capital flows to SSA): given that Uganda seems to have been the only SSA country that liberalized its capital account at one go, it would have been useful to have had a box distilling lessons from its experience.

#### **D. Tone**

102. There is little to distinguish the tone of the SSA reports from that of the reports prepared by other departments. Like the others, the SSA reports are highly prescriptive. Overall, the policy orientation of the SSA reports is more similar to those of APD and MCD than to those of EUR, in that they are less committed to a particular policy stance and are relatively eclectic.

#### **E. Links to the Professional Literature**

103. Like the MCD reports, the early SSA reports make very few references to the professional literature. Instead they place heavy reliance on ad hoc and crude made-to-suit evidence as support for analytical or empirical propositions. Such evidence takes the form of country classifications and simple correlations (such as comparing countries with and without Fund programs, or those with below- and above-median values on some indicator) to draw inferences, such as about the role of public investment in growth.

104. Reliance on existing research has increased over time in SSA reports. While the September 2003 report, for example, contains almost no such references (an exception is the reference to research on exchange rate pass-through in South Africa on p. 10), later reports make extensive use of the professional literature. For instance, though the chapter on aid in the May 2006 report is rather textbookish and mechanical, it does discuss some of the more prominent professional literature on the topic, and the September 2006 report (Box 2.5) contains a good box on the role of remittances in SSA, with literature references.

#### **F. Analytical Strengths**

105. I found some of the analytical chapters in the later reports to be excellent. Chapter 4 of the May 2006 report, on financial development in SSA, is an example: its analysis is sound and its policy recommendations are concrete (e.g., leasing to overcome problems with collateralization, harmonization of the financial institutional environment within monetary unions to allow for economies of scale) and reasonable. Chapter 5 of the same report, on

fiscal decentralization, gives a critical but balanced evaluation of experience to date and makes frequent reference to existing research on these issues in the region.

106. Overall, the April 2008 report is a very good one. Chapter 2 of that report (on monetary frameworks in SSA) is insightful and very useful: p. 34, for example, contains a creative and convincing argument for money targeting during the transition away from fiscal dominance, using money in a “tripwire” fashion to indicate that the stabilization is on track, and p. 35 presents a good argument for implementing some aspects of inflation targeting in countries that are already implementing a flexible monetary framework; the section containing that analysis is well thought out. Similarly, Boxes 2.4-2.6 of the same report, describing the monetary frameworks in various SSA countries, are excellent. The summary appendix table on capital account liberalization in the case study countries (p. 69) is very informative and useful. The chapter on power generation is appropriate, well-written, and thoughtful.

107. The October 2008 report, too, contains good material. On p. 23, for example, the report observes that the recent positive (pre-crisis) SSA growth experience—which was widespread across very different countries—suggests that there is little evidence of a poverty trap. This point is worth making as a counter to development pessimism, because it suggests hope for all countries. Chapter 2, on growth successes, is clearly written and well reasoned; though not analytically ambitious, it is a useful description of how much things have changed in SSA.

108. Other examples of solid analysis include:

- The use of the Global Trade Analysis Project in the September 2006 report to simulate the impact on GDP of higher oil prices.
- The appropriate acknowledgement in the September 2006 report that first-best policies in ameliorating the impact of higher oil prices on the poor are not feasible, and the proposing (p. 26) of a very reasonable set of second-best policies.
- The 2009 reports offer solid analysis of responses to the international crisis. The “four principles” listed in the April report (p. 19) to guide policy responses to the crisis are sensible and balanced, and the priority given in Box 1.5 (p. 21) to spending rather than tax cuts as countercyclical policy, and to spending on labor-intensive infrastructure projects with a low import content, is well placed. The demonstration of fiscal procyclicality in SSA (October 2009 report, p. 36), using the methodology of Kaminsky, Reinhart, and Vegh (2004), usefully illustrates the contrast with the past in SSA’s current countercyclical stance, showing the virtues of fiscal prudence during good times.

