Europe’s Conundrum
Balancing Social Preferences with Growth

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ON MAY 1, as fireworks illuminated Europe’s skies from the Atlantic Ocean to the North Sea and the Baltic Sea to the Mediterranean, 10 countries joined the European Union (EU). With the new members, the EU swelled to more than 450 million people. For the first time, some former centrally planned countries, including three that had been part of the Soviet Union, were welcomed into the club—a culmination of the process launched with the tearing down of the Iron Curtain some 15 years ago. But the mood of elation was clouded by misgivings in Europe and elsewhere about the EU’s ability to adjust to changing economic circumstances, given the lagging performance of many of its established member countries.

The June issue of F&D tries to shed further light on the challenges that an enlarged Europe now faces. Michael Deppler, head of the IMF’s European Department, sets the stage by reviewing continental Europe’s post-war economic history and asking whether the continent’s twin paradigms of stability (or financial discipline) and solidarity (or social equity) will prompt the higher growth needed to sustain the social welfare state. We asked OECD Chief Economist Jean Philippe Cotis why Europe’s growth is so anemic. He cites Europe’s declining labor utilization (percent of the population that is employed) and, to a lesser extent, falling labor productivity growth. A bigger EU could boost the dynamism of labor markets throughout. But as Tito Boeri of Italy’s Bocconi University notes, established EU members worry that enlargement will usher in a flood of new workers that drives down wages and further strains already-stretched welfare systems. “Shutting the door in their faces” through immigration restrictions, he insists, will hurt EU growth while failing to solve the welfare issue.

As for the newest members, whose GDP per capita stands at only about 46 percent that of the established EU, their big hope is that joining the EU club will bring them jobs and higher living standards. We asked Witold Orlowski, Chief Economic Advisor to Poland’s president, what can be done to close this immense gap. He calls for these countries to boost their low levels of domestic saving. We also examine the strategies that they should consider as they debate when and how to join the euro. Finally, F&D explores one of the hottest issues in Europe: the fate of the Stability and Growth Pact, the fiscal agreement that underpins the euro. Since excessive-deficit procedures against France and Germany were suspended last November, the pact has been in a legal limbo. IMF staff offer insights into Europe’s fiscal woes, and three outside experts, with sharply different views, weigh in on the debate.
I. Infections, epidemics, and pandemics

In the March 2004 issue, Bloom, Canning, and Jamison argue persuasively that greater investment in health is necessary to achieve development goals. They highlight the devastating economic impact that HIV is having in sub-Saharan Africa and could have in Asia. Control of these and other infections (such as tuberculosis and malaria) is increasingly hampered by emerging resistance to therapies. However, the article doesn’t fully acknowledge the importance of infections in prejudicing development.

The social and economic history of humanity has been punctuated by damaging encounters with microorganisms. Europe from the Middle Ages onward was swept by epidemics of the black death (bubonic plague), smallpox, syphilis, cholera, and tuberculosis. Each epidemic had a devastating impact and often resulted in societal change. Any strategy for global health and development not only has to factor in epidemics of emerging and reemerging infections. It also has to expect the unexpected.

Technology offers some hope but only when combined with resources and political will. When infections emerge or reemerge, sharply focused responses can be highly effective. Investment in surveillance and control is much more cost-effective than a “wait and see” strategy. The United Kingdom mounted a robust political response to AIDS in the 1980s that alerted the entire population to the risk. As a result, sexual behavior improved, rates of sexually transmitted infections plummeted, and the early spread of HIV was blunted. For a decade, the United Kingdom had significantly lower HIV levels than comparable European countries (sadly, that effect has since worn off; after 1995, new diagnoses of HIV and other sexually transmitted diseases began to rise sharply). Recently, Severe Acute Respiratory Syndrome (SARS) was brought under control following an unprecedented multinational effort. Though only three countries experienced outbreaks, economic loss is estimated at $30–140 billion, mostly in Asia.

It is odd, therefore, that resources to make preemptive strikes against epidemics are usually hard to find at the international level. It took more than a decade for development agencies to factor HIV into their investments. The battle against SARS was coordinated by the World Health Organization (WHO) at the global level only after it passed around a begging bowl. This is true even for the most inevitable of emerging infections: the next influenza pandemic. The WHO recently found great potential for averting a new pandemic caused by bird influenza but also a woeful lack of investment in public health research, therapy, and vaccine technology. It is unfortunate that development bodies do not have the same nimbleness of financial response as infections possess in their ability to threaten human health and development.

II. Culture matters more than institutions

Three articles in the September 2003 issue explain that setting up and managing the right public institutions is the key to development. This seems to be the new mantra of international financial institutions. It is also the basis for the fallacious New Partnership for Africa’s Development.

In my view, cultural factors are at least as important as institutional ones—probably even more so. Culture largely determines the efficiency of public institutions because these are run by people even more than by laws and regulations. The Chinese example of the last two decades shows that a prevailing culture of thrift and effort and a strong belief in individual progress can produce high economic growth even within a framework characterized by relative corruption and a lack of democracy and rule of law. Conversely, in African countries, many analyses show that cultural factors remain the main obstacle to development, even when existing institutions are relatively decent by Western standards. The same could be said of most Arab countries.

Charles J. van der Vaeren
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III. Global surveillance—for whose benefit?

“Assessing Offshore Financial Centers” (September 2003), seems to imply that bodies like the Organization for Economic Cooperation and Development (OECD), the Financial Action Task Force (FATF), and the IMF have a right to exercise “surveillance” over smaller or less developed countries. Why? For whom? Are there hidden agendas? Why should a developing country seeking to attract capital force its citizens to become unpaid informants for, say, European tax collectors? There is no moral or legal rhyme or reason to much national tax or economic legislation. There is a huge moral (and, usually, legal) difference between evils like terrorism and prolix regulations on tax, foreign exchange, or stock markets. No sovereign country should help enforce another’s tax or regulatory laws if that will drive investors away. If the OECD, the FATF, and the IMF wish developing countries, large and small, to cooperate on what really matters (the suppression of real crime), they should stop peddling barely disguised fiscal or economic regulatory agendas that seem aimed more at eliminating economic challengers to the hegemony of former colonial powers.

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

Developed and developing countries are giving a new push to the stalled Doha Round of global trade negotiations. Both groups called for the early resumption of global trade talks after discussions at the IMF–World Bank spring meetings in Washington in April. “Our aim must be to break the trade deadlock, push forward the development objectives of Doha, and both open our markets to developing countries now and remove trade-distorting subsidies,” declared British Chancellor of the Exchequer Gordon Brown, chair of the IMF’s ministerial steering committee.

He attacked what he termed “the scandal of agricultural protectionism around the world,” arguing that it costs developing countries more than double what they receive in aid each year. World trade talks have been stalled since the failure to reach agreement in Cancún, Mexico, last year.

IMF ready with trade cushion

The IMF said it is ready to help cushion the short-term adverse impact of trade liberalization on small developing countries with its new Trade Integration Mechanism. A qualifying member country may request funding if it expects a net balance of payments shortfall as a result of liberalization measures implemented by other countries. The mechanism does not cover balance of payments needs arising from reforms to a country’s own trade regime. The funding would be made available to central banks to offset lower exports as governments adjust to greater competition.

MDGs proving elusive

A report by the IMF and the World Bank warns that, on current trends, most developing countries will fail to meet most of the Millennium Development Goals (MDGs). The Global Monitoring Report 2004 shows uneven progress toward the first MDG of halving the global rate of income poverty between 1990 and 2015. While this goal is likely to be achieved at the global level—largely through progress in the world’s two most populous countries, China and India—Africa will fall well short.

The snapshot the report affords of other MDGs, particularly for health, education, and the environment, is bleaker. On current trends, the goals of reducing child and maternal mortality will not be attained in most regions, and only a small proportion of countries—15–20 percent—currently appear to be on track. The goal of halting and reversing the spread of HIV/AIDS and other major diseases, like malaria and tuberculosis, appears daunting as their incidence continues to rise.

The report, prepared for the IMF–World Bank spring meetings in April, argues that developed countries need to show leadership by delivering on the promises made at the Monterrey Financing for Development Conference in 2002, where they pledged to match stronger reform efforts in developing countries with increased financial support.

Waste plagues small island states

As if rising sea levels, overfishing, water shortages, and inadequate sanitation service were not enough, the world’s small island states are facing a new problem: rubbish. According to the United Nations Environment Program, island states are getting swamped by waste, ranging from discarded beer cans turning pristine shores blue-green to old sofas blocking lush creeks. Many states need help in dealing with the problem of solid wastes.

Car crashes cost billions

Road crashes kill 1.2 million people a year and injure or disable 50 million. They cost low- and middle-income countries $65 billion in extra health spending and forgone family income—more than the total official development assistance the countries receive, the World Health Organization says in support of a new road safety campaign.

EVENTS COMING UP IN 2004

June 14–15, Madrid, Spain
Dollars, Debt, and Deficits—
60 Years After Bretton Woods, Co-organizers:
Banco de España and IMF

July 11–16, Bangkok, Thailand
XV International AIDS Conference

October 4–5, Washington, D.C.
IMF–World Bank Annual Meetings

November 4–5, Washington, D.C.
IMF Annual Research Conference

30 YEARS AGO IN F&D

“The international monetary system is facing its most difficult period since the 1930s. As a result of recent developments in oil prices and supply, 1974 will almost certainly be a year of staggering disequilibrium in the global balance of payments….”

H. Johannes Witteveen,
IMF Managing Director, quoted in F&D, June, 1974
 Alice Rivlin has spent much of her 30 plus years in public service trying to keep budgets in check, including that of the U.S. government. When she joined the White House Office of Management and Budget (OMB) in 1994, she inherited a budget deficit of more than $200 billion that required immediate attention. By 1998, only two years after Rivlin had left the OMB, huge budget deficits had been transformed into substantial surpluses. Rivlin attributes this achievement to the efforts of both U.S. political parties and to the extraordinary performance of the economy.

Earlier in her career, Rivlin served as Assistant Secretary for Planning and Evaluation at the U.S. Department of Health, Education, and Welfare. In that position, she gained experience in areas that are often targeted for cuts when budgets need to be balanced—health care, welfare, and Social Security. Rivlin's curriculum vitae thus makes her an ideal candidate to comment on the fiscal policy issues that so many industrial countries are grappling with today, including the United States and the members of the European Union.

Rivlin was at the Brookings Institution in 1971 when she wrote Systematic Thinking for Social Action, whose theme was using policy analysis to improve the effectiveness of social programs. Today she says of that book, "I thought it would have a very short shelf life because we would solve those problems and move on." But, she adds, "some people still assign that book in their classes." Some of those problems were still on the table in 1992, when Rivlin wrote Reviving the American Dream. For example, the U.S. economy had been performing poorly for almost two decades, and Americans were worried about their economic future. Moreover, she wrote, "the political system appears unable to take decisive actions, such as eliminating the federal deficit and improving education, that would brighten prospects for the economy." But she did not consider the country's problems insurmountable. "We will find ways to solve them," she wrote.

The more things change...
The problems the United States is confronting at the beginning of the 21st century are strikingly similar to those Rivlin described over a decade ago, and some may even be worse today: the budget deficit, income inequality, mounting medical costs, and inadequate education and training. She maintains that, "in a competitive global economy, these are just things that have to be dealt with—they can't be solved, but they can be made better." Nor are they unique to the United States. In particular, "soaring medical costs are a problem in all developed countries, but we know how to handle medical problems now in a way we didn't used to." Rivlin insists that the richest country in the world can afford better medical care for everyone, as well as better training and schools.

The thesis behind Rivlin's recommendations for the 1990s was that it would be a good idea to sort out federalism "so that people were clearer about which level of government did which job." In recent years, she says now, the federal government has given the states more say over what happens. But the division of labor in the United States today still doesn't appear to be optimal. Education, housing, neighborhood services, and crime are best handled at the state and local levels, Rivlin notes, while major transfers like Social Security and problems that spill across state borders, such as pollution, are best handled at the federal level. But that isn't happening, and Rivlin thinks it is because voters are more concerned about the things closest to them. As a result, presidential candidates often feel compelled to say that they can fix whatever is wrong, she says, even if the federal government is not well suited for the job. Otherwise, they would seem not to connect with voters' concerns.

"At least one problem the country was grappling with in 1992—that of slowing productivity—no longer appears to be an issue. "In the 1990s, when productivity growth suddenly accelerated, no one knew quite what to make of it," Rivlin says. People wondered if it was temporary, or if it had something to do with the growth of the economy—which was also taking off—or with some technology that was coming on line. With Brookings colleague Robert E. Litan, Rivlin wrote a book on the Internet's impact on productivity. "We know now that the productivity acceleration may not last forever, but it is significant and has continued through the recession and the storms that followed it," she says. She and Litan wrote that the revolution was just beginning and that the impact would be felt for a number of years. If they're right, the productivity acceleration shouldn't run out of steam any time soon.

The taming of the budget
Of all the positions Rivlin has held, she is proudest of what she accomplished as the first director of the Congressional Budget Office. "It was, in a sense, an entrepreneurship," she
says of the office she headed from 1975 to 1983. "We had to start a new organization, and the expectations were unclear." That was because the Congress was vague about exactly what it wanted the office to do other than supply it with numbers and analysis comparable to what the president received from the Office of Management and Budget. In fact, Rivlin explains, "the House and the Senate wanted different things." The House envisioned more of a number-crunching operation, and the Senate envisioned more of an analytical operation. "I think we achieved both," she says, "which wasn't easy in an intensely political atmosphere." The Congressional Budget Office has been directed by both Republicans and Democrats, and, according to Rivlin, it does good, serious, nonpartisan work and is widely respected.

Rivlin herself has been described in similar terms. Roger W. Ferguson, currently Vice Chair of the Federal Reserve Board, told F&D that, throughout her almost forty years at or near the pinnacle of economic-policy making in the United States, Rivlin "has maintained the trust and confidence of Democrats and Republicans, liberals and conservatives, everyone and everybody." In addition to having people skills, he says, "she is driven by the outcome of solid analysis."

When Rivlin became Vice Chair of the Fed in 1996, she went in with ideas for improving it. Asked if she had been able to achieve her objectives, Rivlin notes, "I was at the Fed for only three years, and it is an organization that changes slowly." At the time, there was concern about whether the Fed was modernizing its payments system quickly enough. "The United States, as you know, uses a lot of paper [bank] checks, and the Fed processes those checks." She laughs. "And the Europeans wonder why, in this modern age, people are sending payments on little pieces of paper that have to be transported by truck and airplane." Although she does not take credit for the achievement, she says the volume of checks has since come down considerably.

According to Edward M. Gramlich, a current member of the Fed, Rivlin left large tracks at the Board. She played an instrumental role in the making of monetary policy and as chair of a committee to examine the Fed's role in the retail payments system. "Alice thinks outside the box," he told F&D. "She will join an organization and say 'we ought to do things differently' and institute a new process." Ferguson agrees. The Fed's role in the retail payments system was "one of the hot nonmonetary, noneconomic policy questions of her time here." The committee ultimately decided that the Fed would remain in retail payments. Although the outcome was the most important thing, Ferguson says, "the process Alice used was also important." It was transparent, open, and consultative, giving it legitimacy. As a result, the outcome also had legitimacy.

**Those taxing problems**

How does the balanced budget guru think the current fiscal difficulties in the United States should be addressed? And how would she respond to Fed Chairman Alan Greenspan's suggestion for addressing the deficit by cutting Social Security benefits instead of raising taxes? When the tax cuts were planned, Rivlin says, considerable surpluses had been projected for the federal budget. But as a result of the 9/11 attacks, an economic recession, and the war in Iraq, she observes, the United States is "now looking at very large deficits over the next 10 years—about 3.5 percent of GDP. After that, it gets worse because of the retirement of the baby-boom generation." And the looming retirement of the baby boomers, she points out, has been predicted for a long time and should not surprise anyone.

Rivlin agrees with Greenspan that large deficits need to be brought down. Although the U.S. economy is still growing strongly, "large sustained deficits are bad for growth: they raise interest rates, make the United States more dependent on the rest of the world, and shift the burden of government onto future generations." It will also be important to get a handle on the deficits, so that U.S. and foreign investors will continue to see the United States as a good place for their money.

As for what should be done, she believes it will take a combination of revenue increases and serious spending restraint, some of which can be in the entitlement programs. But she argues that the Social Security Trust Fund could be balanced without drastic cuts in benefits, for example, by indexing Social Security to a better measure of the cost of living and raising the retirement age further. "The Social Security Trust Fund could be balanced without drastic cuts in benefits, for example, by indexing Social Security to a better measure of the cost of living and raising the retirement age further."

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Rivlin does not think that, in general, the United States spends too much in the public sector. On the contrary, she mentions two problems that require attention: modernizing infrastructure, which would contribute to productivity and future growth, and making work pay for low-wage workers. The latter problem, she explains, is that people with less than a college education or a good technical education are falling behind. In addition to more education and better training,
she argues that it is important to ensure that those at the low end of the wage scale have better health care coverage and better access to good primary care clinics and alternatives to hospital emergency rooms in low-income areas.

But the United States is not the only industrial country with budget difficulties. The European Union is wrestling with its own demons (see the European articles in this issue). And Rivlin, as it happens, wrote her undergraduate honors thesis on European economic integration, when a single currency was a distant idea. Clearly, she says, it was a prescient topic choice in 1952. Rivlin views the European Union as an exciting experiment that will be interesting to watch, given that it is expanding rapidly, even though it is not fully accomplished even with the original members. Contemplating some of the European Union’s current difficulties, she maintains that they are largely political. “From an American perspective, I think more flexible labor markets and consolidation of financial services across borders in Europe are likely to happen but will be slow.”

As far as the European Union’s fiscal straits, Rivlin sees the Stability and Growth Pact as an attempt to solve the difficult problem of how to conduct a common monetary policy without a common fiscal policy. Although the pact imposes a modicum of discipline by limiting deficits to 3 percent of GDP, she says, holding the deficit under the limit isn’t always good fiscal policy for a country in a recession. And, she adds, applying sanctions could be counterproductive. Still, she considers the Stability and Growth Pact a work in progress and a starting point for trying to coordinate fiscal policy in the euro area.

Idealist turned public policy “phenom”

In 1958, when Rivlin earned her Ph.D. in economics from Radcliffe College, few women were choosing to enter this field. (For that matter, less than 35 percent of women over the age of 20 were working in 1958.) Rivlin started out as a history major but settled on economics as offering a more exciting career, primarily on spending cuts, the second relies on tax increases, and the third combines the two, keeping government about the same size but reallocating spending. Written in plain English, it lays out clearly the painful and politically difficult policy choices facing the U.S. government.

But that’s not all Rivlin is doing. For two years, until the commute became too tiring, she taught at the New School University of New York. Then she got an offer to teach economic policy at Georgetown University’s Public Policy Institute (GPPI), where she is a visiting professor. “I love it,” she says simply. And it’s no wonder. According to Judy Feder, professor of public policy and dean of the GPPI, Rivlin is an extraordinary teacher. “Her students rave about the opportunity to be in the classroom with her, which makes the rest of us jealous,” she told F&D.

Although Rivlin may sound like someone who is all work and no play, she is not. She’s in a book club, she admits, “like everybody else.” The group reads all kinds of fiction, including classics and more contemporary books. The one rule, which must appeal to Rivlin’s sense of fiscal rectitude, is that the group doesn’t read a book until it is out in paperback. She has also found time to enjoy hiking and other outdoor activities between balancing budgets and, with her economist husband Sidney Winter, rearing three children. But her outdoor career had a long hiatus when her children were young, and she was very much focused on them, she explains. She got back into outdoor activities once her children were old enough to enjoy them with her. “Going off into the high mountains was something that came a little later,” she adds, alluding to adventure trips she has made over the years to Alaska, Colorado, Peru, and the Himalayas.

Sitting in her unadorned office at Brookings, Rivlin appears restless even as she graciously fields questions. She crosses and uncrosses her arms, fiddles with a rubber band, and leans forward and back in her chair. She has the air of someone with work to do who is anxious to return to it.

Eliza Diehl is on the staff of Finance & Development.

References:

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EIGHT NEW members joined the European Union (EU) on May 1 in the biggest enlargement of the community since its inception. Just 15 years after the fall of the Berlin Wall, eight Central and Eastern European countries joined, along with Cyprus and Malta, expanding the EU's membership by two-thirds, its land area by a fourth, and its population by a fifth (to over 450 million). This latest step in European integration is expected to further help cement peace and promote prosperity throughout the continent. But the occasion is clouded by the considerable misgivings in Europe and elsewhere about the EU's ability to adjust to changing economic circumstances.

The core economic concern is the weak growth performance of Europe—and particularly of the 12 countries at the epicenter of European integration that use the euro as their common currency—relative to the rest of the world and especially the United States. Underlying this concern are the problems of sagging long-term trends in the growth of productivity, the use of labor resources, and—looking forward—the dwindling size of the workforce because of population aging.

But these structural worries gain immediacy from fears about the short term as well. With the euro area still just emerging from a prolonged slowdown and seemingly dependent on exports for growth, the euro having appreciated steeply against the U.S. dollar, and the U.S. current account deficit at 5 percent of GDP, prospects for the global as well as the European economy rest to a large extent on whether Europe can improve its domestically generated growth performance. Adding weight to these concerns are the perceptions that the euro area's fiscal and monetary policies are excessively oriented toward preserving medium-term stability and insufficiently focused on sustaining demand in the short term. In tandem with continuing concerns about the implication of aging populations for long-term growth and fiscal sustainability, tensions stemming from immigration, and international criticism of the high levels of protection afforded to agriculture, it is clear that enlargement has occurred at a time of considerable doubt and misgiving about the integration enterprise.

