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Loan aims to bolster Afghanistan's progress

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On the strength of Afghanistan's performance under a staff-monitored program, the IMF's Executive Board approved a \$119 million loan for the country under the Poverty Reduction and Growth Facility. Despite continued violence in the country, Afghanistan resumed growth and achieved progress on several fronts, including revenue collection and modernization of its central bank. Now the focus will be on sustaining growth at about 10 percent a year, building institutional capacity, and improving health care and education.



ALFRED/SIPA

China: designing an independent monetary policy

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In the frequently heated debate over the correct valuation of China's exchange rate, what is often lost is the fact that as the economy develops and becomes more market-oriented, a truly independent monetary policy will have an increasingly important role to play in securing stable, non-inflationary growth. That independence—argue Marvin Goodfriend and Eswar Prasad, authors of a new IMF Working Paper—will not be possible without greater exchange rate flexibility.



Claro Contes IV/REUTERS

Will a resilient Lebanon tackle its debt?

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Lebanon emerged from a devastating civil war in 1991 and, more recently, weathered a high-profile political assassination. Through it all, the economy has proved amazingly resilient, though rebuilding has sharply increased public debt levels. The authorities have laid out measures that add up to a comprehensive reform agenda centered on debt reduction. The challenge going forward will be for the political leadership to adopt the agenda and for the country to embrace it.



Ramez Haidar/AP/Getty Images

Mining the lessons of experience

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For years, mining and metals companies often took the view that, as long as they did their business responsibly, the host country's broader development was of little concern to them. Now, the International Council on Mining and Metals has launched an initiative to foster sustainable development. It recently briefed IMF economists on findings from four country case studies and efforts to reduce poverty, enhance revenue management, and increase community participation.



Robin Emmott/REUTERS

Forecasting European Central Bank monetary policy

Various aspects of economic behavior are known to be affected by geographic dimensions. For instance, firms in the same industry tend to cluster in geographic areas, indicating a productivity-enhancing role of proximity to other firms. The financial sector is no exception, as is evident from the existence of financial centers. Furthermore, geography plays a role in the performance of investors: local investments tend to be more profitable than remote investments. Do these findings expand into the area of monetary policy? Are there geographic heterogeneities across forecasters of monetary policy decisions? Systematic geographical differences, for instance, could arise in larger currency areas such as the United States or European Economic and Monetary Union, which encompass large and possibly quite diverse geographical regions.

A new IMF Working Paper addresses this question for the case of the European Central Bank (ECB) and finds that the accuracy of analysts' forecasts of ECB monetary policy decisions varies considerably. In particular, there is evidence of agglomeration effects in euro area financial markets, as forecasters in financial centers outperform others. Moreover, ongoing research suggests that the ECB may not be the only central bank faced with heterogeneous expectations.

To better understand this range of forecasting results and the reasons for it, the study analyzed a novel database of monetary policy expectations by professional financial analysts from 120 institutions in 24 countries between 1999 and 2005. The database, surveyed by Reuters, found substantial differences in forecast accuracy (see chart). The top 10 percent of all institutions participating in the survey have a forecast error that is, on average, 8 basis points smaller than the error made by the

worst 10 percent of performers. These differences are significant in economic terms: the best-to-worse difference of 8 basis points is about one-third the typical ECB policy rate change of 25 basis points during the sample period.

Explaining the variability

What explains this heterogeneity in anticipating ECB monetary policy decisions? The analysis found that geography matters for forecast accuracy. There is a surprising amount of cross-country variance in expectations about ECB policy rates—especially in the first years of the sample period. But forecast accuracy depends more on presence in a financial hub than on nationality. In fact, the best forecasters tend to be located in the financial centers of London or Frankfurt. Accuracy tends to be lower with large geographical distance from Frankfurt. In essence, agents in or near a financial hub seem to have a clear advantage over more distant observers.

Another factor driving accuracy of these forecasts is *history*. Analysts in countries with a history of relatively high central bank independence tend to make better forecasts of ECB behavior than others. National *macroeconomic conditions* also tend to influence forecast accuracy, as the predictions of ECB policies become less precise if the forecaster is located in a country where inflation or unemployment rates deviate from the euro area average.

Is the observed variation in forecasting ability systematic, rather than based on differences in “gut feeling” among analysts? The Working Paper finds that, while some systematic differences between analysts are persistent, others have been transitional and are, thus, indicative of learning.

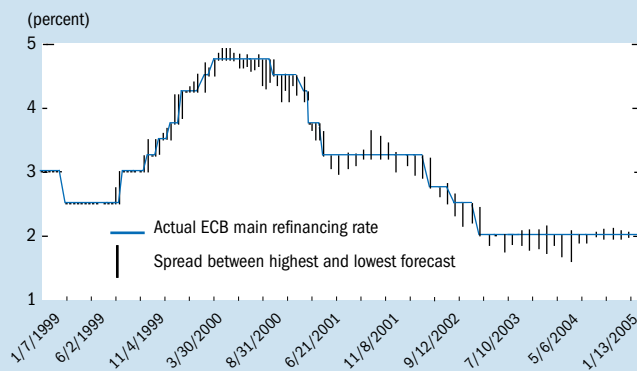
Ongoing research by the authors indicates that these challenges may not be unique to the ECB: the U.S. Federal Reserve also faces some significant regional heterogeneity in forecasting quality among its central bank watchers. Being able to draw on a richer database for the Federal Reserve forecasts, the research suggests that the above-average performance in financial hubs is partly explained by the superior pool of economists available in these locations, suggesting that better forecasts are also at least partly related to the skills of the individual analysts. ■

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A range of expectations

The ability of analysts to accurately forecast the European Central Bank's monetary policy decisions varies considerably.



Data: Reuters survey of 120 institutions in 24 countries between 1999 and 2005.

Copies of IMF Working Paper No. 06/41, “Forecasting ECB Monetary Policy: Accuracy Is (Still) a Matter of Geography,” are available for \$15.00 each from IMF Publication Services. See page 208 for ordering details. The full text is also available on the IMF’s website (www.imf.org).