## G. Analytical Weaknesses

### Vagueness

109. A consistent problem with the SSA regional reports is vagueness with respect to policy advice. The problem is not universal in these reports, which make many concrete suggestions, but it remains true from September 2003 to October 2009 that many good things are advocated in general terms without being translated into concrete policy advice. The September 2003 report (p. 24), for example, advocates labor market reform in South Africa and structural reforms in Nigeria, without giving any specifics. There are many other examples:

- The advice in the April 2007 report (p. 11) to deal with Dutch disease by “close coordination of fiscal and monetary policies, raising productivity and strengthening the supply side of their economies by promoting private sector activity and liberalizing their trade regimes” is (except for trade liberalization) meaningless. Similarly, Box 2.5 of the same report, on promoting private sector development, is preachy and vague.
- Chapter 5 of the April 2007 report, on domestic debt markets, is timely but contains policy advice that is generally vague. Country-specific diagnosis of the reasons why domestic debt markets have failed to develop sufficiently is notably absent. Boxes providing case studies of countries where such markets are more extensive (Kenya and Mauritius) would have been very useful.
- In the October 2007 report (Box 1.2, on p. 12), the use of the Jeanne-Ranciere model to assess reserve adequacy is commendable, but the discussion of the results is too vague and general. More specific results would have been much more informative. If these could not be published for sensitivity reasons, it would have been better not to mention them at all.
- Many of the SSA reports (including the October 2007 report, p. 17) refer frequently to the need for coordinating fiscal and monetary policies, but without much indication of what this means. Similarly, the frequent exhortations (e.g., p. 34 of the same report) to increase the productivity of traded goods sectors to mitigate the effects of real appreciation are all well and good, but how can this be done?
- In the April 2008 report (p. 10), what are the “distortions in monetary and fiscal policy that discourage bank lending?”
- Another example of vague policy advice appears in the April 2008 report (p. 20): “in some countries, exchange rate changes may help rebalance growth.” Which countries? What types of exchange rate changes? Does “rebalance” mean stimulate?

- Even somewhat idiosyncratic aspects of the regional policy experience (such as the prevalence of monetary targeting) are not always explored in enough depth. The discussion of monetary targeting on p. 26 of the April 2008 report, for example, really gives no guidance as to when targeting money may be appropriate.
- Occasionally, too little information is given to enable the reader to evaluate the analysis. For example, in the April 2009 report (Box 1.4, on p. 18) the usefulness of simulations such as those reported on the effects of the global slowdown on SSA is limited without more information on how those simulations were constructed. Another example is Box 2.1 in the October 2009 report (p. 42), which is not very informative about how the debt sustainability analysis for SSA was performed.

### **Unsubstantiated claims**

110. There are many unsubstantiated claims in the SSA reports, as in the reports of other regions. At times this seems to be explained by the authors' acceptance of conventional wisdom inside the Fund. For example, the SSA region achieved a dramatic and widespread acceleration in growth for several years before the recent crisis. The Sub-Saharan Africa *REOs* frequently attribute growth accelerations to good policy frameworks, as is done in the May 2004 report (p. 4). But how do we know? No evidence is given in that report, and this problem of attribution turns out to be a recurring issue. For example, in Box 1.5 of the October 2008 report, on what basis is it judged that growth in agricultural production from 1980–89 to 2000–05 in SSA was due to reduced conflict, greater economic stability, and reduced taxation? While plausible, this interpretation is not substantiated. Finally, where is the evidence for the statement in the April 2009 report (p. 23) that capital controls have been ineffective in SSA LICs? The May 2006 report (p. 49) states that “it already appears that past problems [with development banks] are likely to reemerge.” But this statement is not expanded upon. What are the indicators? How do we know?

111. At other times, evidence is provided but is much weaker than it could be. The May 2006 report (p. 21), for example, contains the odd statement that because sustained-growth countries in SSA have avoided overvalued exchange rates through macro stability, countries that receive aid must manage their economies prudently. I think the author is trying to say that real appreciation undermines growth, so aid-receiving countries need to try to avoid Dutch disease. This is reasonable advice, but it does not have to be based on the particular correlation mentioned and on a very crude notion of overvaluation. There is plenty of professional literature on this issue that could have been cited here, and would make the point much more strongly.