To gain some perspective on these issues, it is useful to step back and look at the broad sweep of Europe's postwar economic history. This article seeks to provide a framework for understanding the main issue—whether and how the core EU social and economic model can deliver robust growth, or whether attaining robust growth requires adaptation of the European model. Looking forward, such a perspective suggests that prospects are neither as bleak as observers sometimes think nor as rosy as European policy choices might suggest.

Europe's twin impulses

Although many factors played a role, postwar developments can be viewed as reflecting two broad-based, ebbing and flowing, and sometimes contrary impulses: toward social solidarity and equity, on the one hand, and financial discipline and economic efficiency, on the other. The historical roots of these preferences run deep. The solidarity dimension stems from a widely shared desire for social peace and cohesion, with roots in the welfare policies inherited from the late 19th
Integration
Social Preferences with Robust Growth

century, the political and social upheavals of the first half of the 20th century that culminated in World War II, and the relative homogeneity of Europe’s populations. The discipline dimension, perhaps surprisingly, seems to have similar roots. Most cited is the case of Germany, where the deep desire for economic stability can be traced back to the devastating hyperinflation of the early 1920s. These twin impulses led many countries to develop increasingly generous pay-as-you-go social insurance systems—systems that took care of social spending within a disciplined, self-financing framework. Along the way, continental Europe’s corporatist traditions, topped by various forms of “social partnership,” cemented the structure, for good or ill, through all echelons of society.

These preferences still obtain today. Fundamentally, continental Europe is committed to a financially disciplined welfare state. Robust growth is on everyone’s agenda, as exemplified by the call at the EU summit in Lisbon in March 2000 to turn Europe into “the world’s most dynamic and competitive economy.” But the quest for growth is also where the differences emerge. To put it simply: can growth best be achieved through discipline (and more supply-oriented approaches that would require adapting the social model) or through solidarity (and approaches that might require, if not a loosening of financial discipline, more spending)? While the differences are fundamental, the two sides are careful not to question, at least loudly, the core value of the other: the welfare state and financial discipline. The reason is simple: a combination of the two has been the revealed preference of the electorate for decades and remains so today. Hence, the general tenor of economic policies has been to call for both, as the Lisbon Declaration does.

Momentum toward integration
Solidarity and discipline have propelled European integration throughout the postwar period, with solidarity as the stepping-stone. On the heels of two disastrous world wars, it provided the momentum for removing barriers and raising living standards through convergence in per capita incomes—a process known as real convergence. In this respect, the EU’s beginnings are traceable to the European Coal and Steel Community, set up in 1952. This led to two further milestones of real convergence: the Treaty of Rome (1957), which established the European Economic Community (a customs union with common external tariffs and a common agricultural policy); and the Single European Act (1986), which committed all members to creating a single EU market for goods, services, capital, and labor.

In time, this impulse toward European integration was balanced by more discipline, perhaps most evident in the institutional developments designed to ensure price and financial stability throughout the union—so-called nominal convergence. Initially, discipline was provided by the Bretton Woods exchange rate system. But its breakdown in the early 1970s set off a scramble for a new nominal anchor, which culminated, in the late 1970s, in the European Monetary System. The exchange rate mechanism (ERM) of this system constrained exchange rate fluctuations among the participating countries, with Germany emerging as the undisputed nominal anchor country. However, continued nominal divergences and the associated pressures on exchange rates within the ERM highlighted the need for more convergence of macroeconomic policies. Matters were brought to a head in the early 1990s when the liberalization of capital movements and German unification prompted the 1992 crisis in the ERM, hastening the ratification of the Maastricht Treaty and the road map for Economic and Monetary Union (EMU). Besides exchange rate criteria, potential member countries were now obliged to meet other nominal convergence criteria as well, particularly for inflation, fiscal deficits, and government debt. The treaty’s fiscal provisions were later fleshed out in regulations known as the Stability and Growth Pact (SGP). At the beginning of 1999, 11 EMU members irrevocably fixed their exchange rates and adopted the euro as their single currency, and the newly constituted European Central Bank (ECB) took on the task of conducting a single monetary policy for the euro area. (See Back to Basics on page 14.)

The impulse to deeper economic integration was accompanied by a like-spirited widening of its reach as the EU
expanded by leaps and bounds—a process set to continue even after the latest enlargement round (see map, page 8). The European Coal and Steel Community comprised six countries in the heart of Europe (Belgium, France, Germany, Italy, Luxembourg, and Netherlands). Successive waves of enlargements in 1973 (Ireland, Denmark, and United Kingdom), 1981 (Greece), 1986 (Portugal and Spain), and 1995 (Austria, Finland, and Sweden) boosted EU membership to 15 countries by the time plans for EMU had gelled into an operational blueprint. With the latest expansion on May 1 of this year, the EU family has grown to 25 countries with considerable economic and cultural diversity—a diversity that will only increase. Bulgaria and Romania are well advanced in their negotiations and are set to join in the next few years. Decisions on the timing of Turkey’s negotiations are also pending. The states of the Western Balkans are next in line, with Croatia’s application already given the green light by the EU Commission. In a step that reaches beyond integration, the EU’s “Wider Europe Neighborhood” initiative encompasses 14 countries to its east and south and aims to develop a “ring of friends” with which the EU desires to have peaceful and cooperative relations on the basis of shared values. Iceland, Norway, and Switzerland remain outside the EU.

Integration has been a major source of European growth. It was part and parcel of Europe’s rapid real convergence with the United States during much of the postwar period, with the creation of the common market being widely credited as having significantly boosted intra-area trade and regional growth. Indeed, the evidence points to further positive trade effects in the euro area following the establishment of EMU. Moreover, despite earlier fears to the contrary, trade with non-EU countries has, over time, also increased. In the same vein, promotion of nominal convergence—particularly through the Maastricht criteria and the establishment of EMU—engendered a disciplining of fiscal and monetary policies, a convergence of inflation back to low single digits throughout Europe, and, for a while at least, a spurt of reforms among most future members. Indeed, by the 1990s, the EU had deservedly become a beacon throughout Eastern Europe for sound macroeconomic policies and aspirations for higher levels of real income, as well as democracy, solidarity, and human rights: becoming a member of the club became the priority of governments and one that enabled them to muster the popular support needed to overcome the challenges of transition.

**Waning growth**

While integration spurred higher growth, in good part by inducing change at the national level, its positive effects were gradually supplanted by the less benign effects of domestic rigidities.

It did not start out that way. During the early years, Europe’s model effectively delivered on all counts: social cohesion, financial discipline, and rapid growth. Real convergence toward U.S. levels was seemingly effortless in the first three decades of the postwar period, as incomes, employment, investment, consumption, and wealth spiraled upward in a virtuous circle. Convergence was fostered, in part, by the externally imposed discipline of the Bretton Woods system and the relatively good inflation and financial performances associated with it.

The next three decades proved difficult, however. The combination of two large oil shocks, an increasingly generous welfare system, and unrealistic income expectations built up during the period of rapid catch-up growth together with the financial indiscipline associated with the breakdown of the Bretton Woods framework resulted in marked macroeconomic instability and imbalances. Indeed, experiments with activist Keynesian stabilization policies during the 1970s were unsuccessful, and such policies became discredited, particularly in Germany. In the end, the system reverted to the paradigm. It protected the jobs and real incomes of those already employed, but it also reasserted financial discipline by increasingly accepting the German mark as its anchor. The outcome was large increases in labor taxation that ultimately undermined employment but stimulated investment. This strengthened labor productivity and preserved the competitiveness of those with jobs.

With unemployment trending upward, the system adjusted further. Wage moderation together with measures to lower the cost of labor and relax labor market restrictions, particularly for new entrants to the job market, yielded hefty increases in employment from the mid-1990s. And the Maastricht Treaty, EMU, the ECB, and the SGP became the successors to the German mark in providing financial discipline.

Overall, however, Europe’s performance remained unenviable. Per capita incomes remained stuck at about 75 percent of U.S. levels up to the mid-1990s, with rapid increases in labor productivity being offset by weakness in employment. Per capita incomes later slipped to close to two-thirds of U.S. levels as productivity growth sagged in Europe and acceler-
The slowing of growth is often ascribed in good part to the EU's (or the euro area's) “stability bias,” that is, its unwillingness to engage in countercyclical demand management policies, which would involve boosting demand (through lower interest rates and larger fiscal deficits) when growth is weak and dampening demand (through higher interest rates and smaller fiscal deficits or surpluses) when it is strong. As suggested earlier, Europe's macroeconomic policy frameworks do indeed spring in considerable measure from the impulse toward discipline, that is to say, from a will to contain what is viewed as the cumulation of monetary and fiscal risks—ultimately pernicious to growth—associated with unrestrained political and social processes. Since the 1970s, in particular, the emphasis has been on establishing and preserving medium-term stability and not on managing aggregate demand in the short run through countercyclical policies. This bent is clear from the ECB's Maastricht Treaty mandate: "the primary objective... shall be to maintain price stability." It is also clear from the treaty's provisions on ensuring sound government finances: "Member states shall avoid excessive government deficits," where compliance with this commandment is assessed relative to reference values of 3 percent of GDP for the fiscal deficit and 60 percent for the debt-to-GDP ratio.

This manifest emphasis on stability tends to prompt misunderstandings about macroeconomic policies. Criticism that European institutions are insufficiently mindful of cyclical considerations falls on deaf ears. This leads observers to think that the criticisms are even more justified than initially thought. And the fact that policies have, in practice, been fairly sensitive to the economic cycle gets lost amid the din. This gap between rhetoric and reality has beset both the ECB and the SGP.

In this vein, the ECB is criticized for taking insufficient account of cyclical conditions in setting interest rates, to which it responds that this is to misunderstand its mission. Its mantra has consistently been price stability now and forever. In fact, however, it has largely behaved like an inflation targeter, mindful of the implications of growth for inflation. This gets overlooked, in part, because the rhetoric prompts the mistaken assumption that the ECB is facing the same kind of economy as the U.S. Federal Reserve. In fact, at least partly because of the welfare element of Europe's paradigm, the ECB has faced considerably smaller output gaps (and employment volatility) and markedly more persistent inflation than the Federal Reserve. The rhetoric has tended to mask the fact that the differences in policies mostly reflect these different conditions.

The same duality between rhetoric and reality applies to the SGP. The pact is widely criticized as a deficient countercyclical policy instrument. This is hardly surprising since its legal core is plainly aimed at defining limits and not at defining countercyclical policies within those limits. The fact that these limits are specified in terms of actual (rather than cyclically adjusted) fiscal balances lends additional weight to the criticism that the pact is procyclical; it appears to require that deficits be reduced when they are being widened by the effects of weak growth, with resulting contractionary effects on the economy, and vice versa.

However, the fact is that fiscal policies under the SGP have been significantly less procyclical than they were in the aftermath of what is now viewed as the Keynesian misadventures of the 1970s (see article, page 22). Indeed, widespread perceptions to the contrary notwithstanding, for the euro area as a whole, fiscal policies since the introduction of the euro have generally allowed full play to the so-called automatic stabilizers—that is, fiscal mechanisms (like income taxes and unemployment benefits) that automatically dampen cyclical swings by boosting demand when the economy slumps (because tax receipts fall) and curbing demand when inflationary pressures build (because tax receipts rise). This is significant because the differences in the size of government in the economy imply that the automatic stabilizers are about twice as large in Europe as in the United States.
The situation is further complicated by the de facto evolution of Europe’s policy frameworks over the past few years toward more cyclically attuned approaches. One example is the gradual narrowing of the ECB’s definition of price stability from 0–2 percent to, in effect, 1–2 percent and, most recently, to “close to but below 2 percent” inflation. Another is the gradual acceptance of the role of the automatic fiscal stabilizers, of estimates of cyclically adjusted balances to measure the underlying fiscal position, and of the objective of achieving underlying balance in the medium term in SGP-linked assessments of fiscal policies. The system is seeking solutions that twin discipline with good demand management policies.

That said, the contrast between European and U.S. approaches to macroeconomic policies remains: the Europeans take a more medium-term view, in good part because the welfare system (solidarity) protects those adversely affected by the vicissitudes of the cycle; the United States is more proactive in securing short-run growth and employment, in good part because there is less such protection. Given these differences in structure, comparative assessments of macroeconomic policies need to focus more on growth and inflation outcomes than on the cyclical shifts in policy stance. In that regard, it may be noted that, measured in terms of the cyclical volatility of output or employment, Europe’s performance is comparable to, if not better than, that of the United States. Perceptions to the contrary mainly reflect something more enduring: the longer-term weakening of growth in Europe.

**Unaffordable solidarity?**

Many view Europe’s weakening growth as a reflection of its overly generous welfare arrangements, which, by muffling incentives to work and protecting businesses and workers from the disciplines of competition, have exacted an inordinate cost in terms of per capita incomes. In this view, this has led to large-scale underutilization of labor resources and slowed incorporation of new technologies and adjustment to shifting sources of comparative advantage.

The reality is more mixed. Europe has undertaken many reforms over the years, some of which have begun to pay off. Many have been designed to strengthen the demand side of the labor market, in the form of either wage moderation and other measures to lower the cost of labor or measures that make labor markets more flexible and encourage new entrants. In the same vein, the single market initiative sought to combat “eurosclerosis” by setting in motion deep and wide-ranging reforms in product and financial markets. These reforms continue to run their course. The resulting increase in competition is boosting efficiency, including in the use of labor in those markets.

These policies have achieved more than is often recognized. The euro area generated almost 10 million jobs between 1997 and 2003, 2 million more than the United States. Although the surge in employment has slowed productivity growth, this could reflect transitional adjustment problems. The payoff to reforms often takes decades, not years, to accrue, and Europe’s employment performance should continue to improve. The uneven distribution of growth across Europe is also noteworthy. It has been especially weak in Germany, the country where labor market reforms have been most delayed. Elsewhere, growth and employment have tended to be more robust. Indeed, they have been strongest in the smaller, more open economies, partly because the interaction of solidarity and discipline has led to more encompassing and proactive policies in these countries. This is also true of the Scandinavian countries, which have the strongest welfare systems.

Nevertheless, differences in per capita incomes exist between the United States and virtually every EU country, and the larger issue is whether they reflect excessive solidarity or a “social choice”—that is, a willingness to forgo higher per capita incomes for certain social goals, such as increased leisure. About half of the difference between U.S. and European per capita incomes is tied to the fact that Europeans work fewer hours per person: about 1,500 hours a year versus 1,800 in the United States (see Chart 2). Many observers in Europe view this as a preference for leisure over work at the going wage. A contrary view, which starts from

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**Chart 2**

<table>
<thead>
<tr>
<th>Time off</th>
<th>Whether because of social preferences or disincentives to work, Europeans have much more time off than U.S. workers.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(annual hours worked per employee)</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>Euro area</td>
</tr>
<tr>
<td>1961</td>
<td>2,100</td>
</tr>
<tr>
<td>1966</td>
<td>2,000</td>
</tr>
<tr>
<td>1971</td>
<td>1,900</td>
</tr>
<tr>
<td>1976</td>
<td>1,800</td>
</tr>
<tr>
<td>1981</td>
<td>1,700</td>
</tr>
<tr>
<td>1986</td>
<td>1,600</td>
</tr>
<tr>
<td>1991</td>
<td>1,500</td>
</tr>
<tr>
<td>1996</td>
<td>1,400</td>
</tr>
<tr>
<td>2001</td>
<td>1,300</td>
</tr>
</tbody>
</table>

Sources: European Commission-AMECO database; OECD analytical database; and IMF staff calculations.

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the observation that annual working hours in the United States and Europe were the same 30 years ago, is that the current gap reflects the large disincentives to work imposed over the past 30 years, implicitly an attempt to “share” employment. With Europe about to shift from an era of a plentiful supply of workers to one of a dwindling labor supply because of aging (see Picture This, page 20), growth prospects hinge in part on who is right and whether incentives, if they are important, will be changed.

Be this as it may, change is in the offing, partly because there is a will to be better prepared for the effects of globalization and new technologies. Change will also be necessitated by the economics of aging populations and discipline. Without change, fiscal policies in many countries are on an unsustainable course, with public debt ratios rising steeply. If nothing else, therefore, the desire for financial discipline should again come to the fore. What remains open, however, is whether the adjustment will enhance growth. Many governments have chosen to deal with aging not by streamlining the welfare system but by shifting budgets into surplus. This reduces the interest payable on the public debt, making governments better able to afford the coming increases in public spending on pensions and health without undermining the fiscal position. This approach, very much in the tradition of the financially disciplined welfare state, leaves incentive systems unchanged, however, and does little to improve future growth prospects.

Looking ahead

With solidarity and discipline seen as the keystones of Europe’s postwar economic history, the continent may be viewed as still seeking to bring them into greater harmony. One must applaud the inclusiveness of the EU, which solidarity has fostered. But one must regret the protection of stakeholders, the slow adjustment to change, and the slowing of growth, with the resulting periodic “dashes for growth” or unaffordable tax cuts that it also encourages. In contrast, discipline and the hard times that made it binding have provided a constructive antidote, fostering necessary changes and reforms. These should lead to improvements in performance in the coming years. But the discipline has too often been in the form of limits (initially on the exchange rate and now, more loosely, on fiscal policies). The resulting policy adjustments have thus tended to be reactive, asymmetric, and insufficiently forward looking, particularly in the larger countries.

The implications of these tensions for short-term demand management policies are relatively slight. While the rhetoric reaches its apogee in downturns, as it has recently, the reality is that—particularly if one accepts the importance of discipline in keeping to a reasonable, long-term course—fiscal and monetary policies have generally been appropriate in dealing with the cyclical component of downturns. If there is a short-term demand management problem, it is rather in the absence of discipline at cyclical peaks when repressed solidarity-bred instincts gain momentum. But these problems affect, in the first instance, the short-run volatility of growth, not its trend rate.

“Politically difficult reforms are widely seen to be necessary if growth is to be robust.”

The implications for the long term are more significant: here, the unresolved tensions between solidarity and discipline remain deeply problematic, particularly at the national level. Because of solidarity-based tendencies to preserve the status quo, electorates resist forward-looking reforms and insist on tangible, direct, and immediate evidence of a problem before accepting that it should be addressed. Hence, the approach to reforms tends to be partial and episodic even though deep, forward-looking, and increasingly politically difficult reforms are widely seen to be necessary if growth is to be robust (see article, page 16).

Thus, while past reforms may ultimately improve performance in the years ahead, growth is still likely to disappoint, and discipline and bad times are still likely to remain an essential spur to reform. Indeed, if the foregoing analysis is anywhere near the mark, obituaries for the SGP are missing the point. While adjustments to the SGP are likely in the light of experience, an essential core aimed at constraining political and social pressures via budgets should and will remain.

But discipline-induced structural adjustment is not the best option. Instead, what is needed is a more forward-looking and thoroughgoing approach to reform whereby solidarity and discipline are reconciled through policies that generate higher long-term growth. This is not impossible. Some of the smaller countries have achieved a measure of success this way. Moreover, at the continental level, European integration is testimony to the generous, forward-looking dimensions of the solidarity impulse. However, achieving thoroughgoing reform at the national level—particularly in the larger economies—will require skill (and perhaps some luck). But most of all, it will require a willingness by policymakers and the electorates to look beyond the current election cycle.

Michael Deppler is Director of the IMF’s European Department.
**Euro Turns Five:**

Hamid Faruqee

This January marked the five-year anniversary of the European single currency—the euro. A historic milestone in the process of European integration, the euro has created a new monetary reality for 300 million Europeans that few would have believed possible a generation ago. While the future course of this “grand monetary experiment” remains unknown, the euro has already seen significant changes in its brief existence. Like most five-year-olds, the euro has had its share of ups and downs, and its role—both within Europe and overseas—continues to evolve and expand.

**History in the making**

The birth of the euro marked a watershed in the postwar history of European integration. Fifty years of endeavor to create a closer union and a cooperative future for the people of Europe in the aftermath of the Second World War, in many ways, culminated in the advent of the single currency. The process that led to Economic and Monetary Union (EMU) with the euro as its currency was accomplished in three distinct stages.

The initial stage was the removal of all restrictions on capital movements between member states by July 1990. With the full liberalization of capital, the European “single market” had a deeper financial dimension. Greater fluidity of financial markets, however, also raised the stakes on possible tensions within an exchange rate regime of currency bands. The second and third stages provided for a compact “euro system”: a network responsible for defining and implementing monetary policy, ensuring the smooth operation of payment systems, conducting foreign exchange operations, and managing official foreign reserves.

Governors of the national central banks within the euro system, together with the ECB’s executive board, constitute the ECB’s Governing Council—the main decision-making body responsible for formulating monetary policy for the area. Making this unprecedented transfer of monetary sovereignty a success depended critically on the credibility of this new supranational institution. Lacking a track record, the ECB has drawn on the experience and credibility of the national central banks in building its reputation. The ECB has come of age in a very short time, owing to its substantial institutional independence and a clear monetary policy strategy aimed at price stability, the meaning of which has more recently been clarified as consumer price inflation “below but close to 2 percent.”

Monetary union also has implications for members’ public finances. While the ECB conducts a single monetary policy, fiscal—and structural—policies remain the responsibility of each member, albeit with the stipulation that national policies be regarded “as a matter of common concern.” One implication is that the monetary integrity of the euro area needs to be supported by sound fiscal budgets. To ensure areawide fiscal discipline, the Maastricht Treaty obligates members to avoid “excessive fiscal deficits,” as defined more fully in the Stability and Growth Pact (see article, page 22). The pact’s principal aim is to maintain sound government finances as a permanent feature of EMU through its monitoring and (if necessary) penalty components. The pact aims to promote budgetary policies that would support a stability-oriented monetary policy without resorting to excessive fiscal deficits during the course of normal cyclical fluctuations.

**New monetary and fiscal architecture**

Adopting the single currency also meant adopting a single monetary policy. Under the Maastricht Treaty, the independent European Central Bank (ECB) safeguards the euro’s value by pursuing its primary objective—maintaining price stability. What became of the national central banks? They now comprise, together with the ECB, what is known as the ECB’s Governing Council—the main decision-making body responsible for formulating monetary policy for the euro area. The ECB has drawn on the experience and credibility of the national central banks in building its reputation. The ECB has come of age in a very short time, owing to its substantial institutional independence and a clear monetary policy strategy aimed at price stability, the meaning of which has more recently been clarified as consumer price inflation “below but close to 2 percent.”

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**Queuing up for the euro**

Along with new institutions, the euro area’s geography has changed since the single currency’s creation. Since Greece’s entry as the twelfth member in 2001, the euro area covers all but three members of the European Union prior to its enlargement this past May: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. When ratifying the Maastricht Treaty, the United Kingdom and Denmark were granted “opt outs” from replacing their national currencies with the euro while leaving the option open for the future.
Europe's Grand Experiment

Sweden was granted a derogation but not permanent exemption and so is required to adopt the euro, but not by a fixed date. Of these three countries, only Denmark currently maintains the Danish krone's rate of exchange against the euro well within narrow (±2 1/4 percent) fluctuation bands of EMU's transitional exchange rate mechanism, ERM2.

All 10 countries that joined the European Union in May are expected to adopt the euro, though no deadline has been set (see the article on page 29). In addition to the other convergence criteria specified in the Maastricht Treaty, a country intending to adopt the euro must undergo at least two years of exchange rate stability in ERM2. With the current diversity of exchange rate arrangements in these countries, the prospect of wider euro adoption will thus entail a shift toward greater use of the euro, first as a reference and intervention currency and, eventually, as domestic money. Nevertheless, deciding whether it is preferable to adopt the euro sooner or later—or at all, as in the case of the United Kingdom and Denmark—is a complex issue. Fundamentally, each country must determine for itself at what point the benefits of conformity—such as the promise of greater trade and financial integration with the euro area—outweigh the costs—notably, accepting a "one size fits all" monetary policy.

Currency without borders

On the global stage, the euro has played a role second only to the U.S. dollar. For its part, the ECB neither promotes nor hinders the internationalization of its currency. Nevertheless, given the euro area's economic size and the legacy of its national currencies, the euro's role as an "international currency" was both immediate and far-reaching from its inception. The uses of an international currency can be categorized in terms of the same functions associated with domestic money—as a unit of account, a medium of exchange, and a store of value.

The euro is used as a settlement currency for about half of the euro area's external trade flows. As a parallel currency for cash-based transactions, the euro's use is more difficult to assess because these trades usually go unrecorded and sometimes involve activities in the informal, or underground, economy. Bank data on net currency shipments—euro banknotes sent abroad minus those received—indicate that more than €30 billion, or nearly 10 percent of all euros in circulation, was provided to nonarea residents during the euro changeover from January 2002 through June 2003.

The euro's most important international role in the private sector has been as a currency of denomination for financial assets. For example, the share of euro-denominated debt (issued by nonresidents) has risen steadily since 1999 and now accounts for nearly one-third of the outstanding stock of international debt securities, behind only U.S. dollar–denominated debt (see chart). In international loan markets, the respective shares of euro and dollar loans to nonresidents are similarly distributed (37 percent and 46 percent).

In terms of the euro's official uses, reference and intervention currency functions tend to be closely intertwined. In 2003, 51 countries and territories outside the euro area relied on the euro as their reference or anchor currency or as part of a currency basket peg. A number of EU accession countries and countries in the western Balkans and Africa use the euro as the sole anchor currency. Moreover, Russia maintains in its currency basket peg a 60–40 split between the U.S. dollar and the European single currency. As a reserve asset, the dominant currency in official holdings of foreign reserves remains the U.S. dollar although the euro has seen its relative share rise steadily from 12.7 percent at end-1999 to 18.7 percent at end-2002. As the currency area's map continues to be redrawn, and backed by the ECB's credibility, the euro's reach in global trade and finance will likely continue to expand.

Hamid Faruqee is a Senior Economist in the IMF's European Department.
Dissecting the causes of Europe's lagging economic performance

Jean Philippe Cotis

Following World War II, European economies entered a 30-year period of rising prosperity. This golden age was one of rapid catch-up with the United States in terms of GDP per capita. The pattern of growth was consistent with the conventional "convergence" view: less advanced economies grow faster than more advanced ones. During the 1980s, however, this catch-up process paused before unraveling during the 1990s as per capita output grew more slowly in large European economies than in the United States. This European setback came as a surprise. In an ever more integrated world, with low barriers to trade, global financial markets, declining obstacles to foreign direct investment, and rapid technological diffusion, one would have expected convergence paths to accelerate.

These developments prompt a number of questions. What is behind the European slowdown relative to other countries in the 30-member Organization for Economic Cooperation and Development (OECD)? What policies and reforms would help rekindle economic growth? And how should these changes be implemented?

Divergent trends

Sizable differences in economic growth have materialized over the past decade within the OECD area. Looking beyond cyclical developments, growth in the United States and a number of other, mostly English-speaking economies, including Australia, Canada, and New Zealand, has averaged 3 percent or more. In contrast, long-term growth is estimated at about 2 percent in Europe as a whole and 1 percent in Japan. But nearly half the 1 percent growth gap between the United States and the European Union (EU) reflects differences in population growth. Moreover, the size of the differences is expected to widen in the years ahead because demographic decline is more advanced in the EU and Japan.

Since countries cannot do much about demography in the immediate future, comparisons of economic performance in terms of GDP per capita are more informative. These too reveal marked divergences. Over the 1990s, annual per capita output growth in the United States was half a percent higher than in the European Union and almost 1 percentage point above what was achieved in the three large euro area economies—France, Germany, and Italy. As a result of these trends, in 2002 per capita incomes converted using purchasing power parities (PPPs) were almost 30 percent lower in the EU than in the United States (see Chart 1). If, on the other hand, the rate of convergence recorded during the 1970s had been maintained, the three major euro area economies would by now have almost the same levels of output per capita as the United States.

Such broad-brush comparisons between Europe and the United States, however, conceal a wide disparity of economic performances within Europe. In fact, there have also...
been extraordinary success stories. For example, in Ireland, average per capita output during the 1990s expanded by almost 6½ percent, the fastest pace recorded in any OECD country. As a result, Irish GDP per capita has risen from a level well below the OECD average to one of the highest. Greece (albeit from a low rate), Luxembourg, and the Netherlands also managed to boost per capita output growth over the 1990s, as did Finland and Spain over the second half of the decade.

Short-run performances have also diverged in unexpected ways, following the bursting of the bubble in high-technology investment spending. Even though the adverse demand shock had its epicenter in the United States, its effects hit continental Europe with as much vigor as the United States. Other OECD economies resisted better, especially English-speaking countries and, to a lesser extent, the Nordic ones.

**Sources of divergence**

All in all, these statistics suggest that continental Europe has suffered from relatively weak performance, in terms of both long-term growth and short-term resilience in the face of conjunctural shocks. The OECD is investigating why some economies are resilient and others are not and has examined in depth the sources of long-term growth (OECD, 2003). What singles out the fast-growing economies is a rare ability to combine a high degree of labor utilization with strong productivity. In contrast, the two principal sources of weakness in Europe are the trend decline in labor utilization and, to a lesser extent, in labor productivity.

**Low labor utilization rates.** Overall, about 30 percent of the working-age population in the European Union is neither employed nor seeking work, compared with less than 25 percent in the United States. Moreover, in many European economies, especially the larger ones, the employment rate has fallen over the past couple of decades while it has remained broadly steady in the faster-growing OECD economies. This dichotomy explains around 85 percent of the gap in Europe's GDP per capita relative to that of the United States (see Chart 2).

The declines in the European employment rate have affected older workers more. For instance, in Belgium, France, and Italy, around one-third or less of the population aged 55–64 has a job while the employment rate in Europe as a whole for this group is just under 40 percent. Other contributing factors include a slower trend rise in female labor force participation—especially of women with limited affordable access to child care services—high marginal effective tax rates, lower average hours worked per employed person, and higher structural unemployment.

A key issue, then, is what has led to this low level of labor utilization? At the risk of oversimplifying, two polar explanations are feasible. First, an argument could be made that Europeans have a greater preference for leisure. In other words, when they become wealthier, Europeans prefer to trade higher incomes for more leisure time. But it could equally be that low labor utilization reflects European labor market and tax policies that have the effect of weakening the incentives to work and of reducing the demand to hire employees.


**Rewards of better policy**

Growth regressions help policymakers evaluate the potential effect of a given change in policy. Adjusting a variable in the left column can have a significant impact in the long run.\(^1\)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Through economic efficiency (percent)</th>
<th>Through investment</th>
<th>Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate of inflation, fall of 1 percentage point</td>
<td>0.4 to 0.5</td>
<td>0.4 to 0.5</td>
<td></td>
</tr>
<tr>
<td>Variability of inflation, fall of 1 percent in the standard deviation of inflation</td>
<td>2.0</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>Tax burden, increase of 1 percentage point(^2)</td>
<td>-0.3 to -0.4</td>
<td>-0.6 to -0.7</td>
<td></td>
</tr>
<tr>
<td>Business research and development intensity, increase of 0.1 percentage point(^3)</td>
<td>1.2</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Trade exposure, increase of 10 percentage points(^4)</td>
<td>4.0</td>
<td>4.0</td>
<td></td>
</tr>
<tr>
<td>Human capital, additional year of education</td>
<td>4.0 to 7.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Organization for Economic Cooperation and Development.

\(^1\)The values reported are the estimated long-run effects on output per working-age person of a given policy change. The range reported reflects the values obtained in different specifications of the growth equation.

\(^2\)The direct effect refers to the impact on per capita output over and above any potential influence on the accumulation of physical capital. The indirect effect refers to the combined impact of the variable on the investment rate and, through that channel, on per capita output.

\(^3\)Percentage of GDP.

Which explanation fits better is a matter of empirical analysis. Although we cannot say much about the relative preferences for leisure on the two sides of the Atlantic, we can say, based on OECD and other evidence, that institutions and structural policies matter for labor utilization (OECD, 1999). This is the case, for example, with labor market policies that subsidize preretirement schemes and financially penalize workers willing to stay at work beyond the legal retirement age. Such policies were implemented in many European economies based on the mistaken belief that, by removing workers from the labor force, unemployment would be reduced. The evidence shows that these policies had a negative impact on the employment rate, particularly of older workers.

We have also found that low labor utilization in Europe is connected to limited labor market flexibility. Restrictive employment protection laws, for instance, tend to dampen both hiring and firing and lengthen average unemployment spells. Through time, some long-term unemployed become discouraged and permanently exit the labor market. Similarly, a high minimum cost of labor provides a disincentive to recruit unskilled and inexperienced workers. And, in many countries, the interplay of tax and benefit systems results in unemployment and poverty traps.

**Labor productivity differs.** Lower labor productivity is a second principal reason why Europe's GDP per capita lags behind that in the United States. It accounts for about 15 percent of the gap between European and U.S. GDP per capita, though the variation between countries is large. In more than one-fourth of the EU economies, labor productivity is higher than in the United States. On the face of it, therefore, there is less scope to improve output in Europe by boosting productivity than there is by raising the employment rate.

This interpretation may, however, be too simplistic because European statistics are somewhat flattering. Indeed, in Europe many people who have below-average productivity are not employed and, thus, are not included in the measurement of labor productivity. Across OECD countries, there is a strong negative correlation between employment rates and labor productivity, although such cross-country comparisons do not amount to a full-fledged explanation of productivity differences. From this perspective, it is reasonable to conclude that many EU countries lag behind the United States in terms of labor productivity and that one challenge is to rekindle productivity growth.

While governments cannot fine-tune productivity, OECD empirical research stresses the importance of good policies and institutions. In this context, it is important that inflation be low and stable and that fiscal policy not be procyclical. Macroeconomic stability, however, is a necessary, though not sufficient, condition. Structural policies that boost flexibility and sharpen an economy's adaptability to shocks are also required. Policies that promote educational achievements, well-designed incentives for research and development, and highly competitive and open markets are some of the levers governments can use to boost productivity. Together, these policies promote efficiency and, ultimately, innovation and the adoption of new technologies.

All these influences can be estimated and put together in a coherent analytical framework using, for instance, cross-country panel data analysis. The results of such a quantitative exercise suggest that the benefits from sound policy can be large. For example, it is estimated that if those sectors that lag in terms of productivity were to modernize their regulatory framework and align it on best practice, their productivity could increase by as much as 10 percent. Similarly, one additional year of education raises output in the long run by about 6 percent. Bringing high returns to individuals and society as a whole. Other examples of the estimated long-run effect of given changes in policy and institutional variables are reported in the table. **EU economies are less resilient.** Growth decompositions traditionally abstract from short-run cyclical developments. This partly reflects the fact that there has not been much to separate the cyclical profile of business cycles. Nonetheless, what may be less appreciated is that those economies that have experienced high long-term growth have also generally been less prone to accidents and have recovered quickly when accidents have occurred. Such economies could be said to be resilient. Indeed, there is prima facie evidence suggesting that countries with stronger long-term growth may also
have gone through less protracted economic downturns during the world slowdown that started in 2001. This, in turn, suggests that the structural policy settings that foster good trend growth may also be conducive to good short-run performance.

To be sure, while structural policies cannot immunize an economy from the business cycle, they can limit the length and magnitude of deviations in output from potential. The channels of operation, however, are less well understood than they are for long-term economic performance. The OECD is investigating further why some economies are resilient, and why others, mostly in the EU area, are not. It is not an easy exercise because many factors are at play. Initial findings, not surprisingly, underscore the role of macroeconomic stabilization policies. But that does not offer a complete explanation. After all, many of the fast-growing OECD economies had relatively conservative macroeconomic policies, suggesting that other factors played a part. Indeed, the weaker resilience appears to be largely the consequence of structural policies and institutions. For example, highly restrictive employment regulations and, in some countries, the interaction of tax and benefit systems are important sources of economic sclerosis that prolong unemployment spells and delay labor reallocation and wage adjustment.

Implementing reforms

Europe has had some success in implementing structural reforms over the past five years or so. Many European economies have managed to generate a "labor deepening process" resulting in stronger job creation and lower unemployment. Labor market policy initiatives have operated both from the demand side of the market by, for instance, cutting nonwage labor costs and promoting wage moderation and, later, from the supply side through in-work benefits and tax credits designed to fight poverty and unemployment traps. A number of governments have also tightened access to early retirement schemes and introduced greater flexibility through an expansion of temporary and part-time employment contracts.

But progress has been uneven, and, in many instances, the initiatives taken, while very welcome, have been the easiest to implement. As we have learned from the OECD's best-performing economies, structural policies that promote competition in product markets and enhance the flexibility of an economy, combined with good macroeconomic policies, are essential for fostering both short- and long-term success in economic performance. A lot of work remains to be done to restore healthy incentives to work and encourage entrepreneurship. For instance, tax and benefit systems should properly balance safety net and incentive considerations, employment protection arrangements should not inhibit hiring, and more focused active labor market programs are often needed.

These OECD policy prescriptions have a broad consensus among economists. Yet it has often been politically difficult to translate this professional consensus into concrete policy reform. The challenge facing policymakers is how to overcome this resistance. There is no self-evident or sure-handed way of doing this. The best one can do is observe the conditions and methods adopted by those countries that have been successful in implementing structural reforms and attempt to distill the lessons learned.

On this basis, and in recognition of the diversity of country experiences, there appear to be two common elements. First, it is always important to identify, quantify, and disseminate estimates of the costs of maintaining existing policies and how they are likely to evolve. This process helps to put into perspective the short-term adjustment costs against the long-term costs associated with inaction. The OECD can play a supporting role in this process through its reports, based on impartial cross-country analyses. However, even though the benefits of reform are greater than the costs, often resistance to change is large and well organized. This is partly because of vested interests and the dilemma of weighing short-term pain (borne by a small fraction of the community) against the long-term gains (which are widely dispersed).

The second common element of successful implementation of structural reforms is the bundling of reforms. Such an approach has several advantages. It allows for the design of a coherent reform package, including, where considered appropriate, measures to compensate groups for the impact of changes that conflict with policy objectives in other areas. Furthermore, a broad-based reform package is more likely to result in a more balanced distribution of the adjustment costs and benefits of reform, thereby softening resistance to change.

The best time to implement reforms is open to debate. It is sometimes argued that reforms are more easily introduced when an economy is growing fast. This may help to ensure that displaced labor is more quickly reallocated, but a strong economy also tends to make the need for reforms more difficult to sell in the first instance. In contrast, if it is widely recognized that slow growth reflects, in part, the structural problems faced by an economy, the costs of inaction come to the fore, leading to a general acceptance that something must change. Examples are New Zealand and Australia in the early 1980s, when these countries saw their ranking, in terms of per capita GDP, decline and initiated reforms in response. It may also currently be a dynamic operating in Germany, where a wide-ranging and ambitious structural reform program has recently been outlined.

“A lot of work remains to be done to restore healthy incentives to work and encourage entrepreneurship.”

References:


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Can Europe Afford

OVER THE coming decades, an increasing share of the European Union's (EU’s) population will turn elderly as baby boomers reach retirement age and life expectancy rises. This is true of both the 15 original members and the 10 new ones. Enlargement will, at best, have a brief rejuvenating effect, given the current, much younger age profile of the new members. Projections indicate that, by 2020, the share of older people in the EU-25 will approach that of the EU-15, reflecting a plunge in these new members' fertility rates over the past decade or so. In fact, the onset of serious population aging in the EU is no longer a distant event, as it will start as early as 2010.

Across major industrial countries, populations are aging.

(elderly dependency ratio; ratio of population aged 65 and over to population aged 15–64)

![Graph showing aging populations across major industrial countries]

Sources: European Union Economic Policy Committee 2001; UN Population Prospects Publication (Revision 98); and IMF staff estimates.

In the European Union, the share of the elderly in the population will double by 2050 . . .

(elderly dependency ratio; ratio of population aged 65 and over to population aged 15–64)

![Graph showing elderly dependency ratio in the European Union]

Sources: European Union Economic Policy Committee, 2001; and IMF staff estimates.

and the share of the employed in the population will decline sharply.

(employment rate; percent of total population)

![Graph showing decline in employment rate]

Sources: European Union Economic Policy Committee, 2001; and IMF staff estimates.
For most EU countries, aging populations will cause major fiscal headaches—chief among them, fiscally unsound pension systems. Europe recognizes that dramatic pension reforms are urgently needed. Currently, public pensions financed on a pay-as-you-go (PAYG) basis dominate in most countries. These schemes pay pensions out of current contributions or taxes. The problem with PAYG systems is that they are in danger of becoming massively underfunded when the number of people drawing pensions begins to markedly increase relative to the number in the active labor force paying into the systems. By contrast, prefunded pensions—both private and public—play a subordinate role in most countries. These schemes make pension payments from a fund that is an accumulation of financial assets built up over a period of years from its members’ contributions.

So what are Europe’s options? Three stand out:

- **Closing PAYG financing gaps** on a year-by-year basis through “parametric” reforms that boost pension revenue (increasing pension contribution rates or the number of contributors) or cutting pension spending (reducing benefits or the number of pensioners), or both.

- **Shifting to public prefunding of pensions**, which would imply running surpluses in the public pension system, at least over the next two decades or so.

- **Shifting to private prefunding of pensions**, which would lead to deficits in the public pension system during the transition period as contributions are diverted to private pension accounts (assuming the diversion of contributions cannot be fully offset by parametric reforms).

So far, different EU members favor a range of strategies that embrace all of these options. Some member countries plan to cut public debt and use the resulting interest savings for extra aging-related spending; adopt labor market reforms to raise employment rates, especially for older workers and women; and, particularly among the new member states, rebalance the public-private pension mix by shifting to private prefunding. However, the reality is that, given the size of the problem, public pension benefits will also need to be cut—and substantially—which, at the political level, would require a graying electorate to accept an erosion of its promised benefits. No doubt then, resolving these tensions in a forward-looking way would require more reliance on option three—that is, starting to build up a private pension component now so that it will eventually help to compensate for the unavoidable future cutbacks in public pension benefits without pitting younger and older generations against each other.
Europe’s Quest for Fiscal Discipline

Will the Stability and Growth Pact help Europe find the right balance between fiscal discipline and flexibility?

Anthony Annett and Albert Jaeger

While the euro area’s monetary policy is conducted by a single institution—the European Central Bank (ECB)—fiscal policy remains decentralized. When Europe’s leaders agreed to form the Economic and Monetary Union (EMU) in 1989, they recognized the need for some form of fiscal coordination. Without coordination, the irresponsible policies of one member state could have a negative impact on the entire union, for example, by raising public debt. The Stability and Growth Pact (SGP), setting out regulations for the conduct of fiscal policy that reinforce the provisions of the Maastricht Treaty, was therefore agreed to by member states in 1997, nearly two years before stage three of EMU, when exchange rates were irrevocably locked.

But seven years later, the SGP is mired in controversy. France and Germany—the euro area’s largest economies, founding members of the European Union (EU), and the main driving force behind the creation of EMU—are likely to breach the pact’s deficit ceiling of 3 percent of GDP for the third year in a row. In November 2003, the European Commission—the official guardian of the EU’s treaties—recommended that both France and Germany be placed under enhanced fiscal surveillance, one step short of actual sanctions. However, the Council of Economic and Financial Affairs (ECOFIN)—the decision-making forum for the EU’s ministers of finance and economics—recommended that both France and Germany be placed under enhanced fiscal surveillance, one step short of actual sanctions. However, the Council of Economic and Financial Affairs (ECOFIN)—the decision-making forum for the EU’s ministers of finance and economics—suspended the excessive-deficit procedures against the two countries, effectively side-stepping the SGP’s rules and leaving the pact in a legal limbo. As it was unclear by what authority the Council acted when it decided not to take action, the European Commission took the case to the European Court of Justice.