112. Lack of substantiation also emerges even when the professional literature is cited, since those citations are not always offered in the most convincing way—that is, in a way that convinces the reader that what is being reported is something close to a professional consensus. On p. 4 of the October 2005 report, for instance, only one source is cited on

behalf of the proposition that increased spending on infrastructure is good for growth. But is there any contrary evidence? Why not cite the findings of a survey of the literature, rather than of an individual paper? There must be several such surveys. By contrast, the reference in the October 2009 report (p. 46) to surveys such as Nijkamp and Poot (2004) on productive public spending is very appropriate.

### **Missing analysis**

113. Some of the policy advice provided in these reports is not backed by economic reasoning. For example, the May 2006 report (p. 14) prescribes tighter fiscal and monetary policies for fixed-exchange-rate oil-importing countries that experience an oil price increase. Why is this necessarily the right policy stance? What is the implicit objective that would be achieved with such policies? Is it just price-level stabilization? There is no unambiguous general prescription for such policies in response to an oil price shock, and no justification is given here.

114. In several instances, statements in one regional report either contradict those in earlier reports or seem to run counter to policy prescriptions in earlier reports, but the inconsistency is not acknowledged or explained. For example, the October 2005 report (p. 16) discusses a World Bank study finding that reductions in distortions in agricultural trade in OECD countries would not yield large benefits for Africa. This runs counter to claims made in earlier regional reports about the importance for Africa of advanced-country liberalization of agricultural trade, but the issue is not discussed in more depth. In another example, the April 2009 report (Box 2.6 and the material surrounding it, p. 39) seems to suggest that industrialization is a necessary concomitant of sustained fast growth. Whether this is right or wrong, it conflicts with the views expressed in an earlier report, which referred to the counterexamples of Argentina and New Zealand as countries that have grown successfully without industrializing. What is the department's view on this issue?

115. Other examples of missing analysis include:

- In the April 2007 report (p. 32), the simulation model for Nigeria (essentially a financial programming model) seems far too simple to tackle the question posed (the macro effects of a large scaling up of public spending). A more sophisticated framework is required for addressing such a question.
- Chapter 2 of the October 2007 report, on case studies in creating fiscal space for productive spending, is very appropriate. However, it suffers from lack of detail, such as on how these countries managed to increase revenue and improve the efficiency of spending. For example, how much did opening the large taxpayer office in Rwanda (p. 32) contribute to the large increase in tax revenue there? The analysis of tax reforms in Tanzania (p. 34) is much better.

- The October 2008 report (p. 11) refers to the absence of traded-nontraded price indexes and the consequent need to use CPI-based real exchange rate measures. But real exchange rate measures using foreign producer price indexes and the domestic CPI are also an option, and because they typically cover traded goods, have the advantage of not being contaminated by changes in relative prices of foreign traded-nontraded goods.
- Box 1.1 of the same report is useful and informative, but it begs the question of why—if world food prices have had a relatively small impact on domestic food prices—headline inflation in the East African Community (EAC) increased from 8 percent in 2007 to 20 percent in mid-2008.
- The April 2009 report contains several pieces of analysis that could usefully have been extended. In Box 1.1, for example, if the financial channel is indeed growing, and if this is increasing the impact of world growth on SSA's growth, these trends could have been picked up in the regressions by allowing the coefficient of partner-country growth to change over time. Also, it would have been useful to have provided measures of the fiscal impulse in response to the global growth slowdown.

### **Incoherent analysis**

116. Several examples of analysis that I found incoherent may reflect the *REO* authors' uncritical acceptance of conventional wisdom inside the institution, while other examples appear to be less easily explainable.