Not surprisingly, the SGP is increasingly becoming a lightning rod for pundits debating its economic and political merits. Critics argue that besides being hard to enforce, the pact promotes procyclical fiscal policies (that is, it forces countries to reduce deficits during cyclical downturns) and lacks a rationale for its medium-term goal of bringing the underlying fiscal deficit close to balance or into surplus. Supporters, however, think the pact should be credited with controlling Europe's fiscal deficits. They also point to the countercyclical behavior of fiscal deficits since the introduction of the euro and note that most member countries have managed to live up to their commitments under the pact.

Proposed solutions and blueprints abound, ranging from minor tinkering to completely rewriting the pact. This article tries to shed light on the controversy by reviewing the history of Europe’s fiscal policy before and after the pact. It concludes with some thoughts on possible reforms.

Europe’s fiscal past

Prior to the signing of the Maastricht Treaty in 1992, fiscal policies in EU member countries were widely divergent. Some countries ran large and persistent deficits that fed into rapid public debt accumulation, while others preserved a remarkable degree of fiscal discipline. By the early 1990s, gross public debts in Belgium, Greece, Ireland, and Italy had spiraled to over 100 percent of GDP, with fiscal policies on a clearly unsustainable path. At the other end of the spectrum, public debt accumulation in Germany and France was kept well in check. Given many prospective EMU members’ apparent inability to maintain fiscal discipline, Germany, in particular, insisted on a common fiscal framework to rein in

Box 1

What is the Stability and Growth Pact?

The SGP consists of two regulations and a resolution agreed by the European Council to underpin the fiscal framework of the Maastricht Treaty. It combines discipline and flexibility by requiring countries to reach fiscal positions “close to balance or in surplus” over the medium term (a reference to the underlying or structural fiscal position) and keep their actual deficits below 3 percent of GDP, except in the case of unusually large shocks. Member states submit annual plans for public finances over the medium term. The Council offers opinions on them and, if necessary, delivers early warnings. Unless exceptional circumstances apply, the excessive-deficit procedure is initiated when a country’s deficit exceeds 3 percent of GDP. The procedure starts with a recommendation to reduce the deficit, moves on to enhanced fiscal surveillance, and culminates in the imposition of financial sanctions. If no action is taken along the way, sanctions can be imposed within 10 months of the procedure being initiated. If excessive deficits persist, sanctions can be converted into fines after two years.
the spending of profligate countries before the euro was allowed to replace national currencies.

These deliberations resulted in two key provisions in the Maastricht Treaty, which state that fiscal deficits should be kept below 3 percent of GDP and debt ratios should not exceed 60 percent. To ensure compliance, member countries also agreed on a preventive arm focused on multilateral surveillance and a dissuasive arm for addressing "excessive deficits." The SGP was agreed nearly two years before stage three of EMU and provides more detailed guidance on implementing the Maastricht provisions on fiscal discipline (see Box 1).

One way to understand what the SGP was designed to do is to look at a matrix on fiscal discipline and flexibility—the two key objectives of a successful fiscal policy rule. Even though fiscal policy frameworks differ widely across countries, they can be evaluated using the same two criteria: Is the policy framework capable of ensuring medium-term fiscal discipline? Is it flexible enough to help smooth short-term business cycle fluctuations? These two criteria suggest a broad four-way classification of policy outcomes (see Box 2).

The upper left quadrant (A) illustrates "fiscal nirvana"—the outcome most prized and hoped for by architects of fiscal policy rules—delivering both medium-term discipline and short-term flexibility. The lower right quadrant (D) depicts the worst possible fiscal policy outcome, namely, a lack of both discipline and flexibility. The two other quadrants (B and C) contain the mixed cases, with the lower left quadrant (C) illustrating what is probably a fairly common occurrence: a policy framework that delivers fiscal discipline but does not help stabilize the economy.

Supporters of the SGP argue that the pact, in principle, allows countries to occupy quadrant A on the grounds that underlying (or structural) balance provides a large enough cushion to allow automatic stabilizers to operate fully without normally breaching the 3 percent limit. Furthermore, the requirement of keeping the underlying budget position close to balance or in surplus is justified, they say, by fiscal sustainability considerations—including future expectations of large fiscal costs related to aging. However, critics question the concept of underlying balance, which they say is unrelated to the fundamental issue of fiscal sustainability. They also say there is no economic rationale for the debt ratio to converge (in theory at least) toward zero. Moreover, they argue, the pact would, at best, nudge fiscal policy into the less-than-ideal quadrant C, as the fixation on nominal balances constrains fiscal policy flexibility.

But what was the starting point for Europe? While the pre-EMU record on fiscal discipline across countries was mixed, there is considerable evidence that most EU countries ran highly procyclical fiscal policies during the 1980s and 1990s (deficits during the latter period reflected, to some degree, efforts to meet the 3 percent deficit limit by 1997). In particular, the estimated discretionary fiscal response of the general government balance to output growth was negative for all EU countries, bar the Scandinavian ones (see Chart 1). In four countries (Belgium, Germany, Ireland, and Italy), policy procyclicality was large enough to more than fully offset the automatic fiscal stabilizers. Procyclical fiscal leakages were particularly severe during "good times," when high growth softens fiscal constraints. In sum, most countries occupied quadrants C and D of the discipline-flexibility taxonomy. In fact, some of the countries with the most procyclical policies were also those with the least fiscal discipline, landing them squarely in quadrant D—reflecting the worst possible outcome for fiscal policy. Other countries gravitated toward quadrant C, given that maintaining fiscal discipline in no way guaranteed short-run fiscal flexibility with respect to the cycle.

Assessing the pact's performance
Given the dismal historical starting points of most member countries, it is hard to see how the pact would not have improved fiscal policy behavior. In its design, the SGP clearly puts the emphasis on maintaining fiscal discipline. Thus, combining discipline with anticyclical flexibility in the short run would require a significant measure of forward-looking fiscal policy management, particularly by allowing fiscal stabilizers to operate during good times.

So what does the track record of the pact over the past five years show? By the time the euro was introduced in 1999, all 12 euro area countries had succeeded in reducing their deficits to below 3 percent of GDP. A good one-third of the countries were running surpluses, including some that had a history of high public debt accumulation. Nevertheless, initial fiscal positions in most countries were not in line with the pact's requirement that fiscal positions be close to balance or in surplus over the medium term—something that did not augur well for the future.

But despite worries about the short-term nature of measures implemented by some member countries to comply with the deficit ceiling, the pact proved conducive to fiscal discipline—at least generally speaking. Looking at the big picture, the average euro area deficit during the euro's first five years stood at 1½ percent of GDP, a full 3 percentage points lower than the pre-EMU average from 1980 onward. Indeed, from a sustainability perspective, the euro area's fiscal position over the past five years compares favorably with that of other major currency areas. At under 3 percent of GDP, the
area's structural fiscal deficit in 2003 was less than half that of the United States and less than one-fourth of Japan's.

In another major turnaround of policy behavior, the pact also caused fiscal policy to become distinctly less procyclical in most, if not all, euro area countries. Looking at the most recent business cycle (1999–2003), the structural fiscal balance of the euro area barely budged while fiscal deficits increased, as automatic fiscal stabilizers were generally allowed to operate unhindered (see Chart 2).

Also during this period, however, a gulf emerged between large and small countries. While the structural balance improved by more than 1 percent of GDP in the nine small countries, it deteriorated by roughly the same amount in the three large countries (see Chart 3). In particular, Italy, France, and Germany allowed their underlying fiscal positions to slip during the slowdown, starting from an already unfavorable level in 1999. In contrast, the small countries, as a group, continued to consolidate during the slowdown. In sum, the pact seems to have worked well for countries that found external commitments to be a valuable disciplining device. As a result, a new dichotomy replaced the old high-debt—low debt nexus: With the large countries seemingly unwilling to push for underlying balance, the small countries seized the mantle of fiscal rectitude by sticking to their commitments under the pact. Even more ironically, France and Germany—the traditional bastions of fiscal stability in the prepact era—together with Portugal became the first test cases for the pact's excessive-deficit procedure.

So the pact did unquestionably deliver a high—but certainly not perfect—degree of fiscal flexibility during the downturn. On the issue of fiscal discipline, the track record is more mixed. Clearly, none of the euro area's member countries reverted to the lack of fiscal discipline prevalent before the pact. At least from a historical perspective, therefore, one could argue that under the pact's influence most countries seem to be gravitating toward quadrant A. By the pact's own standards of fiscal discipline, however, much remains to be done before quadrant A "membership" can be certified. In particular, several countries—including the largest—failed to reach "secure" underlying positions before the slowdown began and, in addition, allowed their structural deficits to slip further during the downturn. With automatic stabilizers largely allowed to operate, the resulting fiscal outcomes were repeated breaches of the 3 percent deficit limit by these countries. Moreover, most of the high-debt countries—the "original sinners" that provided the main impetus for having a pact in the first place—made only limited progress in bringing debt levels in line with the treaty's 60 percent of GDP reference value.

Problems of enforcement

The application of the SGP's enforcement procedures has certainly not been smooth. When Portugal and Germany looked set to exceed the deficit limit in early 2002, ECOFIN refrained from issuing early warnings despite calls to do so from the Commission. Both countries ended up breaching the 3 percent limit, in 2001 and 2002, respectively. But when France exceeded the limit in January 2003, it did receive a warning. ECOFIN also acknowledged excessive deficits in Portugal in November 2002, Germany in January 2003, and France in June 2003.

Countries reacted in different ways to ECOFIN's warnings. Portugal succeeded in reducing its deficit to under 3 percent in 2002 and 2003. France and Germany both failed to do the same. And while ECOFIN acknowledged in June 2003 that Germany had taken measures worth 1 percent of GDP, it soon became clear that the excessive deficit would persist in 2004. Likewise, France made little headway, and its deficit is now also expected to persist for the third consecutive year.

Against this background, the pact's procedural machinery broke down in November 2003. Citing France's and Germany's failure to curb excessive deficits, the Commission recommended stepping up the pressure. First, the countries...
would be requested to reduce their cyclically adjusted deficits in 2004—by 1 percent of GDP for France and by 0.8 percent of GDP for Germany. Second, recognizing adverse economic circumstances, the Commission proposed giving the two countries an extra year (until 2005) to eliminate their excessive deficits. Third, the countries would be placed under enhanced fiscal surveillance and required to submit regular progress reports. But ECOFIN did not endorse this strategy. Instead, while agreeing with the Commission on the need to eliminate the excessive deficits by 2005, it effectively suspended the legal framework.

The differences between the Commission and ECOFIN on what constitutes a desirable fiscal policy are not significant. Indeed, ECOFIN could have altered the size of the adjustment or the time frame needed to eliminate the excessive deficit—all the while remaining within the legal framework. But, by failing to take action within the framework, it induced the Commission to ask the European Court of Justice to rule on the matter.

What next?

Given this mixed track record, what should happen to the pact? Should the limits on fiscal deficits and debt simply be dropped, as some have argued? With the euro area facing a serious fiscal sustainability problem, its strong preference for a welfare state ring-fenced by strict financial discipline is understandable. In this light, the medium- to long-term dimensions of the pact fulfill a valid function that is generally accepted by member states. Looking back, the experience with rapid public debt accumulation in some member countries reinforces the need for strict limits on fiscal deficits and debt. Looking to the future, maintaining fiscal discipline will be even more important, given the enormous unfunded liabilities associated with aging populations in most member countries. Finally, a framework emphasizing fiscal discipline would also prove particularly valuable to the 10 new member states that joined the EU on May 1—some of which are burdened by high current transfers and widening fiscal deficits that, if unchecked, will dampen long-term growth prospects.

While these factors speak against relaxing the main parameters of the Maastricht Treaty, the pact should be politically credible and economically meaningful. In this regard, potential reforms to the SGP could usefully be evaluated against three criteria. First, reforms should reduce the chances that countries with strong and proven domestic fiscal governance structures get entangled in protracted excessive-deficit procedures that quickly lead to sanctions. Second, reforms should help push higher-debt countries toward adopting stronger fiscal adjustment strategies. And, third, given that a significant number of countries have already aligned their fiscal policies with the SGP, potential reforms should preserve the incentives to maintain fiscal discipline. In the light of these criteria, a reform strategy could focus on the following planks:

- More emphasis on symmetric implementation of the SGP during good times, which means beefing up the pact's preventive arm. Had France and Germany attained "close to balance or in surplus" positions during the upswing (1999–2000), as did several of the other euro area countries, their fiscal positions might not have triggered the excessive-deficit procedure. Specific measures to this end would include developing better measures of structural balance, encouraging "rainy day funds," and replacing pay-as-you-go (PAYG) financing mechanisms with prefunding or more tax smoothing. Early enforcement could also be encouraged by using "national watchdog" institutions that can exercise moral suasion over their governments' fiscal policy behavior.

- A less rigid procedure for dealing with excessive deficits so that it is easier to distinguish between patent fiscal policy misbehavior and deficit overshoots that result from protracted weak growth. Although the SGP already has significant built-in procedural flexibility, its dissuasive arm could be softened, for example, by relaxing the rather strict conditions in which "exceptional circumstances" apply.

- A stronger role for fiscal sustainability considerations. Flexibility should also be enhanced at the preventive stage by including country-specific sustainability issues in determining the numerical targets for the "close to balance or in surplus" condition. This would imply a greater role for initial debt levels, as well as implicit pension liabilities.

For Europe, the challenge ahead will be to find a better balance between enforcing discipline and allowing flexibility. To do this, the pact may have to evolve further. In particular, for the sake of the pact's credibility, the present procedural impasse needs to be resolved quickly. Otherwise, some of the smaller member countries, aggrieved by what they perceive as double standards, might be less inclined to respect the pact in the future—and there are early signs that this is already occurring. However, it is also clear that there are limits on how far reforms can go in practice, given that 25 member states will have to agree on any reform package.

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Consensus that the Stability and Growth Pact (SGP) will need some adjustment appears to be growing. The recent failure of the European Union’s (EU’s) Council of Economic and Financial Affairs (ECOFIN) to follow the pact’s prescriptions for addressing excessive fiscal deficits in several member countries has only added to already urgent calls for reform. But how far should reform go? Should the pact be completely rewritten, as some have argued? Or is it basically sound, making the problem one of enforcement rather than structure? Below, F&D presents the views of two private sector economists—David Walton and Angel Ubide—and a political scientist—Mark Hallerberg.

**How Should the Stability and Three points of view on the future of Europe’s fiscal pact**

**Time for Radical Surgery**

David Walton

*Chief European Economist, Goldman Sachs*

THE SGP was flawed from the start and needs to be reformed to provide the euro area with a durable fiscal framework built on solid economic foundations.

France and Germany may have breached the rules of the pact, but fiscal policy has not been conducted irresponsibly. The rise in the euro area’s budget deficit in the past couple of years has been mostly due to the effects of the economic cycle. By allowing the automatic stabilizers to work in full, governments have helped cushion the downturn in economic activity rather than exacerbate it. Unlike the United States, France and Germany do not have “twin deficit” (fiscal and current account) problems. If the deficit limit of 3 percent of GDP had been strictly enforced, a much greater burden would have been placed on the European Central Bank to use monetary policy to support the economy. This would hardly have been sensible, given that interest rates are already at historic lows.

It is no good resurrecting the pact in its existing form. Without credible reforms, further breaches are inevitable. Other countries could invoke France and Germany as precedents.

Several flaws in the original design of the pact need to be addressed.

- By requiring each country to achieve cyclically adjusted budgets “close to balance or in surplus,” the pact treats each country the same despite very different ratios of government debt to GDP across the euro area.
- The balanced budget rule implies a decline in debt ratios toward zero. This makes little economic sense and even less political sense. The rule takes no account of the fact that public investment can add to a country’s assets as well as its debts.
- The pact is asymmetric: it does not make proper allowance for cyclical effects. Once the deficit breaches 3 percent of GDP, member states are expected to eliminate the “excessive deficit” the year after it is identified, with little regard for the stage of the economic cycle. Conversely, the pact is not forceful enough in requiring fiscal consolidation during good times.
- The sanctions mechanism lacks credibility. Sanctions are unlikely to be applied when they run against what governments regard as their sovereign decisions, particularly when deficits are the consequence of weakness in economic activity.

**Need for a new pact**

Thus, the time has come to create a new pact that takes account of the experience of the past couple of years. A new pact should be geared to the following six principles:

First, all member states should reaffirm the need to adhere to a fiscal framework that guarantees the long-run sustainability of public finances within the euro area while allowing fiscal policy to help smooth fluctuations in the business cycle.

Second, there needs to be a clear focus on what governments need to do to achieve debt sustainability over the medium term. The pact should recognize explicitly that the debt-to-GDP ratio is more important than the deficit-to-GDP ratio. The appropriate budgetary position will vary from country to country. Highly indebted countries should be required to balance their budgets or even to run surpluses to reduce their debt ratios at a satisfactory pace. In determining the appropriate path for public debt, policymakers should take account of the need for higher public investment in some countries (especially in many of the new member states) as well as future liabilities (in particular, because of aging populations).

Third, to avoid excessive adjustment costs in the face of negative shocks and insufficient adjustment in the face of...
Growth Pact Be Reformed?

The economic costs of excessive deficits—what the Maastricht Treaty calls fiscal profligacy—have become even more relevant now than when the treaty was concluded. Potential output growth in Europe has declined in recent years—the day the baby boomers retire has come closer, and public debt ratios are increasing again. If these trends are not reversed, Europe risks economic warfare between pensioners and workers over the distribution of income.

Of course, fiscal policy discipline always appears more bearable in the future than in the present. Politicians are thus receptive to economists brandishing the SGP as a fiscal straitjacket and offering absolution for their recent rule breaking. But describing current deficit reduction as procyclical—that is, as forcing countries to reduce deficits during cyclical downturns—is simply wrong. Most forecasts for 2004 point to above-trend growth. When, if not now, should steps be taken to put government finances on a more sustainable basis?

How to save the pact

In my mind, the problem with the SGP is how it is applied, not how it is written. Hence, the opportunity should be seized to strengthen the procedures. Two main changes are necessary. First, the Commission should be given more power as the supreme enforcer of the Maastricht Treaty and the SGP. Second, incentives for fiscal discipline should be strengthened by creating a system that exacts a political cost for noncompliance.

The first change is necessary because significant errors in budget forecasting are at the heart of the recent conflict. The excessive-deficit procedure is anchored in the expectation that countries will undertake measures to reduce the cyclically adjusted deficit to agreed-upon levels. But if budget forecasts are inaccurate and must be revised every other month, the procedure becomes unenforceable. Indeed, recent experience shows that, even within the same year, deficit forecast errors were close to 1 percent of GDP. No wonder the German authorities claimed they had honored their commitments: They had implemented the measures that a few months before were supposed to deliver the expected reduction in the cyclically adjusted balance!

To improve the quality of fiscal forecasts, the Commission must be given adequate resources to generate its own forecasts and fund independent national budget agencies that are monitoring budget developments—including debt issuance. Moreover, an early warning system should be developed to detect forecast errors before it is too late, perhaps by establishing confidence intervals around the baseline forecasts.
The Commission could issue early warnings whenever the lower end of the confidence band indicated a certain probability—say, 30 percent—that the deficit would be higher than 3 percent five quarters ahead.

The second change is needed because peer review has failed to prevent procyclical fiscal policies during upswings. As a result, financial sanctions arrive too late in the process, typically during the downturn, when fiscal consolidation is seen to perpetuate procyclical policy. Thus, prevention is paramount to ensure that countries have room for cyclical increases in nominal deficits during downturns.

Politicians are little impressed by financial sanctions that must be borne by the taxpayer. Sanctions should therefore create political rather than economic costs for noncompliance. This could be achieved if governments—in the context of the multiyear fiscal planning process—had to testify before their own parliaments following a negative report from the Commission. Governments should be required to explain the reasons for the slippages and lay out remedial measures.

Debt sustainability requiring both fiscal consolidation and structural reform to increase potential growth is the raison d'être of the Maastricht Treaty provision on excessive deficits. However, the political cycle is too short to trust governments with implementing proposed structural reforms. There is thus no trade-off between fiscal consolidation now and structural reform later. The SGP, if reformed along the lines suggested here, would raise incentives for structural reform while preserving existing incentives for fiscal consolidation.

A fiscal pact that seeks to reinforce domestic institutions will need to be sensitive to failures under both types of fiscal governance.

It is fairly easy to differentiate between the two types of fiscal governance in practice. Fiscal contracts arise under coalition governments in which political parties have competing policy priorities and expect to face each other in elections (Finland, Netherlands). Strong finance ministers emerge in systems where there is only one party in government (United Kingdom) or where the parties in government share similar policy views and usually run together in elections (France).

If states are classified according to this framework and the economic downturn in the early 1990s is compared with economic weakness today, a pattern emerges. It is striking that fiscal contract countries have tighter fiscal discipline than they did a decade ago. In contrast, states with strong finance ministers are not performing worse, but neither are they performing better. This evidence suggests that the SGP has had a discernible impact only in contract states. The explanation lies in the domestic sources of failure to maintain fiscal discipline in the two types of states. In the first case, one or more parties break the contract. In the second case, the finance minister cannot rein in spending or raise taxes effectively.

A fiscal pact that seeks to reinforce domestic institutions will need to be sensitive to failures under both types of fiscal governance. The goal in the first case should be to strengthen the durability of the domestic contract. By enabling partners to monitor one another effectively and to identify clearly a contract violation, the SGP does just that. Its annual evaluations provide additional scrutiny of the budget in countries with fiscal contracts. It also provides clear goals for coalition partners and the public to judge the government's performance. In contrast, in states that delegate fiscal powers to a strong finance minister, the goal should be to strengthen his or her position. How this can be done in practice is less clear. There is a hope that pressure from Brussels would reinforce the position of finance ministers in domestic budget negotiations. But it seems unrealistic to expect private beratings at ECOFIN meetings to strengthen a finance minister's position at home. A weak finance minister may look even weaker in the eyes of his or her colleagues and the public if Brussels is seen dictating policy decisions.

The reality is that many of the established EU countries have coalition governments with fiscal contracts in place. The SGP has worked well by reinforcing fiscal discipline in these countries. Moreover, such contracts would also benefit most of the new EU members. This suggests that the SGP will become more effective once the new members join EMU. Over the medium term, therefore, the pact is perhaps better left untouched. If reform is attempted, however, it should take into account the possible effect on countries' domestic fiscal institutions.
Charting a Course Toward Successful Euro Adoption

Newest EU entrants should reap net gains from joining the euro area

Susan Schadler

The first wave of transition countries to join the European Union (EU) are turning their attention to the next step in their integration with Europe—replacing their national currencies with the euro. Upon joining the EU, these countries also became members of the Economic and Monetary Union (EMU) with a derogation on adopting the euro. This means that each will be committed to taking the step but can choose when to do so.

Joining the euro area will involve major economic changes for these countries. On the benefit side, they will gain in growth and efficiency from closer integration with the euro area; they will also leave behind emerging market risk. The potential cost of monetary union stems from the susceptibility of member countries to asymmetric shocks—economic shocks that affect one or more members differently from the rest of the currency area. Economies linked by a monetary union have a common monetary policy, which may not be the optimal one for a country facing an asymmetric shock. Relinquishing the ability to conduct a national monetary policy could, therefore, result in greater economic volatility unless other macroeconomic policies or behavior—primarily fiscal policy and wage and price flexibility—is effective in smoothing the effects of asymmetric shocks.

Current conditions in the new member states present challenges for the approach to euro adoption. Real convergence—narrowing the gap in real per capita income—is markedly behind that of even the poorest euro area members. While nominal convergence—the narrowing of gaps in inflation—is rather advanced, policy convergence—particularly aligning fiscal deficits—is at least as much of a hurdle in most of the new member states as it was for the most difficult pre-EMU cases. These initial conditions raise questions about the balance of benefits and costs, the policies that must be put in place for a successful experience in the monetary union, and the challenges of meeting the entry tests—the EU Maastricht convergence criteria. This article examines these questions with a focus on the Central European countries and the kinds of considerations that should guide IMF surveillance in these countries.

Since each new member state is committed to adopting the euro, the critical issues are when and how to do so. The considerations are complex but broadly reflect three distinct questions:
- Do the long-term benefits of being in the euro area outweigh the costs? If the gains from increased trade, growth, and policy discipline are expected to be larger than the costs of relinquishing monetary policy as an instrument for economic stabilization, countries should move ahead quickly to put in place policies necessary for euro adoption. If benefits and costs are balanced and net gains are likely to rise over time, a slower approach to euro adoption might be preferable.

- What policy or institutional changes are required to ensure a successful experience in the euro area? Broadly, these involve enhancing both synchronization with the euro area economies and economic mechanisms—such as wage and price flexibility and fiscal policy—for absorbing asymmetric shocks.

- How long will it take to credibly and efficiently put needed policies in place and to meet the Maastricht criteria? Any policy regime change carries risks of macroeconomic volatility, and a strategy for managing such risks is essential.

“**The Maastricht criteria coincide with goals—low inflation and a conservative fiscal position—that any country should have before joining a low-inflation currency union.”**

Identifying costs involved in meeting the Maastricht criteria, ways of minimizing these costs, and the optimal time for bearing them is important.

**Pros and cons of currency union**

Recent research on the benefits of currency unions for trade and income suggests that gains over 20-30 years can be large. For example, a 2003 study by Andrew Rose (University of California at Berkeley), concludes that a currency union can increase trade between members by amounts ranging from 10 to 100 percent—almost entirely through trade creation rather than trade diversion. Together with estimates of the impact of greater trade on income, euro adoption could raise GDP by up to 10 percent over 20 years in Poland and up to 20–25 percent in most of the other Central European countries. Recent work on the actual experience of EMU in its first four years finds that, even during its short life, it has had positive effects on trade and growth for the existing members that—if continued—could be consistent with large long-term effects.

One unresolved puzzle, however, is what causes increased trade in a currency union. The elimination of foreign exchange risk seems to be an obvious channel. However, studies looking at how exchange rate volatility affects trade in a wide cross section of countries within and outside Europe do not unambiguously point to significant gains from its elimination. And most models of the benefits of currency union membership control for free trade arrangements, so the removal of trade barriers is not the explanation either. This suggests that other effects of a currency union—notably, lower transaction costs and greater competition and transparency of prices—must play a role. Euro adoption should also produce some other, less well researched benefits, including lower risk premiums on interest rates in member countries and a stronger framework for policy discipline.

These gains must, however, be viewed against the costs of giving up an independent monetary policy as a tool for stabilizing the economy. A key point to bear in mind here is that economies linked by a monetary union are obliged to follow the same monetary policy, whether or not it is appropriate, while economic shocks may differ across countries. The optimum currency area literature, pioneered by Robert Mundell in 1961, assesses the scope for costs associated with the loss of national monetary sovereignty with two aims. The first is to determine a country’s susceptibility to real shocks that are asymmetric to those in the broader currency union and that therefore would ideally be met by a country-specific monetary policy. The more weakly synchronized a country’s business cycles with those in the broader currency union, the lower its intraindustry trade with the currency union, and the more a country’s sectoral composition of output differs from that of the currency union, the more susceptible it is to asymmetric shocks. The second aim is to assess the ability of countries to adapt—mainly through wage and price flexibility but also through the use of countercyclical fiscal policy—to these shocks in the absence of monetary policy.

Generally, the new member states display optimum currency area properties that are as strong as those in the Southern European members of EMU or stronger. Moreover, Jeffrey Frankel and Andrew Rose, among others, argue that entering a currency union can launch processes that change members’ economic structures to make them less susceptible and more adaptable to asymmetric shocks.

Two other questions are important in evaluating the costs of relinquishing monetary policy. First, in small open economies such as those in Central Europe, how effective is monetary policy as a shock absorber? Borghijs and Kuijs in 2004 suggest that the largest share of recent macroeconomic shocks to Central European economies may have been financial shocks that, in their view, are best countered by fluctua-

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**Box 1 What is the Balassa-Samuelson effect?**

The Central European economies’ catch-up to euro area income levels will be driven at least partly by productivity gains from increases in capital-labor ratios and total factor productivity. Generally, these gains are faster for tradable goods—which face foreign competition and tend to attract the larger share of technology-intensive foreign direct investment—than nontradables. As wages in the tradables sector rise with productivity, they also bid up wages in the nontradables sector. To maintain profit margins, prices of nontradables must increase relative to those of tradables. This process is called the Balassa-Samuelson effect.
tions in money supplies rather than by exchange rates. In this case, irrevocably fixing exchange rates may not end up being much of a loss in the arsenal of macroeconomic policy tools. Second, do countries have fiscal, wage, and structural policies that not only help absorb shocks but do not themselves create shocks? Ensuring this—the aim of nominal convergence embodied in the Maastricht criteria—is critical for successful currency union membership.

Whether the gains for trade and growth are likely to exceed the costs from possible macroeconomic volatility is ultimately a matter of judgment. Models that integrate both effects and draw inferences in terms of a single metric—such as net effects on welfare—do not exist. Some observers see the risks of increased volatility in Central European countries that adopt the euro before achieving greater real convergence—and, by extension, they argue, synchronization of shocks—as outweighing the benefits. Others argue that the potential benefits for growth are large; better-disciplined macroeconomic policies might reduce volatility; and susceptibility to asymmetric shocks is, anyway, unrelated to real convergence. After a qualitative weighing of the evidence, an IMF staff study concludes that, on balance, provided countries adopt structural and fiscal policies that minimize economic volatility, euro adoption can be expected to hasten real convergence at the risk of a modest increase in volatility.

Preparing for EMU
The Central European countries approach euro adoption with certain basic macroeconomic characteristics that distinguish them from existing euro area members yet create risks that need careful management. Five specific characteristics stand out:

- These countries should continue to attract large and possibly volatile net capital inflows. Reflecting capital-labor ratios, which are a fraction of those in Western Europe, and therefore relatively high rates of return on investment, recent net inflows have been about twice the size relative to GDP as those in the pre-EMU Southern European countries. The predominance of foreign direct investment, typically small derivative markets, and fundamentally high rates of return offer some protection from sudden reversals. But the size of the inflows coupled with the risk of contagion and changing expectations make capital account volatility a vulnerability.
- Productivity growth is likely to be strongest among traded goods, where technology transfers are apt to be largest. Increased productivity should give rise to real exchange rate appreciations owing to the so-called Balassa-Samuelson effect (see Box 1). Once nominal exchange rates are indelibly fixed (or movements are constrained), this real appreciation will have to occur through slightly higher inflation in the Central European countries compared with the euro area average.
- Inflation in some of these countries is above the optimal rate and, even in those where it is lower (Czech Republic and Poland), it remains unclear whether low inflation will be sustained through the cycle (see chart).
- With bank credit to the private sector in these countries less than half the euro area average, bank credit booms are likely. Banks remain reluctant to lend to enterprises but are already stepping up lending to households. Rapid credit growth could create risks of asset price bubbles and overheating.
- Except in Slovenia, general government deficits are large (see table), reflecting moderate revenue ratios but high current primary expenditures, especially on social transfers, relative to per capita GDP. Debt ratios, however, range from low (in the Czech Republic and Slovenia) to borderline high (in Hungary and Poland).

These characteristics mean that the requirements for a successful experience in the euro area—and, perhaps to an even greater extent, for navigating the path to euro adoption—are demanding. Beyond synchronizing economic activity and wage and price flexibility, three elements are of central importance.

### Prices coming down
Inflation in the Central European economies has been on an overall trend of convergence with the euro area average.¹

<table>
<thead>
<tr>
<th>Year</th>
<th>Czech Republic</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovak Republic</th>
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<td>11.3</td>
<td>13.0</td>
<td>7.7</td>
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<tr>
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<td>12.0</td>
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<td>8.9</td>
</tr>
<tr>
<td>2003</td>
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<td>9.1</td>
<td>11.6</td>
<td>5.6</td>
<td>8.5</td>
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</table>

Sources: IMF, International Financial Statistics; and IMF staff estimates.

### Mixed bag
How the newest entrants fare on fiscal criteria.

<table>
<thead>
<tr>
<th>Fiscal deficit</th>
<th>Government Financial Statistics</th>
<th>European System of Accounts 95</th>
</tr>
</thead>
<tbody>
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<td>-5.2</td>
<td>44.9</td>
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<td>Slovak Republic</td>
<td>-5.1</td>
<td>57.2</td>
</tr>
<tr>
<td>Hungary</td>
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<tr>
<td>Slovenia</td>
<td>-4.9</td>
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</table>

<table>
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<tr>
<th>Debt</th>
<th>Government Financial Statistics</th>
<th>European System of Accounts 95</th>
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<td>Slovenia</td>
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</tbody>
</table>

Sources: National authorities; and IMF staff estimates.

¹Consumer price index (CPI) inflation for 1996–2003 for the Central European economies and average CPI inflation for 2000–03 for the euro area.

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First, fiscal deficits and rigidities from subsidies and formula-driven social transfers must be low. With output and demand growth likely to remain volatile in the Central European countries, prudent debt levels—levels that could be serviced without undue strain on the economy even in slack periods—would be no more than 40–50 percent of GDP. Countries should also have overall fiscal deficits well below the EU’s Stability and Growth Pact (SGP) limit of 3 percent of GDP to allow automatic fiscal stabilizers to operate. At the same time, fiscal policy will need to be able to respond nimbly to restrain demand in the event of credit booms.

Second, financial market supervision must be strong. Rapid growth of bank credit to the private sector is almost inevitable, regardless of the timing of euro adoption, as bank intermediation approaches Western European levels. Effective bank supervision, alongside fiscal restraint, will be key to containing any risks of asset price bubbles and overheating—particularly since countries will no longer be able to conduct an independent monetary policy. The large presence of foreign banks in these countries makes coordination of supervision with euro area countries important.

Third, competitiveness must be robust. This principle should guide the choice of the central parity rate for ERM2—the transitional exchange rate mechanism (ERM) that countries have to join at least two years before adopting the euro (see Box 2)—and, later, the euro conversion rate. Downward price and wage rigidities in the new EU members would make adjustment to an overvalued parity costly in terms of employment and forgone growth. An important adjunct to proper conversion rates will be securing low inflation so as to ensure that competitiveness remains strong.

**Strategies for the approach to euro adoption**

Beyond these basic preparations for strong performance in EMU, each country must elaborate a strategy to meet the Maastricht criteria. These nominal convergence criteria consist of four conditions to be met during a single assessment year: annual average inflation not exceeding by more than 1½ percentage points that of the “three best-performing Member States in terms of price stability”; annual average nominal interest rate on the 10-year benchmark government bond no more than 2 percentage points above the average in the same three countries; a fiscal deficit below 3 percent of GDP, and public debt less than 60 percent of GDP; and the value at which the currency trades against the euro held within the “normal fluctuation margins” of ERM2 without severe tensions for at least two years.

In broad terms, the Maastricht criteria coincide with goals—low inflation and a conservative fiscal position—that any country should have before joining a low-inflation currency union. The new member states are no exception. But charting a course to meet the Maastricht criteria, as well as the basic conditions each country sets for itself, will require strategies that pull together several macroeconomic policy strands.

Fiscal adjustment will be the bellwether of the seriousness of each country’s commitment to adopting the euro. Framing and meeting medium-term targets will be essential. Typically, these targets will need to go beyond the Maastricht fiscal criteria to ensure that debt ratios stay within safe ranges and deficits stay within the SGP limits after euro adoption. The short-term effects of this adjustment will be depressing. But in a setting likely to include rapid credit expansion and strong export growth, this process may be appropriate even from a strictly demand management viewpoint. Most important, thoughtful structuring of the adjustment—trimming bloated social transfers and subsidies while fully utilizing EU transfers for infrastructure and other spending—will produce longer-term supply-side benefits. Contrary to concerns in some circles that deficit targets at or below the Maastricht fiscal limits are too restrictive for the Central European countries with still sizable development needs, the IMF staff study views these targets as providing an appropriate medium-term anchor for fiscal policy.

Getting central parities right will be another key part of the strategy. The 1992–93 ERM crisis underscores the importance of avoiding unrealistic parities and responding quickly when signs of misalignment arise. Estimating equilibrium exchange rates will, at best, produce fairly wide ranges: deciding where within the range to set the parity will be part of risk management strategies. In general, the adverse effects of getting parities too low (inflation and overheating) are likely to be less disruptive than those of getting the rate too high (low growth, high unemployment, and the need for downward price and wage adjustments). Attention to minimizing the risks of the latter is thus key.

Low inflation will be essential to preserving competitiveness. The evidence on the Balassa-Samuelson effects suggests that sustainable inflation in these countries will likely be 1–2 percent above that in the euro area once exchange rates are fixed. Countries will need to keep inflation at this level through wage and fiscal restraint. This would put inflation rates similar to those in the other “catching up” member states—Greece, Ireland, Portugal, and Spain—where the average has been 3.4 percent since the beginning of the common monetary policy. Whether the Maastricht inflation criterion will force the Central European countries to go beyond this during the assessment year remains to be
seen. Interpreting the "three best-performing Member States in terms of price stability" as those closest to the European Central Bank's inflation objective (close to 2 percent) would appropriately render a ceiling of about 3-3 1/2 percent. Interpreting them as the three lowest-inflation countries would put the ceiling below 3 percent—lower than rates that should be sustainable in the Central European countries.

Choosing robust monetary policy frameworks will also be critical. Until entry into ERM2, existing, generally well-functioning frameworks—in most cases, inflation targeting with flexible exchange rates—should be continued; these have protected the countries from disruptive effects of capital account volatility by discouraging any presumption of implicit exchange rate guarantees. After ERM2 entry, frameworks will need to be adapted to enhance the stabilizing effects of the central parity, maximize the chances of meet-

A final question concerns the time horizon for ERM2. One view is that ERM2 should be used as a testing ground over an indefinite period. That is, managing the exchange rate within a ±15 percent band and gradually narrowing the band to a small margin around the central parity would test policy consistency and the appropriateness of the central parity for final conversion. In this perspective, the exchange rate is an indicator of market sentiment rather than an instrument for managing emerging market risks. An alternative view—favored by IMF staff—is that countries should enter ERM2 only when they are well prepared to adopt the euro upon completion of the two-year mandatory stay. According to this view, entering ERM2 before policies suitable for euro adoption are in place could, by removing the urgency of a clear target date for euro adoption, slow the mobilization of political support for needed policy changes. And, without adequate supporting policies, even a wide band could invite speculative attacks.

Conclusion

With proper supporting policies, euro adoption is likely to bestow substantial net gains on the new member states over the long term and make them stronger, more self-reliant members of the EU. But the policy requirements to make their experience in the euro area successful are rigorous. Even before they enter ERM2, the Central European countries, in particular, will need to embrace fiscal adjustment with determination, secure low inflation, and ensure considerable wage and price flexibility. With this degree of commitment, the economic effects of this major regime change should be manageable and, indeed, prosperity-enhancing.

Susan Schadler is a Deputy Director in the IMF's European Department.

This article is based on a 2004 IMF staff study: "Adopting the Euro in Central Europe—Challenges of the Next Step in European Integration," by Susan Schadler, Paolo Drummond, Louis Kuijs, Zuzana Murgasova, and Rachel Van Elkan (Washington: International Monetary Fund).

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"Fiscal adjustment will be the bellwether of the seriousness of each country's commitment to adopting the euro."
Accelerate Change

Higher saving is the key to higher growth for new EU members

Witold M. Orlowski

FOR THE EIGHT Central and Eastern European countries (CEE-8) that have just joined the European Union (EU), membership marks the fulfillment of their main political and economic goal of the past decade. Without doubt, meeting all the EU's entry conditions required an enormous modernization effort. Indeed, after the initial period of liberalization and stabilization during the transformation from centrally planned to market-based economies, their wish to join the EU was a major factor driving further adjustment and reforms.

Now that the eight—Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia—have joined the EU, are their problems over? Not necessarily. While membership brings with it big business opportunities and clear financial benefits, the key question remains whether the CEE-8 can really catch up with the established EU members. In my view, this question is still open.

EU membership does not change the fact that there is a big gap in the economic development, productivity levels, and living standards of the CEE-8 and Western Europe (see Chart 1). The average per capita GDP in the CEE-8 is just 46 percent that of the EU-15, measured at purchasing power parity (PPP). That is not the only difference. Their economic structure is less modern, their institutions less efficient, their technology less advanced, the skills of the population lower, and the market infrastructure much less developed. In a nutshell, the new member states need policies that will accelerate structural change and long-term GDP growth.

Growth too slow

The CEE-8's performance during the past decade has been somewhat disappointing. In 1995–2003—after the recession stemming from the transition period was over—these countries recorded an average annual GDP growth rate of 3.6 percent. This was only slightly better than that of the three established EU member states that are least well off (Greece, Portugal, and Spain, or the Med-3). But the Med-3 had an initial per capita GDP almost twice as high as the CEE-8's, so the new members could have expected a much stronger growth rate.

Why was growth disappointing? Obviously, one could blame the ongoing restructuring process. But the CEE-8 countries benefited enormously from economic liberalization and from their growing attractiveness as places for investment. In my view, the main macroeconomic explanation may be found in their very low level of domestic saving.

On the surface, CEE-8 countries save a share of GDP similar to comparable Western European economies. The CEE-8's ratio of domestic saving to GDP was 19 percent in 2001. That, together with significant inflows of foreign direct investment, allowed for relatively high investment-to-GDP ratios. In some countries, such as the Czech Republic, Estonia, and Slovakia, the rates approached 30 percent.

The problem, however, is how the values of consumption, investment, and GDP are measured. All the above-mentioned ratios were calculated using domestic prices. Compared with the EU average, the prices of consumer goods in the CEE-8 are much lower while the prices of capital goods—particularly machinery and equipment—are roughly the same. Seen in this light, the relative prices of consumption are depressed in the CEE-8, while the relative prices of investment are overstated, thus boosting the ratios of investment and saving to GDP. One could argue that, for the sake of international comparison, one should use PPP prices in making intercountry comparisons of saving and investment rates. The point is that we should try to compare the relative volumes of resources that a given country spends for consumption and investment. Consider, for example, two countries, A and B, that spend exactly the same real amounts on goods for consumption and investment. Common sense tells us that the investment-to-GDP ratio in both countries would be identical. If, however, prices of capital goods are equal in both countries, but prices of consumer goods are lower in Country B, the relative price of investment...
with the transition. The enterprise sector has suffered from building wealth, first by central planning and then by economic instability—especially high inflation—associated with such imbalances (Hungary in 1995-96, the economic instability that characterized the CEE-8, forcing the governments to apply tough stabilization policies to counteract an excessive buildup in the current account, as investment in excess of domestic savings can be financed only with foreign capital. That, in turn, would lead to serious economic imbalances in the CEE-8, forcing the governments to apply tough stabilization policies to counteract an excessive buildup in the current account, as investment in excess of domestic savings can be financed only with foreign capital. That, in turn, would lead to serious economic imbalances in the CEE-8, forcing the governments to apply tough stabilization policies to counteract an excessive buildup in the external deficit. All the economies of the CEE-8—except for high-saving Slovenia—have suffered serious growth setbacks caused by such imbalances (Hungary in 1995-96, the Czech Republic in 1997-99, the Baltic states in 1999, Slovakia in 1999-2000, and Poland in 2001-02).