117. Cases where conventional wisdom may have stood in the way of clear analysis include the following:

- In the April 2007 report (p. 18), the claim that domestic absorption can be raised by liberalizing trade (a policy frequently advocated by the Fund) is unsupported. While trade liberalization may affect the composition of absorption, why should it affect total absorption? Does this proposition simply rely on an income effect? If so, how quantitatively important is this effect?
- Box 1.4 of the October 2008 report (p. 19) advises that because the first-round inflation effects of increases in food prices may be difficult to distinguish from the second-round inflation effects, central banks may want to resist even first-round effects. This does not logically follow. At the very least, it places a large weight on inflation relative to output stability.
- I do not understand the statement in the October 2008 report (p. 22) that countries experiencing expansionary aggregate demand pressures should resist a combination of expansionary fiscal policy and loose monetary policy because "it would place excessive pressure on nominal exchange rates to facilitate external adjustment."

Countries in this situation should avoid this policy package because they are facing excess demand, not because of what happens to the exchange rate.

118. An example of incoherent analysis that does not fit a systematic pattern appears in the October 2009 report (p. 35), which does not adequately address the tension between its advocacy of countercyclical fiscal policy and the reported finding that fiscal multipliers tend to be very small in LICs. The tension might be reconciled by emphasizing, more than is done in the report, spending that is specifically targeted to have larger impacts on both aggregate demand and supply (e.g., infrastructure investment rather than tax cuts).

### **Incorrect analysis**

119. The September 2006 report (p. 24) erroneously refers to remittances as “private capital.” Worker remittances are not capital flows, and these reports should not make that mistake.

120. The April 2007 report (footnote 32, on p. 33) makes some questionable statements. First, it claims that sterilization would reduce domestic demand. This is incorrect: it would merely prevent an increase in domestic demand. Second, it claims that selling foreign currency (causing the real exchange rate to appreciate) would “facilitate the resource transfer necessary to stimulate growth.” Under what conditions does real appreciation stimulate growth?

121. In the October 2008 report (p. 35), the measurement of overvaluation is too simple and should not be taken seriously, since PPP is not an appropriate benchmark for the equilibrium rate.

122. The October 2009 report (Box 1.1, on p. 14) looks at the fiscal response to the crisis. Because output was affected by the crisis, the authors question whether normalizing fiscal deficits by output is a good idea, and instead look at spending normalized by revenues. But revenues are likely to have been affected even more than output. Why not normalize, say, by de-trended output?

## **VII. WESTERN HEMISPHERE**

123. I read eight *Regional Economic Outlook* reports prepared by the Western Hemisphere Department (WHD), covering the period from May 2006 to October 2009.

### **A. Structure**

124. Perhaps because of the special characteristics of the regional economy, I found the structure of the Western Hemisphere *REOs* to be analytically more appealing than those of other regions. The WHD reports typically begin with an overview of the world economic situation, to describe the international environment in which regional developments play out.

Since this environment is exogenous to all of the countries in the region except the United States, this makes sense. Next, the reports consider developments in the United States. Because the United States is by far the largest economy in the hemisphere, and dominates economic events in most of the rest of the countries in the region, this is an appropriate second step. The first chapter is completed with an analysis of developments in Canada which, while itself affected by events in the United States, is also largely in the role of influencing rather than being influenced by other individual countries in the region. The second chapter analyzes the situation in Latin America and the Caribbean (LAC), taking account of spillovers from both the United States and Canada, as well as from countries outside the region.

125. In turn, LAC is subdivided into three parts: commodity-exporting countries with inflation targeting (IT) regimes, commodity-exporting countries without IT regimes, and commodity-importing countries. This structure is also appropriate because the largest economies in the region (Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela, the “LAC-7”) all tend to be commodity exporters, and fluctuations in commodity prices thus represent an important link between events in those countries and in the rest of the world, including the United States and Canada. These large commodity exporters are all fairly closely integrated with international financial markets (at least in normal times). Yet the large commodity exporters differ with respect to their overall macroeconomic policy orientation, in ways that are highly relevant to the analysis of domestic macroeconomic developments in those countries. Specifically, the largest subgroup of these countries (which includes Brazil, Chile, Colombia, Mexico, and Peru from the LAC-7, but also Uruguay), has made much more significant progress in reforming its domestic macroeconomic institutions (with floating exchange rates, inflation targeting, and substantial fiscal reforms, including the enactment in several of these countries of fiscal responsibility laws), than the smaller subgroup (including Argentina and Venezuela from among the LAC-7, but also Bolivia, Ecuador, and Paraguay). Accordingly, the former group has achieved more significant fiscal adjustment, lower inflation, and lower sovereign risk premiums than the latter.