No coincidence

Obviously, the CEE-8’s low saving rate is not a coincidence. The household sector was discouraged from saving and building wealth, first by central planning and then by economic instability—especially high inflation—associated with the transition. The enterprise sector has suffered from low profitability, resulting partly from the unfinished restructuring and privatization of loss-making, state-owned firms. The government sector has run up big deficits. In 2003, only the Baltic states and Slovenia had public sector deficits of less than 2 percent of GDP; Poland, Slovakia, and Hungary had deficits ranging from 3.6 percent to nearly 6 percent, and the Czech Republic logged 12.9 percent.

Will the opportunities created by EU membership change this situation quickly? That cannot be taken for granted, as previous rounds of enlargement have shown. When Greece joined the EU in 1981, its per capita GDP was 70 percent of the EU-15 average. Over the next decade, slow growth relative to the EU-15 meant that per capita GDP was only 58 percent of the EU-15 average by 1990—indeed, it is only recently that the figure has risen to 71 percent. Similarly, when Ireland joined the EU in 1973, its GDP was 60 percent of the EU-15’s. Over the next decade, this figure still hovered at 66 percent. Only a radical change of economic policy—as was needed by Greece—changed Ireland into a “Celtic tiger,” enabling it to greatly outperform all the other EU countries and achieve ultrarapid real convergence (that is, catch up in per capita GDP) by the mid-1990s.

The key for Ireland was to boost domestic saving dramatically by implementing radical public sector reforms and drastic reductions in the public sector deficit. It is a lesson the CEE-8 countries must take to heart if they hope to generate the higher saving, investment, and GDP growth necessary for real convergence. EU membership—and, in the future, the adoption of the euro—creates an enormous opportunity for the accelerated development of the eight. However, the key to success is still in the hands of the CEE-8’s policymakers.

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New Citizens, Old Borders

Why Europe has not put out the welcome mat for its new members

Tito Boeri

The European Union (EU) welcomed the citizens of the 10 new member countries (NMCs) by shutting the door in their faces. Actually, it did worse than that. Because there is no agreement at the EU level on common rules to be applied to the new citizens during the seven-year transition period, each of the old members decided to establish its own without coordinating with the others. In general, these rules substantially tighten migration or other restrictions that affect the newcomers.

Austria and Germany, the destinations of four out of five migrants from Eastern Europe, announced in 2002 that they would restrict migration from the NMCs for the full seven years. France and Belgium decided to maintain current restrictions on immigration for new EU citizens for at least the first two years. The Danish government met fierce resistance when the Ministry of Labor proposed opening Denmark's borders to all new citizens who could prove they had a job. Greece and Italy opted to treat NMC citizens as if they were migrants from countries outside the EU. Finland, initially intending to take a liberal stance, postponed the opening of its borders for at least two years. A Swedish government draft bill in the same vein was not approved by the parliament, but Sweden also has plans to limit access. If that happens, all countries bordering the NMCs will have restricted migration by workers from the "New Europe" (see map).

This tightening of restrictions is a reaction to the mounting concerns of the public in the established EU members (the EU-15) about migration issues. The new members are small economically—they have significantly lower incomes per capita than the EU-15—but large demographically: the two phases of eastern enlargement (the CEE-8, plus the planned admission of Bulgaria and Romania) involve more than 100 million people. More than fearing large waves of migrants from the NMCs, citizens of the EU-15 are concerned that workers from the new members will sponge off their welfare states. According to a 2002 survey by Eurobarometer, the polling organization of the European Commission, one in two EU citizens believes that migrants, wherever they come from, are already abusing the welfare state, and two out of three consider that the EU should open up only to countries whose living standards are comparable. Not surprisingly, the survey shows that the largest declines in popular support for enlargement have occurred in the EU countries with the most generous welfare benefits.

Bad for growth

But closing the door to the new citizens will hurt EU growth while at the same time failing to solve the welfare issue. The new restrictions will alter the geographical orientation of migration, preventing migrants from the NMCs from going to the countries where they can be most productive. In Central and Southern Europe, where the labor markets have low mobility, migrants play an important role by increasing average productivity, contributing not only to stronger growth but also to higher incomes per capita.
Meanwhile, the EU’s redistributive policies should be focused on encouraging economic growth, rather than financing the welfare state. Unlike legal migrants, illegal workers do not help finance the welfare state. Forgone revenues are sizable because migrants are generally young and work most of the time. Furthermore, illegal migrants tend to be less skilled than legal migrants. When they are regularized (the EU has a long record of migration amnesties), illegal migrants are more likely to draw cash transfers than if migration restrictions had not already been in place. Moreover, regular migrants from the NMCs are generally better educated than the average EU worker, let alone migrants from other nations.

A better way

A better way to deal with migration would be to adopt a common (and rather generous) transitional quota set by the EU as a whole—enabling at least part of the potential welfare gains to be realized in the form of higher growth while providing information on migration pressures. The quota could be based on past migration episodes (Boeri, Brucker, and others, 2001), perhaps accommodating an annual inflow of some 400,000 people.

While transitional restrictions are in place, reforms should be carried out that tackle concerns about the future viability of the welfare system. In seven years, when the transitional period is over, differences in incomes between old and new members will still exist. Studies by Barro and Sala-i-Martin (1991) and Levine and Renelt (1991), using traditional growth regressions to extrapolate the growth prospects of the new members, show projected annual growth rates in the NMCs of around 5 percent—a rate that implies a rather slow process of convergence not only to the average income of the EU but even to that of low-income members like Greece, Portugal, and Spain (Fischer, Sahay, and Vegh, 1998). These estimates are broadly consistent with the 2 percent rate of "conditional convergence" found by Barro and Sala-i-Martin (1991, 1995). (Conditional convergence is the rate of convergence toward the steady-state income level of the benchmark countries, taking into account the effects of variables affecting economic growth.)

Thus, economic convergence is a long-term business. Meanwhile, the EU’s redistributive policies should be reformed to help curb migration pressures and discourage "welfare shopping" by citizens of the poorest nations. Some evidence exists that immigrants to the EU from non-EU countries are receiving proportionally more social transfers than the native population (Boeri, Hanson, and McCormick, 2002), a difference that cannot be accounted for entirely by such observable characteristics of migrants as number of dependent children, marital status, and skill level. But actual welfare shopping involves a relatively small number of people.

Even so, there is a risk that public opinion may induce governments to adopt policies reducing social protection for workers moving within the EU. This would be a bad outcome for Europe, a continent whose citizens are much less keen to change residence than in the United States: less than a tenth of 1 percent of the European labor force changes region of residence within a year (compared with 2.5 percent moving across states in the United States). Indeed, Europe needs a more mobile workforce to correct its large labor market imbalances.

Thus, the critical challenge facing EU policymakers is to reconcile policies that promote mobility with the needs of its immobile citizens. One solution would be to coordinate at the EU level the programs—such as social assistance—that are financed out of general government revenues. In principle, common standards could be defined in terms of minimum guaranteed-income schemes (Bertola, Boeri, and Nicoletti, 2000; Bean and others, 1998), protecting such programs from fiscal competition across jurisdictions and preventing a potential "race to the bottom" in welfare provision. All EU countries, including the new members, should therefore be encouraged to gradually adopt their social assistance programs (which exist also in the NMCs) to meet some basic income requirements. EU coordination at the level of these minimum guaranteed-income schemes should be gradually pursued, with the long-term intention of building up a pan-European safety net as one of the pillar institutions of the European Union.

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CONTRARY TO a common impression, poor people need and use a variety of financial services, including deposits, loans, and other services. They use financial services for the same reasons as anyone else: to seize business opportunities, improve their homes, deal with other large expenses, and cope with emergencies. For centuries, the poor have used a wide range of providers to meet their financial needs. While most poor people lack access to banks and other formal financial institutions, informal systems like moneylenders, savings and credit clubs, and mutual insurance societies are pervasive in nearly every developing country. The poor can also tap into their other assets, such as animals, building materials, and cash under the mattress, when the need arises. For example, a poor farmer may pledge a future season’s crops to buy fertilizer on credit from commercial vendors.

However, the financial services usually available to the poor are limited in terms of cost, risk, and convenience. Cash under the mattress can be stolen and can lose value as a result of inflation. A cow cannot be divided and sold in parcels to meet small cash needs. Certain types of credit, especially from moneylenders, are extremely expensive. Rotating savings and credit clubs are risky and usually don’t allow much flexibility in amount or in the timing of deposits and loans. Deposit accounts require minimum amounts and may have inflexible withdrawal rules. Loans from formal institutions usually have collateral requirements that exclude most of the poor.

Microfinance institutions (MFIs) have emerged over the past three decades to address this market failure and provide financial services to low-income clients. Most of the early pioneer organizations in the modern microfinance movement operated as nonprofit, socially motivated nongovernmental organizations. They developed new credit techniques: instead of requiring collateral, they reduced risk through group guarantees, appraisal of household cash flow, and small initial loans to test clients. Experience since then has shown that the poor repay uncollateralized loans reliably and are willing to pay the full cost of providing them: access is more important to them than cost.

The poor need and use a broad range of financial services, including deposit accounts, insurance, and the ability to transfer money to relatives living elsewhere. Experience has shown that the poor can be served profitably, on a long-term basis, and in some cases on a large scale. Indeed, well-run MFIs can outperform mainstream commercial banks in portfolio quality. The top-performing MFIs in some countries are more profitable than the top-performing local commercial bank.

In turbulent times, microfinance has been shown to be a more stable business than commercial banking. During Indonesia’s 1997 crisis, for example, commercial bank portfolios deteriorated, but loan repayment among Bank Rakyat Indonesia’s 26 million microclients barely declined. And, during the recent Bolivian banking crisis, MFIs’ portfolios suffered but remained substantially healthier than commercial bank portfolios.

Today, microfinance is reaching only a small fraction of the estimated demand for financial services by poor households. While a few hundred institutions have proved the
poor can be served sustainably and on a large scale, most of
the institutions are weak, heavily donor-dependent, and
unlikely to ever reach scale or independence. Only financially
sound, professional organizations have a chance to compete
effectively, access commercial loans, become licensed to col-
lect deposits, and grow to reach significant scale and impact.
To achieve its full potential, microfinance must become a
fully integrated part of a developing country's mainstream
financial system rather than being confined to a niche of the
development community.

Encouraging signs of integration are beginning to emerge.
In some countries, the walls between microfinance and the
formal financial sector are coming down. The commercial
success of some MFIs has begun to attract new, mainstream
actors. Partnerships are forming, and
public and private sector infrastruc-
ture and knowledge are being shared
and leveraged. New technologies are
also driving costs and risks down to
provide services to poorer clients
more cost effectively. The quality and
comparability of financial reporting,
ratings, and audits are improving,
and domestic and international com-
mmercial investors are investing in the
sector.

What's at stake

Reliable measurement of the impact of financial services on
household welfare is expensive and methodologically diffi-
cult. However, an increasing number of serious studies are
suggesting that microfinance can produce improvements in
a range of welfare measures, including income stability and
growth, school attendance, nutrition, and health. Microfinance
has been widely credited with empowering
women by increasing their contribution to household
income and assets and, thus, their control over decisions
affecting their lives. Of course, microfinance has generated
considerable enthusiasm—not just in the development com-
unity but also politically—with the predictable result that
some of its merits have been oversold.

Microfinance alone is not a magic solution that will propel
all of the poor—particularly the very poorest people—out of
poverty. But there is no doubt that poor clients themselves
value microfinance very highly, as evidenced by their strong
demand for such services, their willingness to pay the full
cost of those services, and high loan repayment rates that are
motivated mainly by a desire to have access to future loans.
Moreover, because microfinance can be delivered sustain-
ably, its benefits can be made available for the long term—
well beyond the duration of donor or government subsidies.

MFIs form one part of a much broader spectrum of
socially oriented financial institutions (SOFIs) that includes
state-owned development, postal, agricultural, and savings
banks, as well as smaller entities like savings and loan coop-
peratives. These institutions are considered socially oriented
because, for the most part, they were created not to be profit-
maximizers but, rather, to reach clients who were not being
well served by the commercial banking system. SOFIs repre-
sent a vast infrastructure and clientele: a recent, far from
exhaustive survey identified well over 600 million accounts
in these institutions. Although no concrete data are available
on the proportion of SOFI clients who are poor, average
account sizes suggest that this proportion is substantial.

Despite their extensive outreach and infrastructure, SOFIs
also have significant limitations. Some of them—especially
the state-owned ones—provide inferior services, are highly
inefficient, and generate large, continuing losses. In many
countries, financial authorities do not consider SOFIs part of
the mainstream financial system and do not supervise them
as seriously as commercial banks. Except in a few countries,
SOFIs account for a small percentage of financial system assets and may not
pose systemic risk. But in many coun-
tries, a large proportion—sometimes
the majority—of households using
financial services access them
through SOFIs. The SOFI share of
total financial system accounts is, for
example, 50 percent in Bolivia and
65 percent in Côte d'Ivoire.

When large SOFIs can be turned
around and run on a commercial
basis, the results can be dramatic. In
Mongolia, for example, the state agri-
cultural bank restructured, moved into microfinance, and
has been privatized. The bank, which serves half of all rural
households in Mongolia through 375 points of sale, is now
profitable. Bank Rakyat Indonesia is another restructured
SOFI that now provides high-quality services to massive
numbers of poor people and generates very healthy profits.

Increasingly commercial orientation

Most leading MFIs operate today on a commercial basis
using the techniques and disciplines of commercial finance.
They are investing in more sophisticated management and
information systems, applying international accounting
standards, contracting annual audits from mainstream
auditing firms, and seeking ratings from commercial rating
agencies. Last year, rating agencies, including industry lead-
ers Standard & Poor's and Moody's Investors Service, carried
out over 100 credit ratings of MFIs.

There is growing awareness that building financial systems
for the poor means building sound domestic financial inter-
mediaries that can mobilize and recycle domestic savings.
Foreign donor and social investor capital diminishes as indi-
vidual institutions and entire markets mature. For this reason,
increasing numbers of MFIs are getting licensed as banks or
specialized finance companies, allowing them to finance
themselves by accessing capital markets and mobilizing
deposits from large institutional investors as well as poor
clients. Several MFIs, mainly in Latin America, have tapped
local debt markets, largely by issuing private placements taken
up by local financial institutions.
Dozens of countries are considering legislation to create new types of financial licenses, usually with lower minimum capital requirements, designed for specialized microfinance intermediaries. Although generally positive, this trend does pose risks. Supervisory authorities who are already stretched thin trying to monitor commercial banks can find it difficult to take on responsibility for a new group of small institutions. Moreover, a move toward specialized MFIs sometimes overlooks opportunities to involve mainstream commercial banks in microfinance.

In countries as different as Haiti, Georgia, and Mexico, partnerships between commercial banks and MFIs are an alternative to MFIs seeking their own financial licenses. These partnerships enable MFIs to cut costs and extend their reach, while banks can benefit from the opportunity to tap new markets, diversify assets, and increase revenues. Partnerships vary in their degree of engagement and risk sharing, ranging from sharing or renting front offices to banks making actual portfolio and direct equity investments in MFIs (see figure). In Africa, Asia, and Latin America, some local financial institutions are pursuing lower-end retail banking directly, as financial globalization heightens the competition posed by international banks for larger corporate customers. Banque du Caire in Egypt, for example, entered the market two years ago and now delivers microfinance alongside traditional wholesale operations and retailing front offices to banks making actual portfolio and direct equity investments in MFIs (see figure).

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Creative new delivery channels and new information technology also hold promise for reducing risk and cutting delivery costs. Microfinance providers are now exploring ways to piggyback financial services delivery onto existing infrastructure, such as retail shops, Internet kiosks, post offices, and even lottery outlets. Existing distribution systems may make it possible to provide financial services more cost effectively and, thus, to poorer and more sparsely populated areas. On the technology side, companies in southern Africa are developing low-cost cell phone-based banking services for poor clients. MFIs in Bolivia, Mexico, India, and South Africa are also making use of smart cards, fingerprint readers, and personal digital assistants to improve efficiency and expand into rural areas. Not surprisingly, the actual performance of such new technologies and strategies does not always match the initial level of enthusiasm generated. But some of these new approaches have proved themselves already, and others will no doubt continue to emerge.

Twenty years ago, the main challenge in microfinance was methodological: finding techniques to deliver and collect uncollateralized loans to “microentrepreneurs” and poor households. After notable successes on that front, the challenge today is a more systemic one: finding ways to better integrate a full range of microfinance services with mainstream financial systems and markets. While it is not yet clear how far that integration will go, the early signs are encouraging. Advances taking place around the world would have been dismissed as unthinkable just a decade or two ago.

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A SEO SANG, a Hmong widow living on less than 25 cents a day in the mountainous region of Vietnam, needed help. She had sold her pig to pay for her husband’s funeral, paid a fine incurred by her son by selling one of her buffalo, and redeemed a debt with the other. She had borrowed all she could from relatives. Moneylenders, if they would even lend to her, would charge exorbitant interest (up to 10 percent a month). She needed money to survive.

Sang’s plight raises many issues related to extreme poverty, of which lack of access to credit is one. Part of the solution is microfinance—the provision of basic financial services to the poor. Microfinance can offer a path out of poverty. But how long is the path, and can it be shortened? Vietnam’s experiment with the Mobile Banking Program under the World Bank’s Rural Finance Project provides a partial answer to those questions. It suggests that creative ways can be found not only for lenders to reach out to the poor but also for the poor to “reach in” to lenders.

Getting credit to the poorest

According to a 1999 World Bank survey, the proportion of people living below the poverty line ($128 per capita a year in 1998) in Vietnam dropped markedly in the 1990s, but extreme poverty still affects pockets of the population. Under various programs, significant credit was earmarked for rural development. The Vietnam Bank for Agriculture and Rural Development (Agribank), with one of the most extensive branch networks in the world, was the main conduit for this flow. However, lack of access roads and high transaction costs prevented it from serving the poorest.

In 1998, Agribank initiated a mobile banking program modeled after similar programs in Bangladesh and Malaysia. It procured 159 vehicles equipped to travel on dirt roads and hilly pathways, enabling loan officers to reach remote areas to process loan applications, disburse money, collect repayments, and mobilize savings deposits. The visits followed a fixed calendar and were announced in advance. Scheduled to coincide with weekly village markets, they saved borrowers traveling time and transportation costs. This summer, another 172 vehicles will enter service.

Once the program was launched, it became clear that more than just difficult access prevented the poorest from taking advantage of its services. Their isolation caused them to have feelings of helplessness and fear. In the upland ethnic group, the higher up a mountain people lived and the longer their isolation, the more they seemed to believe that they could not get credit. Suspicion was another issue. What if the lender offered a loan and then, if a payment were late, took a farmer’s buffalo, as had happened to Sang?

Above all, the poorest people lacked confidence and self-esteem. For example, the illiterate poor would wonder how they could fill out applications and receipts. Others felt they could do nothing to earn extra income to repay a loan. Many were afraid to venture into activities other than cultivation and animal husbandry, even though opportunities existed. In Lao Cai Province, for example, an increase in tourism had created a market for ethnic cloth.
Sustainability of borrowers

But for mobile banking to work for borrowers, the following services had to be made available.

**Offering appropriate loan products.** To meet the needs of the poor to finance crop production, storage, marketing, and trading, Agribank is diversifying its loan portfolio and considering a range of low-cost products that would be easy to understand and use and could be disbursed when they are needed. The poor’s access to credit has also been hindered by a lack of collateral, but Agribank waived collateral for loans of up to $645; the limit has since risen to $1,290.

**Linking lending and saving.** Initially, Agribank focused on rural lending because its credit officers perceived that the poor were too poor to save. But training and exposure to international microfinance schemes changed this perception, and Agribank began to mobilize small savings, targeting women. The effort was enhanced by data that showed that people kept only 17 percent of their savings in banks; the rest was in gold and U.S. dollars (44 percent) and other assets (39 percent).

For Agribank, linking the two means that when credit officers disburse loans and collect payments, they are also responsible for mobilizing savings. Savings both help smooth consumption and act as insurance in hard times. Unlike Bangladesh’s Grameen Bank and its Rural Advancement Committee, however, Agribank did not require borrowers to open a savings account. It decided that, for the poor to feel good about the program, saving should be voluntary. Instead, the mobile banks offered people incentives to open savings accounts. They guaranteed safety for deposits and offered attractive interest rates for different maturities.

It was no easy task in Vietnam’s cash economy to persuade people to open savings accounts, but after only a year, each mobile bank began to add more than 200 new accounts every month. The excellent repayment rate suggests that the poor have responded favorably to these initiatives.

**Combining credit and human asset building.** When credit is combined with training, borrowers become more productive and are more likely to be able to repay their loans. Lenders and nongovernmental organizations can work with local agencies to provide information about the market and profitable opportunities and to explain market risk and how to cope with it. There are signs that the poor have responded favorably to these initiatives.

Sustainability of lenders

For lenders, it was necessary that the mobile banking experiment be financially self-sustaining. It thus required the following ingredients:

- **Group-based lending.** Agribank lends to individuals directly and through village-based groups: joint-liability groups (members are liable to each other) and solidarity groups (the sponsoring organization guarantees loan repayment). Group-based lending minimizes both asymmetrical information (when lenders know little about borrowers) and moral hazard (the danger that, because a borrower does not bear the downside risks of her actions, she will undertake riskier projects, making it less likely that the loan will be repaid). Moreover, the peer pressure inherent to groups ensures that members repay. Again, unlike other schemes, Agribank does not require individuals to join but offers incentives to those who do, such as simple lending procedures, longer-term loans (three years), installment payments, and other services. Through groups, members also gain a sense of collective protection and of empowerment.