126. The more recent Western Hemisphere *REOs* include analytical chapters that are meant to probe more deeply into important policy issues in the region. These chapters usually emerge as natural extensions of the two overview chapters since they address issues that arise naturally from those chapters (though, like some of those in other regions, a few of them appear somewhat forced). As an example of the former, the May 2009 report has a particularly sensible structure, with a chapter on the United States and Canada, a chapter on LAC with very relevant annexes, a chapter on banking systems in LAC (which was very appropriate given crisis-related developments at the time) and a chapter on role of foreign banks in transmission of financial shocks, which was again very appropriate in light of the origin of the crisis in the U.S. financial system.

## **B. Analytical Perspective**

127. The analytical approaches adopted in the Western Hemisphere *REOs* appear broadly appropriate and up to date. In my view, the use of a coherent implicit model of how the region works as an economic unit helped the staff get some aspects of the economic outlook right in these reports. For example, the April 2006 *REO* emphasizes the risks posed to the region by a potential deterioration in the U.S. housing market. This turned out to be very prescient.

## **C. Boxes**

128. As I have mentioned before, in my view boxes should be used to illuminate and/or illustrate issues that arise in the text. The boxes in the WHD documents generally do a good job on this score. Those in the November 2006 report, for instance, seem particularly well chosen.

## **D. Tone**

129. Like the reports from other regions, the WHD reports are quite prescriptive. Rather than just simply analyze recent developments and the regional outlook, they take strong positions on policy priorities as well as on the types of policies that should be undertaken to satisfy those priorities.

## **E. Links to the Professional Literature**

130. The links to the professional literature in the Western Hemisphere *REOs* are more similar to those in the *REOs* produced by APD and EUR than to those produced by MCD and AFR, in the sense that fairly generous references are made to professional research. Overall, I found the reports produced by WHD to be adequately grounded in the professional literature, though with some gaps. For example, the claims made in the April 2008 report (p. 10) about the impact of remittance flows on poverty and inequality are not supported by evidence from existing research.

## **F. Analytical Strengths**

131. These reports occasionally make very perceptive observations. Two examples follow.

132. The April 2008 report (p. vi) cautions against fiscal stimulus in LAC based on “analytical work,” because such stimulus would tend to undermine policy credibility. It argues that though discretionary stimulus can be appropriate when people believe that fiscal policy responds symmetrically to the business cycle, the expansionary fiscal policy that some countries adopted during the recent pre-crisis upswing in the LAC region would tend to call that symmetry into question in those countries—suggesting that fiscal expansion is more likely to be interpreted as just another instance of pro-deficit bias, which would create

uncertainty about fiscal solvency. I found this argument to be well reasoned and worth taking seriously.

133. The May 2009 report makes a courageous (and in my view sensible) pessimistic forecast for the U.S. economy. Most impressive is that the pessimism is based not just on past cyclical patterns or past experience with banking crises, as one often finds, but rather on a clear-headed forward-looking assessment of the political constraints that were likely to prove operative in the formulation of policy in the United States. In particular, the argument takes into account the likelihood of a protracted political stalemate on financial rescues and financial reforms in the specifically American context. I found such realism refreshing.

134. In addition to these perceptive observations, another attractive feature of these reports is their reliance on systematic evidence to interpret events. For example, the April 2007 report very usefully employs an empirical model from Osterholm and Zettelmeyer (2007) to explore how growth in Latin America is linked to external variables. The same model is used in subsequent *REOs*. Its application in the October 2009 report (Box 3.1) to document the region's surprising resiliency in the face of the latest crisis is very convincing.

### **G. Analytical Weaknesses**

135. Like the reports prepared by other area departments, the WHD reports are not immune to vagueness and unsubstantiated claims, or to missing, incoherent, and incorrect analysis. To avoid repeating some of the commentary provided for the *REOs* prepared by other departments, this section simply describes how Western Hemisphere *REOs* do or do not differ from those prepared by other departments, and provides examples of each of the analytical deficiencies listed above.

#### **Vagueness**

- Like those of other regions, the Western Hemisphere *REOs* do not describe how their “baseline scenario” was generated.
- Like those of other regions, WHD reports occasionally fall into the financial reporting trap of explaining important events as the result of rather vague causes. For example, there must be more to say about the significant projected slowdown in U.S. growth in 2008 than that it is due to a “correction” in the housing market and the “effects of financial turmoil on confidence” (November 2007 report, p. 1). Does the “financial turmoil” not have any effects on the real economy on its own, but only through confidence?
- What is meant by the statement that “monetary policy is close to neutral” (November 2006 report, p. 14)?

### **Unsubstantiated claims**

- The April 2006 report (p. 7) attributes an acceleration in credit growth in Brazil and Mexico to improved credit market infrastructure, but provides no supporting evidence. How do the authors know that this is so?
- The November 2006 report (p. 27) refers to a deficient allocation of public investment in LAC, but provides no supporting evidence.
- Why is the scope for raising revenues through higher tax rates limited in Latin America, as claimed in the November 2006 report (p. 29)? Are Latin American countries at the tops of their Laffer curves? How do we know?
- On what basis does the staff conclude, as claimed in the April 2008 report (p. 23), that most countries in Latin America need to further reduce their public debt ratios over the medium term? Similarly, in the October 2009 report (p. 30) the advocacy of reducing public debt is not backed by analysis of what public debt objectives should be, or why. Overall, though they call frequently for reducing the levels of debt, these reports are not specific about the optimal levels of debt. They should either try to argue for a specific approach to determining optimal debt levels or explain why this cannot be done and how a judgment has nevertheless been made.

### **Missing analysis**

- Why have debt/GDP ratios been falling in Latin America (April 2006 report, p. 9)? More details are needed on this important development. Specifically, a debt accumulation decomposition exercise would have been instructive.
- The much poorer governance indicators in Latin America than in other regions, and the deterioration in these indicators during recent years (April 2006 report, p. 14), deserve much more attention (and explanation) than they receive. Can poor governance be reversed in relatively short order through policy? If so, what needs to be done, and why?
- Why were capital inflows small in Latin America during the period preceding the November 2006 report (p. 9), even though borrowing costs were very low? This needs more explanation.
- The May 2009 report contains no discussion of the role of accumulated foreign exchange reserves in easing financing constraints for fiscal stimulus in Latin America.

- The same document (pp. 34–35) also does not provide a clear and quantitative analysis of which countries have room for how much fiscal stimulus, or of what form that stimulus could take, restricting its discussion to generalities.
- The October 2009 *REO* adopts as a standard for debt sustainability the stabilization of debt/GDP ratios at end-2008 levels (p. 61). This choice seems to be completely arbitrary (especially in light of recent improvements in debt/GDP ratios), and is not justified in the text.

### **Incoherent analysis**

- In the November 2007 report (p. 23), the box on effectiveness of central bank intervention seems to come out of nowhere, and does not fit into the surrounding analysis.
- Why should a stronger primary balance provide more room for countercyclical policies without raising concerns about debt sustainability, but a lower debt ratio *not* do so, as claimed in the October 2009 report (p. 39)?

### **Incorrect analysis**

- A recurrent problem in the WHD reports involves an apparent confusion between inflation and a change in the relative price of food. This appears, for example, in the April 2008 report (p. 24) and in the October 2008 report (pp. 14 and 28).
- I suspect that the positive effect of lower inflation on investment reported in the October 2008 report (p. 60) probably reflects the influence of a more stable overall macro environment, rather than of inflation per se, since it is hard to see why an increase in a stable inflation rate would discourage private investment, except perhaps through distortions in the taxation of capital.
- The October 2009 report (p. 28) claims that premature tightening of macro policies is not as big a problem in the LAC region because recovery there does not depend exclusively on domestic fiscal and monetary policies. This is a *non sequitur*. The fact that external influences have a large effect on these economies does not mean that inappropriate domestic policies can do no harm.