- **Linking formal and informal credit.** Local organizations provide forums to help the poor increase their self-confidence and act as a link between the formal and informal credit conduits. For example, by helping organize a solidarity group and providing loan guarantees, the Women’s Organization served as a financial intermediary in an informal and imperfect market. Agribank is also studying the prospect of linking traditional mutual credit clubs (known in Vietnamese as Hạt or Hạt Ho) with the joint-liability group’s activities.

- **Reasonable interest rates.** Lending to the poor involves high risk, and the risk premium must therefore be high. In the past, Agribank offered the poor in remote areas lending rates 30 percent lower than market rates. However, such subsidies affect the lender’s sustainability and undermine other microfinance programs. When credit is subsidized, borrowers tend to regard it as charity and make little effort to repay. Under the Mobile Banking Program, Agribank took a dramatic step and began to charge a rate that would recover costs. The recovery rate had to include a premium to cover the cost of running vehicles and managing small accounts and the higher level of risk in rural areas. The interest rate for rural borrowers is now 12 percent a year compared with 8.4 percent for urban borrowers.

Agribank has kept this premium as low as possible to make the lending rate acceptable to borrowers. Instead of cutting interest, it cut transaction costs. It minimized operational costs by using vehicles for multiple purposes (to transfer cash between branches, and to solicit and collect savings from small businesses en route from the markets) and by holding long hours on each visit to accommodate more clients.

It has also kept the premium low by helping borrowers understand market risk, such as the volatility of coffee prices, and the need to avoid speculative activities. So far, borrowers have performed well, with loan repayment rates of 97 percent. A number of mechanisms led to this outcome: small repayment installments, access to larger repeat loans, and simplified loan documents. Repeat borrowers were not required to prepare loan applications but could sign their loan receipt or, if illiterate, mark it with their thumbprint.

So far so good

 Barely five years in operation, the Mobile Banking Program has proved to be relatively cost effective, providing financial services to 315,000 poor households, about 6 percent of Agribank’s clients. Preliminary data show that, on average, each mobile bank disbursed 1,921 loans, collected 1,387 payments, and transported cash on 75 occasions to 16 local points monthly. The excellent repayment rate suggests that the poor are good credit risks. The program also mobilized 1,983 small savings accounts every month, showing that the poor can be good savers.
It was also instrumental in helping the Rural Finance Project ($110 million credit component) achieve its objective of increasing the rural poor's access to financial services. Small loans (weighted average of $452) helped borrowers diversify their activities, and 99 percent of them increased their income because of the loans.

Although Agribank has not yet made a profit on its overall operations, its Mobile Banking Program has been more successful. On average, each vehicle recorded a modest profit of about $1,000 a month after allowance was made for the cost of funds, gasoline, depreciation, and staff.

In light of its progress, Agribank is studying the possibility of using groups to expand its services. In a given season, one group of farmers (say, coffee growers) may do less well than another (for example, tea or fruit tree growers). Groups in different locations would also have different results. Can IOUs be issued to channel funds from surplus groups to deficit groups? Positive answers to this question would make it possible for mobile banking to further strengthen financial intermediation in the rural economy.

Despite the program's positive results, a number of weaknesses need to be addressed.

**Security.** Although there have been no robberies of Agribank vehicles in Vietnam, where security is high, carrying cash in remote areas is risky. In countries where security is a problem, mobile banks could carry the minimum amount of cash needed for transactions and would incur some costs for protection. In new programs, Internet access can link mobile banks operating in the field with district branches. Still, the presence of mobile banks in remote areas is symbolically important.

**Accessibility.** Mobile banks provide limited opportunities to withdraw funds, hampering saving by the poor. Agribank is studying whether groups can offer their members access to funds in an emergency. In a mobile bank's subsequent visit, it would reimburse groups for withdrawals.

**Regulations.** A market economy only since 1990, Vietnam needs to develop a strong, effective legal framework for the financial system, especially in the area of prudential regulations. Two existing laws govern credit activities but do not cover the operations of microfinance institutions, whose legal status is ambiguous. Regulations are necessary for group activities and for contract enforcement.

**Monitoring.** Loans, payments, disbursements, and group transactions must all be monitored in places where accounting and auditing are not commonly practiced.

**Group formation and training.** Over the long run, lending institutions incur costs for forming and training groups—for example, in simple accounting methods, bookkeeping, cash flow auditing, and management skills.

These last three areas—regulations, monitoring, and group formation and training—are ones that international aid donors may be able to support in microfinance operations.

**Lessons learned**

The Mobile Banking Program is still being developed. Much remains to be explored to address weaknesses and maximize the effectiveness of microcredit programs. But the lessons learned thus far suggest that creative ways can be found to reach out to the poor, reducing their transaction costs and thereby improving their economic prospects. The psychological dimension of poverty, which entails a propensity toward self-exclusion, needs to be considered in the design of microfinance programs.

The most controversial aspect of microfinance is its cost. Interest rates must be high enough to ensure the lender's sustainability and low enough to be acceptable to borrowers. Many experts insist that the poor are capable of paying high interest rates and are willing to do so. Others argue that, if not for microcredit, with its high interest rates, the poor would have to borrow from moneylenders at rates two or three times higher. Nevertheless, when microcredit requires a rate substantially higher than that paid by urban borrowers, the poor could perceive that they are being exploited, especially in countries where poverty eradication has traditionally implied the use of subsidies. In the long run, how the poor feel about their loans can affect how well they perform using their loans.

As for Ma Seo Sang, she received a loan of about $300 from Agribank and used the money to buy some chickens and pigs to raise. The income she made from selling her animals helped her earn a living.

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I N L A T E 1997, when it approached the IMF for assistance, Korea was in the midst of a full-blown banking crisis, with Seoul Bank at the forefront. The crisis was brought on by the bankruptcies of several large industrial conglomerates and contagion from the financial crises that had begun in Thailand. But Seoul Bank was in bad shape even before the onset of the Asian crisis. Its difficulties were attributable to weak management following two decades of infighting since a merger in 1976; the tradition for Korean banks, at the government’s direction, to provide credit for industrial development, leaving them with weak commercial orientation and limited risk-management discipline; and generally lax prudential regulations.

As part of the banking sector restructuring, the IMF identified Seoul Bank and Korea First Bank as the country’s most distressed commercial banks. To prepare Seoul Bank for early sale to foreign investors, the government recapitalized it in January 1998, thereby assuming control; removed its management; and appointed a financial advisor to develop a privatization strategy. This initial plan included obtaining bids for the bank’s sale by mid-November 1998. With each subsequent IMF review of the restructuring, the IMF and the government set tight deadlines for reprivatization, making management’s job more difficult.

Although Seoul Bank sold its training center, halved the number of overseas branches, and reduced the workforce by 35 percent by the end of 1998, its ratio of loans (assets) to employees remained among the lowest in the industry. And unfavorable market conditions delayed the government’s plan. By June 1999, Seoul Bank was again insolvent, and, in September, the government injected a second round of new capital. With no interested buyers, Seoul Bank drifted into a fix-and-sell mode. In contrast, the government sold Korea First “as is” to Newbridge Consortium. Although it was generally recognized that Seoul Bank required more extensive restructuring than Korea First Bank, the latter took more public money because the “put-back” option, which lasted until the end of 2002, required the government to cover any unexpected losses on preexisting commitments.

In April 2000, Deutsche Bank was appointed financial and restructuring advisor, and, in May, the government hired me to prepare Seoul Bank for privatization. Although a Korean banker, I was the first from a non-Korean bank to be appointed CEO of a government-controlled bank. My challenge was to bring in quickly as many professionals as possible with the necessary expertise to build a new corporate culture centered on international best practices in banking. By June 2002, Seoul Bank was successfully restructured (see table), resulting in its sale and privatization in December 2002. The road we traveled offers insights into fixing up distressed banks in crisis situations.
Downsizing

When I joined Seoul Bank, it was organized by seniority rather than by function. Functional responsibilities were assigned without regard for the incumbents’ expertise, which, in any case, was in short supply. A week after taking over, I asked for the resignation of all but one director, whom I retained for the sake of continuity.

The bank had 4,643 employees in June 2000, about 80 percent of whom were union members. The leader of Seoul Bank’s labor union was a key member of the Korean Federation of Financial Unions, and it became obvious that we had to deal with this internal political force to effect change quickly. Despite the 1998 layoffs, the bank remained top-heavy, and a further reduction in staff was generally expected. The only remaining questions, to be negotiated with the labor union, were how many to let go, who, when, and how.

In my first meeting with the union leader, I was encouraged that we agreed on the need for drastic change. But the Federation of Financial Unions, whose agenda included seeking a guarantee of stable employment, stopping government intervention in bank management, and opposing the government’s plan to form a financial holding company, was organizing a general strike and rally. To my surprise and frustration, Seoul Bank’s union participated in the strike.

A few days later, the new management team, adopting a medical metaphor, announced to senior managers that it was prepared to operate on the bank—a “sick patient”—but would not begin until the patient demonstrated the will to live. The next day, the union leader confirmed his support for the restructuring, and we agreed to implement an early retirement program. The program included an informal arrangement, designed to avoid difficult personnel decisions, whereby all employees born in or before 1948—most head office general managers and regional managers—would retire. By October 2000, 640 positions had been eliminated, and 2 staff members had been promoted to management positions. A new functional organization chart was drawn up, and, by December 2000, responsibilities had been delegated to the management team.

Nitty-gritty of restructuring

Restructuring essentially required that the bank be completely overhauled. I likened the work ahead of us to transforming an old vacuum tube radio into a new transistor radio, which meant changing the control system, the circuitry, and the look and the size of the radio.

We launched the operational restructuring in July 2000 with the assistance of about twenty advisors. By mid-July, we had 13 functional project teams, each consisting of one or two advisors and three to five bank employees. The teams reviewed existing procedures and organization, mapped out new procedures and organizational structures, presented recommendations to management, and helped implement the agreed-upon recommendations. In the process, the project leaders and advisors made a point of transferring knowledge to members of the Seoul Bank restructuring team.

Until December 2000, the management team met regularly with the project leaders to update and fine-tune the work in progress, making periodic presentations to the Board of Directors and the government shareholder. By early 2001, we had implemented key concepts of international best practices in banking: we established a functional organizational structure; formed an independent and consolidated credit department; segregated the duties between the front office and the back office at headquarters and in each branch; established specialized business lines separating retail from corporate banking business and appointed separate officers for each; instituted process mapping and produced guidelines for controlled back-office operations; introduced an audit system based on systems and procedures; created a management information system; and strengthened risk management.

Restructuring the balance sheet

When I took over, Seoul Bank had insufficient reserves and the highest ratio of nonperforming loans (20 percent) of any Korean bank. To regain credibility in the market and earn customer confidence, we had to clean up the balance sheet quickly. It was essential also because the bank needed one last recapitalization by the government. We immediately liquidated 50 billion won worth of Korean stock in the trading portfolio. For the rest of 2000, we disposed of impaired assets (the first sale consisted of foreign currency loans and securities for non-Korean obligors), defined strict loan classifications, built up the bank’s reserves, and increased loan loss provisions by a trillion won.

In June 2000, Seoul Bank was a main bank for five companies in voluntary workout programs, with a total exposure of 705 billion won. One of the largest was Woobang Construction, whose total borrowings were 1.2 trillion won (about $1.1 billion), with 181 billion won owed to Seoul Bank. Woobang suffered cash-flow problems in late June; in early July, it requested new loans of 155 billion won from creditor banks. The bank creditor group advanced the company 44.4 billion won and engaged an accounting firm to assess it before deciding on the

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business was extending credit to corporate clients. It had also by credit cards. Our goal was to minimize market risk. To dining room to all employees.

The nonperforming loan ratio declined rapidly during the second half of the year. By the end of 2001, Seoul Bank’s loan portfolio was among the cleanest in the market, and, by mid-2002, its net nonperforming loan ratio was the lowest of all Korean banks.

New image, new focus
But cleaning Seoul Bank’s balance sheet and downsizing the staff were not our only challenges. We also had to change its image and focus. Even before the crisis, Seoul Bank had a bad reputation because of infighting and poor service. The fact that it received public funds during the crisis only worsened its image.

The vision I brought to the bank was of a “small but strong and clean bank” (it sounds better in Korean). Reducing Seoul Bank’s size would enable it to change more quickly and improve its ability to provide personalized customer service. The bank’s strength was to come from a new culture of working together toward the common goal of implementing international best practices in banking. Training to accomplish this began three months after I arrived.

During the first few months, the management team also made changes to show that informality, open communication, transparency, and a focus on work were Seoul Bank’s new values. Among other changes, we instituted an open door policy for all department heads’ offices and removed their televisions; prohibited stock trading and Internet surfing not related to business during office hours; freed the CEO-only elevator for general use; and opened the executive dining room to all employees.

Like most Korean banks before the crisis, Seoul Bank’s main business was extending credit to corporate clients. It had also had a dominant share of the custody business for local investment trust companies and foreign investors in the Korean market. We decided that retail banking, particularly household mortgage loans, would be our primary business focus, followed by credit cards. Our goal was to minimize market risk. To address corporate banking, we hired a former foreign bank corporate banker to train our people in financial analysis and other corporate banking skills. Through 2001, Seoul Bank was the fastest-growing retail bank. By end-2001, its loan portfolio was balanced between corporate and retail exposures.

Outcome
From the first quarter of 2001, the bank’s quarterly operating income, before provision for credit losses, began growing. Most of the new income came from retail business (as interest) and credit card business (as fees). In the second half of 2001, Seoul Bank took a haircut from Hynix (former Hyundai Semiconductor) and wrote off its exposure of 260 billion won.

Following a government cabinet shuffle in August 2000, a new agenda emerged. Some of the new policymakers felt that Korea’s banking sector was still overbanked, that most of Seoul Bank’s quality employees had left during the crisis, and that, even with a successful restructuring, Seoul Bank was too small to survive following consolidation. In this environment, Seoul Bank was in danger of being put into a financial holding company—an outcome I worked hard to avoid by seeking potential investors. In late January 2002, the Minister of Finance and Economy announced that preparations for the bank’s sale would proceed simultaneously with discussions about a merger with a sound bank. In December 2002, Seoul Bank was sold to the larger Hana Bank, one of a few banks that did not need government recapitalization to weather the crisis.

What kept the bank going from late 2001 was the power of the management team to reinforce and maintain international best banking practices. Employees associated the rapid reduction in nonperforming loans and the equally rapid growth of retail and mortgage loan portfolios with best practices. But the bank was also blessed with good timing, including in beginning the restructuring and in pushing for retail and mortgage loan business, but especially in the timing of the sale.

My Seoul Bank experience yielded several lessons:
• Even under full government ownership, a professional management team can turn around a damaged bank and make it commercially attractive for privatization if the government does not interfere with the bank’s management.
• Bank restructuring is essentially an exercise in building a sound risk-management infrastructure—a functional organization, proper segregation of duties, consolidated credit functions, and a management information system that produces segmented balance sheets and profit and loss statements on a timely basis.
• Key to this exercise is training employees to work within the new infrastructure, which builds a risk-sensitive culture, and providing specific training for specialized functions. ■

Before joining Seoul Bank, Chungwon Kang worked for 5 years at Citibank, 15 years at Bankers Trust Company, and 1 year at Deutsche Bank (following its acquisition of Bankers Trust in 1999). After 1996, he was chief country officer for the Korean operations of Bankers Trust and for Deutsche Bank. His selection as CEO of Seoul Bank was managed by an international human resources firm. He currently serves on the board of LG Investment & Securities Company and is a senior advisor to the law firm of Kim & Chang in Korea.

This article is based on 2003 IMF Working Paper 03/235, “From the Front Lines at Seoul Bank: Restructuring and Reprivatization” (Washington).
THE INITIAL impetus for what was to become Finance & Development came from the late Frank J. Southard, then IMF Deputy Managing Director, who was renowned for his stern oversight of every aspect of the IMF's operations. He conceived of a "Fund Survey" that would seek to explain the purposes and operations of the IMF. His initiative came at a time when there was virtually no public understanding of the IMF and its work, not even a basic pamphlet to explain its operations to the curious.

Yet there was much to explain. The IMF had been intimately involved in rebuilding the international monetary system after the Second World War, it had provided large amounts of financing to France and the United Kingdom following the 1956 Suez crisis, and its membership had begun to expand as newly decolonized countries became members. The purpose and operations of the institution, though, were still little known to the public at large and even to the officials of many member countries.

A paper prepared for the IMF's Executive Board proposed the establishment of the new publication. However, when Southard mentioned his plan to some of the vice presidents of the International Bank for Reconstruction and Development (better known as the World Bank), they immediately expressed an interest in being a part of the endeavor. There was little enthusiasm at the time among senior IMF staff for entering into a partnership with the Bank, but Southard sent down a memorandum saying firmly that he had decided that there would be a joint publication and that was the way it would be. The Board paper was accordingly delayed until the details of a joint publication could be worked out. As part of the understanding, it was agreed that the IMF would be responsible for the editing and production.

First issue
Volume 1, Number 1, of what was then called The Fund and Bank Review: Finance & Development appeared in June 1964. The chosen name reflected the two main purposes of the IMF and the Bank. A foreword written by Pierre-Paul Schweitzer, then Managing Director of the IMF, and George W. Woods, President of the Bank, explained the purpose of the new venture—namely, "to explain for a wide audience the business of the IMF and of the World Bank and its two affiliated institutions." It noted that, while "this business is carried on by specialists . . . , many other people are interested in our work, and . . . they would like to be informed about it and without too many technicalities." The new publication, the foreword emphasized, would not be an official document or a scholarly journal,
such as Staff Papers, which the IMF was already publishing.

To oversee the magazine, the IMF appointed John D. Scott, an experienced author and editor who had worked on the official U.K. history of the Second World War. He began cautiously. In contrast to today’s publication with its attractive color graphics and wide range of articles from authors both inside and outside the IMF, the first issues of F&D were relatively sober affairs. Smaller in format than the present magazine, with a simple, unadorned cover, the maiden issue stuck closely to its mandate of explaining the IMF and the Bank.

The initial two articles introduced the Bretton Woods twins. The first, by J. Keith Horsefield, then the official historian of the IMF, was later reprinted as the first in the IMF’s basic pamphlet series, a precedent that was followed by a number of later articles. But other articles took a wider perspective, looking at Japan’s plan to double income, issues of inflation and growth, and hopes and problems in world education, all based on ongoing work at the two institutions. The issue concluded with articles reviewing recent activity in the IMF and the Bank, a practice that would continue until the introduction of the IMF Survey in 1972 made it redundant. From the beginning, the magazine was produced in French and Spanish, as well as English. Circulation for the three editions was set at a modest 20,000.

**Evolutionary development**

The patterns set by the first issue continued for a number of years. Change in F&D was evolutionary rather than revolutionary. The editorial focus was still largely devoted to explaining the work of the IMF and the Bank in layman’s terms. For example, articles examined the process that had led to the Bretton Woods Conference and the consequent formation of the two institutions, the IMF’s relations with Latin America, international liquidity, and balance of payments issues. In December 1964, the magazine published comprehensive reports on the IMF–World Bank Annual Meetings. These continued until, in the 1970s, the IMF Survey began to report on the meetings.

In June 1965, F&D began to publish rather severe looking photographs of its contributors, a practice that was to continue, with some interruptions, until 2002. One side effect of publishing the photos was to prompt the occasional marriage proposal from far-flung readers, much to the astonishment of the authors! By 1966, more articles on nontraditional topics, such as tourism, transportation, and industry, began to appear, and the use of photographs, maps, and even illustrations by staff artists increased. In December of that year, K. Sundara Rajan, the Indian Executive Director at the Bank, published an article questioning official policy—a first for the magazine. He argued that preferential tariffs would help developing countries and that their advantages would outweigh the disadvantages. The following March, the first letter from a reader was published.

The March 1968 issue appeared triumphantly in a new, larger format—the size it is today—and with a modest use of color on the cover, but still only two colors. In another innovation, a large map section drawn from the World Bank Atlas was inserted. Circulation was expanded to 85,000, and some issues grew to 76 pages. In June 1969, proudly proclaiming that “The Central Banker Is a Lady,” F&D included a photo of the first four women to take courses at the IMF Institute, the IMF’s training arm. In December 1970, the range of language editions expanded to include a German edition, published in cooperation with the Hamburg Institute of International Economics (a selection of articles in Portuguese was already being published in Brazil).

**Changing priorities**

During the 1970s, international monetary relations developed in both extent and complexity. Such issues as European integration, the impact of the oil embargo, developing country access to the markets of industrial countries, income distribution, and population pressures came to the fore. These were increasingly reflected in the content of F&D.

The results of the first, limited readership survey were reported in September 1973, and, as one outcome, more libraries were invited to subscribe. Limits were set on circulation to individual subscribers in an effort to encourage institutional subscriptions. Additional
surveys would be conducted in later years, all of which revealed readers’ enthusiasm for *F&D* and the striking finding that each copy was passed on and read by an average of five persons. This indicated that the effective readership was considerably greater than bald circulation statistics might indicate.

An Arabic edition was introduced in June 1975. At first, it comprised a selection of articles that were published as a supplement to *Al-Iqtissadi*, the economic publication of the important Al-Ahram publishing house in Cairo. Interestingly, the first editor-in-chief for this venture was Boutros Boutros-Ghali, who later served as Secretary-General of the United Nations. A Chinese edition was also founded, using the services of the China Financial and Economic Publishing House in Beijing.