## **VIII. CONCLUSIONS**

136. Forty-four *REOs* were reviewed for technical quality in this evaluation. These reports were intended as policy documents and not academic pieces. At times they made use of novel analytical perspectives. Some reports supported the analysis with references to the relevant professional literature, and the policy analysis was usually reasonable. There was a clear

improvement of the technical quality over time. I will list four directions in which a reconsideration of the content of the *REOs* could go.

137. First, these documents are highly prescriptive, and often advocate very specific policies, rather than simply identifying policy options and the trade-offs that these often involve between conflicting economic objectives. There is a risk that a seemingly arbitrary policy choice strongly advocated in a *REO* may undermine the credibility of the otherwise solid analysis in the report, and make the report too easily dismissed—to the extent that the specific policy advice is rejected. Consider, for example, the policy response to a sharp increase in oil prices in an oil-importing country. Such an adverse supply shock creates a choice between stabilizing the price level, at the cost of a contraction in economic activity, or stabilizing activity, at the cost of an increase in the price level. In more than one instance in these reports, the staff recommends tight fiscal and monetary policies in response to such a shock, implicitly opting for price level stability. This may indeed be the correct choice in many cases, but it is not unreasonable for a country to make the opposite choice. *It may be more constructive for the staff to indicate the conditions under which it would be optimal for a country to do one thing or the other (e.g., describing the roles of domestic wage indexation, the anti-inflationary credibility of the central bank, the fiscal impact of the oil price increase, and so on), and to summarize lessons from past experience in responding to such shocks, rather than to simply make a uniform policy prescription.*

138. Second, there are certain areas in which the documents reveal specific policy predilections (many of which I strongly agree with, by the way) that are not necessarily shared by the profession at large. Examples include a preference for pro-poor policies, an emphasis on keeping inflation low, a strong concern with medium-term fiscal sustainability (which occasionally results in too strident a stance against fiscal stimulus to counter recession and a strong bias in favor of the early removal of fiscal stimulus), and a preference for exchange rate flexibility. To be sure, the preference for pro-poor policies is widely shared outside the Fund, and based on its past experience the Fund has very good reasons to be wary of inflation as well as to be sensitive to fiscal unsustainability. But many people have argued that the poor are best helped by fostering growth, that sometimes an increase in inflation may be the lesser of two evils, and that the fragility of a country's fiscal solvency can sometimes be overstated by the Fund (the Asian crisis comes to mind). The point is not that these policy predilections are unjustified, but rather that they should be questioned. *To that end, the REOs might usefully incorporate the views of a diverse panel of experts from outside the institution.*

139. Third, in cases where I have found the analysis lacking (e.g., instances of vagueness, unsubstantiated claims, missing analysis, incoherent analysis, or incorrect analysis), in my view these problems have often arisen from an uncritical acceptance of conventional wisdom inside the institution. *Again, exposing these documents to some outside review before they are issued might help to address this problem.*

140. Finally, the issues dealt with in these documents make clear a number of areas in which reviews of the professional state of the art or new research would be extremely useful in helping to inform policy choices (either of the staff or of the authorities in member countries) in the Fund's particular areas of expertise. The analysis in the *REOs* that I reviewed was weakened by absence of concrete criteria on which the staff could form objective judgments regarding:

- The desirable sustained rate of inflation for specific countries.
- The degree of real exchange rate misalignment.
- The presence or absence of output gaps.
- The effects of changes in economic activity on the inflation rate (i.e., the slope of the Phillips curve).
- The presence or absence of fiscal space.
- The efficiency of government spending.
- The degree of financial integration.
- The presence or absence of monetary autonomy under officially-managed exchange rates.
- The stance of monetary policy (i.e., the operational meaning of a “neutral” monetary stance).

141. *The Fund could usefully review the professional state of the art on each of these issues and support additional research on them where the state of knowledge is not sufficiently advanced to provide concrete guidance to the staff* (and where additional research may actually hold promise of delivering useful insights). Doing so could significantly improve the quality of the analysis in future *Regional Economic Outlook* reports.

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