An article in the September 1975 issue by Mahbub ul Haq, the distinguished development economist who was at the time a staff member of the World Bank, aroused considerable internal controversy. In the article, entitled “Toward a New Framework for International Resource Transfers,” a cogent analysis of the strengths and weaknesses of the new international economic order, ul Haq took issue with official Bank policy, writing, “In order to become a truly international institution and to shed its image of a Western club, the World Bank must aim at universality of membership.” Although such sentiments might seem unexceptional today, strong reservations were expressed by senior IMF management, and the article was published only after the Bank’s vice president for external relations, William Clark, declared his support. The article eventually came out with an explicit qualification that it represented the view of the author and not official Bank policy. This episode established the principle that *F&D* should not be bound to publish only articles that reflected official policy.

**Opening to discussion**

The trend toward opening up the pages of *F&D* to well-known external authors expanded markedly after June 1982, when a new editor, Bahram Nowzad, was appointed. Nowzad was the first editor to have come to the helm from a career position in the IMF, where he had been an assistant director in what was then the Exchange and Trade Relations Department, now the Policy Development and Review Department. He was the author of a memorandum advocating the establishment of an external relations department in the IMF and had a wide range of contacts in academia and elsewhere.

The first guest article by an outside expert appeared in June 1983. Nicholas Kaldor, an emeritus professor at Cambridge University and advisor to the Labour government in the United Kingdom, tackled the limitations of devaluation for balance of payments adjustment. His article appeared with a brief “Rejoinder” by the editor-in-chief of the magazine arguing that devaluation was often necessary to restore payments equilibrium. Other guest articles followed in later issues. Among outside contributors, Jagdish Bhagwati of Columbia University wrote on the future of global trade negotiations; Henry Owen of the Brookings Institution, on changing public perceptions toward aid; and Max Corden, then a professor at the Australian National University, on protection, the exchange rate, and macroeconomic policy. Also, Tony Killick, the Director of the Overseas Development Institute in London, engaged in a discussion with the editor on the appropriateness of IMF policy prescriptions.

The subject of curbing military expenditures in the developing world, which had hitherto been a taboo topic in both the IMF and the Bank, was opened up by the magazine. In September 1991, this subject attracted contributions from the most senior levels in the form of a guest article by Bank President Robert S. McNamara and an accompanying statement on the issue by Michel Camdessus, then Managing Director of the IMF.

During the 1990s, successive editors-in-chief of *F&D* faced the challenge of adapting the content of the magazine to reflect new priorities and emphases in the international system. Issues dealt with the environment; the status of women in development; the Uruguay Round; global warmings and, with the weakening and later breakup of the former Soviet Union, the new challenges of managing centrally planned economies and economies in transition. The editors in the early 1990s also sought to make the publication livelier, printing letters to the editor and debates between two authors on a single topic.

Withdrawal of World Bank

On several occasions in the 1980s and the 1990s, the World Bank had raised the issue of terminating its relationship with the IMF in publishing *F&D*. Each time, though, it had reconsidered. In 1997, however, the Bank decided to end copublication because of budgetary considerations, its own shifting external relations priorities, and its wish to focus limited resources increasingly on broadcast and film media. This decision was to end what, over the years, had been a perfect example of IMF–World Bank cooperation and left the IMF with a dilemma. Should it continue to support, on its own, a magazine that had considerable public relations merit and that was greatly appreciated by its worldwide readership, but whose costs were expected to increase markedly?

After considerable internal discussion and cost analysis, the IMF's senior management—particularly Stanley Fischer, the First Deputy Managing Director, who had published a number of articles in the magazine—decided that the advantages of continuing publication outweighed the potential disadvantages (mostly cost). To save some costs, publication of the German and Portuguese editions was ended. These had only a limited circulation, and the high cost per copy made it uneconomical to continue their publication. The Joint Committee that had overseen policy and the magazine's budget was ended, and the Bank staff regretfully withdrew from the editorial advisory board. The author of this article was appointed to edit the revamped magazine.

At the same time, the editorial staff recognized that *F&D* suffered from an outdated two-color design and a clearly inexpensive paper stock. To enhance the publication's visual appeal and attract new readership, there was a shift to four-color processing, with all photographs, illustrations, and charts in color. Previously, beginning in 1994, four-color process had been used only for the cover. Also, in hopes of raising some extra revenue, the IMF hired a New York company to sell advertising, a venture that had also been tried in the early 1990s. This effort was again only partially successful although the magazine continues to carry some institutional advertising.

Faced with the need to open up a whole new spectrum of articles, the editor expanded the effort to enlist more authors from outside the IMF—in business, central banking, and finance. World Bank authors were still invited to submit their articles, but these were considered external submissions and judged accordingly. The first issue to be published entirely by the IMF, in June 1998, highlighted the Asian crisis, which was still creating financial turmoil across the world. Articles on this topic were contributed by IMF First Deputy Managing Director Stanley Fischer; the Mexican Central Bank Governor, Guillermo Ortiz; John Lipsky of Chase Manhattan Bank; and staff from both the IMF and the Bank.

Subsequent issues followed the pattern of highlighting important current concerns. These included the relationship between economic policy and equity; issues surrounding European economic and monetary union; opportunities for reform in Africa; the problems of transition from centrally planned to market economies; the new, vocal force of civil society; and—in December 1999—issues for the new millennium.

The breakup of the former Soviet Union in the early 1990s led not only to articles covering the new successor states but also to a recognition that there was a considerable demand for Russian-language publications. *F&D* was a perfect candidate to provide basic information on the international economy and financial system to these countries. An agreement was reached with a Moscow publisher, Vez Mir, to produce a Russian edition. To reach the broadest possible audience, this edition has recently been replaced by an edition that is entirely Web-based.

"F&D seeks to alert readers to the major issues being debated within the IMF and the international financial community."
**Current priorities**
The pattern followed in recent years has been to keep a corpus of articles by IMF staff as the magazine’s mainstay. At the same time, important pieces are sought from Bank staff, particularly when these tie in with an issue’s overall theme. *F&D* also continues to invite a variety of outsiders to contribute to the ongoing debate on development and the future of the international financial and trading systems.

In keeping with these objectives, and with the need to provide an increasingly diverse readership with a diverse palette, the magazine has launched a number of shorter and more visual features, entitled Picture This, Back to Basics, and Country Focus, as well as profiles of individuals under the rubric of People in Economics. In addition, it introduced a column that enables the IMF’s head of research—first Kenneth Rogoff and currently Raghuram Rajan—to outline his views in an informal fashion. The design of the magazine continues to evolve, in part owing to the influence of the Web and its impetus toward shorter, more accessible pieces. Circulation of Arabic, Chinese, English, French, and Spanish editions has increased to a total of 110,000 copies, and *F&D* is also available on the Web in English, French, Russian, and Spanish.

As the IMF expands its interests and areas of responsibility, *F&D* seeks to alert its readers to the major issues being debated within the IMF and the international financial community, sometimes even before these have been brought to the IMF’s Executive Board. To round out its content, *F&D* has also focused on broader development issues, such as the role of institutions and health, and has attracted contributions from leading authorities in these areas.

A new readership survey is under way. It will seek both to obtain more information on readership demographics to ensure that *F&D* continues to meet the needs of its readers and also to gain data on readership habits, given the increased global access to publications on the Web. Eventually, a Website could even offer additional content to readers beyond the print version, provide more room for letters and other features, and contain more topical information.

What is encouraging is that, as it enters its fifth decade, *F&D* continues to evolve while attempting to examine current issues in a provocative and lively fashion. This should help the magazine live up to Rogoff’s challenge to the current Editor-in-Chief—to be on the cutting edge of informed thinking. ■

Ian S. McDonald was the Editor-in-Chief of *Finance & Development* from 1997 to 2001. He has benefited from the contributions of former chief editors Bahram Nowzad, Shuja Nawaz, Pamela Bradley, and Claire Liukisila and of the current Editor-in-Chief, Laura Wallace.

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**How’s your car running?**

"Economics is a very difficult subject. I’ve compared it to trying to learn how to repair a car when the engine is running."

Ben S. Bernanke
Member, Federal Reserve Board of Governors

From an interview with Ben Bernanke in the June 2004 Region
The quarterly magazine of the Federal Reserve Bank of Minneapolis
minneapolisfed.org/pubs/region/04-06/
The Other IT: Getting the Big Picture

STARTING in the early 1990s, many countries—initially industrial and, later, emerging market countries—began to adopt inflation targeting (IT) as a way of achieving price stability. IT countries make an explicit commitment to meet an inflation target (or target range): they regularly announce their targets to the public, and they have institutional arrangements to ensure that the central bank is accountable for meeting the target. About twenty countries have adopted an IT regime, and the trend appears likely to continue.

Ted Truman, a former senior official at the U.S. Federal Reserve Board and the U.S. Treasury, applies his considerable experience to a big-picture assessment of the inflation targeting regime. He describes himself as “an inflation targeting sympathizer, not a proselytizer,” and he believes that IT should be employed flexibly. The book is well thought out, and we agree with most, but not all, of its assessments and recommendations.

Truman urges the IMF to take a “more benign and constructive attitude” toward IT, based on his perception that the IMF has discouraged its adoption in emerging market countries. While it may be true that the IMF was slow to warm to IT, it has become much more supportive, including by providing extensive technical assistance to countries that want to consider adopting such a regime. Still, the IMF’s advice has to be tailored to each country’s circumstances. A message that is largely missing in this book is that, although IT is flexible, it may not work well for countries that do not have the credibility to stick to a target or are extremely open and vulnerable to large exchange rate fluctuations.

Truman recommends that IMF conditionality—specifically, the conditions attached to the performance of monetary policy—be tailored to IT frameworks. This, in fact, is already the case. The so-called performance criterion in IMF programs for countries with an IT regime is based on deviations from the inflation target; thus, it dovetails with the country’s chosen monetary framework. At the same time, the condition that international reserves must not fall below an agreed level is maintained with a view to safeguarding IMF resources.

The book argues for the United States, Japan, and the euro area (the so-called G3) to adopt IT. However, Truman seems to overstate his case. Inflation in the United States and the euro area is already low and stable, and deflation is fading away as a policy issue. For Japan, a strong case can be made that financial reforms would improve monetary policy more than would the adoption of IT. Further, the specific measures that Truman recommends for the G3 represent a watered-down version of IT. Indeed, the impact of the adoption of IT on the international financial system presumed by Truman may be inflated.

An important theme in the book is that IT does not require a free float of the exchange rate. Truman recommends, therefore, that IT not be ruled out even when a country’s policymakers have a “fear of floating”; that is, they are unwilling to let the exchange rate float completely freely. We agree that the exchange rate need not be ignored under IT, and, indeed, many IT countries intervene in exchange markets to support the inflation target. But meaningful IT does require subordination of the exchange rate to the inflation target, especially when exchange rate movements work against adherence to the inflation target. In short, policymakers in countries where the exchange rate is subject to wide fluctuations are in a somewhat more difficult operating environment under IT than Truman acknowledges.

The book also gives rather short shrift to the institutional and operational issues that must be addressed if IT is to work. For example, it is important for the government to assume “ownership” of the inflation target because a strong fiscal position is important for the success of IT. Financial market development is another key issue: countries that do not have sufficiently liquid money markets will find it more difficult to use the interest rate as an operating target to manage liquidity and signal policy intentions.

But despite these reservations about some aspects of the book, we feel it will become a widely used reference on inflation targeting. In some cases, its conclusions are a bit overstated. Still, its accessibility and broad scope make it important reading for academics and policymakers concerned with the practice of monetary and exchange rate policies.

Edwin M. Truman
Inflation Targeting in the World Economy

Scott Roger and Mark Stone
Senior Economist and Deputy Division Chief
IMF Monetary and Financial Systems Department
Still Living Dangerously?

Theodore Friend

**Indonesian Destinies**

**INDONESIA** is the world’s fourth most populous nation and its most populous Muslim nation. It is the world’s largest archipelago and straddles important shipping lanes. But despite its size and strategic importance, the country’s economic and political history has not received the attention it deserves from scholars. A handful of international academics, mainly Australian, have studied the country in depth, but some of them have shown a tendency to portray the country in an overly sympathetic light.

In a welcome departure, Theodore Friend, a renowned American scholar of Southeast Asian countries, has written a balanced, fascinating, and richly illustrated book about Indonesia. He notes that the culture of the cold war era meant that the international community largely condoned corruption in anticommunist countries like Indonesia. The end of the cold war “blew away the hypocrisy that had induced donor nations to ignore political corruption in anticommunist countries. . . . After the mid-1990s, the World Bank and the IMF, for whom corruption had been a hushed topic, began to ventilate it.” As the financial crisis hit, the World Bank appealed for help in combating “the cancer of corruption.” But this was too little, too late: Friend writes that the crisis “had apparently so accelerated the cancer’s growth as to make it inoperable.” One example he cites is the “misuse” by commercial banks of the emergency liquidity support credits injected by the central bank at the onset of the crisis to stabilize the situation. Another attempt to siphon off money, this one unsuccessful, was one by Suharto’s children to adopt a currency board at an exchange rate of 5,000 rupiah to the dollar. “It was,” Friend writes, “too clearly a device for Suharto’s family and cronies to buy dollars for 5,000 rupiah each, instead of being savaged at 10,000 by their own borrowings and speculations.”

In sum, Friend traces Indonesia’s collapse in 1997–98 to deep-rooted structural causes, and so it is not surprising that he is more sympathetic than most to the role of the IMF over this period. “Did the IMF’s stress on structural reforms merely worsen the crisis? I don’t think so,” he writes. “The international business community largely played the local game, without pressing for reform. Most domestic voices for change had been forced into exile, jailed, intimidated, or ignored. In a critical situation, only a body of world standing like the IMF could have made the case for the dismantling of a corrupt empire, Friend concludes.

Vasuki Shastry
Senior Information Officer
IMF External Relations Department
Markets versus the Masses

JAVIER SANTISO, chief economist for Latin America at Banco Bilbao Vizcaya Argentaria, does a superb job in this book of demystifying the world of emerging markets finance, unmasking it for what it often is: a confidence game. In the best possible way to research his subject, he frequently interviews market practitioners directly. As someone who spent nearly 10 years in these markets, I found that the Rolodex Santiso consults turns up familiar names—global finance is a small world.

Santiso captures well the inherent tension between the nature of the markets and the imperatives facing leaders of the emerging world, who are trying both to develop their economies and to get reelected. Occasionally, the interests of markets and politicians are mutually reinforcing, but for the most part their agendas are at cross-purposes. He notes, for example, that politicians sometimes try to win the confidence of markets by delivering on a few reform policies—generally common to all countries—that the markets deem important. But because markets may have focused on those policies in a capricious manner, politicians may not necessarily be acting in sync with their country’s optimal development strategy.

This tension comes to the fore when the election cycle requires politicians to turn their attention to winning over the populace rather than just the markets. In short, there is often an incongruence between the political calendar of governments and the economic calendar of markets. The warning that surfaces from Santiso’s analysis is on target: by playing to the expectations of the markets rather than to fundamentals, policymakers are putting at risk, if not undermining, the economic well-being of the people they represent.

Javier Santiso

The Political Economy of Emerging Markets
Actors, Institutions and Crisis in Latin America
Palgrave Macmillan, New York, 2003, 268 pp., $59.95 (cloth).

Nevertheless, Santiso overplays his hand by coming too close to suggesting that markets are mostly to blame for the ills that have befallen the developing world while the countries themselves are generally guiltless. He is particularly off the mark in portraying Argentina as the victim of its own blind commitment to the much-maligned Washington Consensus. Argentina may have been held up as the star pupil, in great measure as a result of some self-promotion and the vested interest of the international financial community, but it was the Argentine government’s own missteps that ultimately did the country in. Argentina broke an important commandment of the Washington Consensus in not living the life of fiscal rectitude that its convertibility regime required. Santiso may also be reaching when he suggests a direct correlation between the eruption of financial crises and the bonus calendars of investment banks.

All in all, Santiso succeeds in raising the right questions, which is what good books do. For this book, the questions include: How can we best harness the power of the markets to improve conditions in the developing world? In particular, can we reconcile the short-term bias of markets with the long-term nature of development planning?

The book gets us thinking about the right balance between the benefits that come from the accountability markets impose on policymakers and the risks presented by the markets’ propensity to urge similar reforms—some of which may be no more than fads—on countries that are at very different stages of development. In short, as Santiso says at the end of the book, there is an “unfinished dialogue between states and markets.” This book provides a rich context in which to undertake this dialogue.

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Illustrations: pp. 8 and 36, World Bank.
India's economy is rebounding strongly, providing a golden opportunity to tackle fiscal challenges decisively.

Growth was strong in fiscal year 2003/04 (April–March) after recent lackluster performance and declining investment.

The recovery was strongest in agriculture, following a severe drought in 2002/03, but services are increasingly driving India's economy.

Exports have benefited from competitiveness gains in the past three years despite the recent rupee strengthening against the U.S. dollar.

Despite large fiscal deficits, interest rates have fallen with global integration, and inflation is moderate.

It has also resulted in a steady rise in the debt of both the central and state governments, which, over the medium term, could constrain growth.

Sources: Central Statistical Organization and Reserve Bank of India; CEIC Data Company Ltd.; and IMF staff estimates.
Why Are Structural Reforms So Difficult?

The benefits of structural reforms aren't always as obvious as the smaller, short-term costs

Raghuram Rajan

ANY economic problems are due to problems in the working of markets, rather than, say, to resource shortages or an excess or deficiency of overall demand. To most economists, the need for structural reforms—measures that change the institutional and regulatory framework governing market behavior—then seems obvious. Such reforms can impose costs on a few in the short run but will potentially make many more better off in the long run. Economists believe that the opposition of these few can be overcome through compensation from the government. But this rarely happens. Why?

Reforms are hard to sell

The first problem is that the gains from reform are never as clear to the wider public as they are to economists, often because they are indirect. Consider the removal of interest rate ceilings on loans. The public is likely to view such a reform as a license for lenders to charge extortionate rates.

In truth, if interest rate ceilings are removed in a competitive financial system, the prices of loans will reflect risk accurately, and loans will be allocated more efficiently. The kind of distortion that ceilings introduce depends on the kind of lenders present in the system. If the lenders are private banks that aim to maximize profits, they will simply not lend to projects requiring a break-even rate above the ceiling. So risky projects will be shut out, even if they are worthwhile.

But if lenders don't care about profits or can't evaluate risks, they will be inundated with loan applications from high-risk borrowers with financially unviable projects. Because lenders can't charge a rate that exceeds the ceiling, they may use some other way of choosing among applicants willing to pay a higher rate—for example, the ones who pay the largest bribe. Applicants who have the most to gain from bribing will be those with the most unviable projects because they will get the largest interest subsidy. Thus, lenders (often state-owned) will not only succumb to corruption but will also make very risky loans.

When interest rate ceilings are in place, regardless of whether lenders maximize profits, loan allocations aren't optimal: the economy assumes either too little or too much risk. Moreover, lenders can't make a large enough return from lending to pay savers a high enough rate to generate savings in the economy.

The trouble is that it requires a high-minded and articulate politician to appreciate these arguments and compress them into the persuasive sound bites that would probably be needed to sell interest rate liberalization to the public. Far easier to attack the Shylocks and retain ceilings!

Another problem with selling structural reforms is the possibility of short-run costs to some. For example, a reform that makes it easier to fire employees enhances a firm's ability to shape its workforce to its needs and makes it more willing to hire. In the short run, firms will use the newfound freedom to prune deadwood. And workers, concerned about the increased job uncertainty the reform implies, may consume less, thereby reducing growth. But in the long run, although it may strike the noneconomist as paradoxical, greater freedom for firms to fire should boost employment and incomes.

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The costs and benefits of reform may also accrue to different people. Economists believe that if a reform is beneficial overall, those who benefit could, in principle, compensate those who are hurt by it. If the compensation actually took place, the losers would be more likely to drop their opposition, and everyone would benefit. Unfortunately, such compensation may be hard to implement: the labor reform described above helps firms and the unemployed who now find jobs, but it hurts the workers who would be fired. How, for instance, should one compensate a steelworker who loves his job and knows he will never again find work that pays anything remotely near his current salary? And how will compensation arrangements differentiate between good laid-off workers, who will find new jobs, and bad ones, who won't, without destroying the incentive of the former to remain in the labor force? How does the worker know whether, once he gives his job up, public opinion will support paying his benefits at a future date when he is powerless?

The bottom line is that those who perceive themselves to be potential losers—possibly a majority of workers, given the uncertainty surrounding who will be axed—may oppose reforms, and their cohesiveness will make them a very effective lobbying group.

**Timing is all important**

Despite these impediments, policymakers do implement structural reforms. The IMF’s April 2004 *World Economic Outlook* devoted a chapter to analyzing when and how structural reforms take place in industrial countries in financial, labor, and product markets, and in trade and taxation. Here are some of the findings and some possible explanations.

First, a period of weak or negative growth is conducive to reforms: it either causes people to see the need for reforms or weakens opposing interest groups. For example, in New Zealand and the United Kingdom, where deep structural reforms were implemented in the 1980s, persistent, difficult economic conditions had built up support for change.

Second, when there is fiscal room in the budget, reform is more easily accomplished. It helps to have such flexibility if, for example, interest groups need to be paid off. Labor market reforms in the Netherlands in the 1980s and 1990s were aided by sizable budgetary support. While unemployment, sickness, and disability benefits were cut, workers’ taxes and social security contributions were also cut, making the reforms more palatable.

Third, some reforms seem to feed off others. For example, product market reforms appear to make labor market reforms easier. A possible explanation is that when competitive pressures are unleashed by product market reforms, organized labor may be forced to worry about the risk to employers if it doesn’t accept greater flexibility.

Fourth, external pressure helps. If a country’s three main industrial country trading partners implement reforms, its own reform efforts typically increase, too. It may well be that the reforms one country implements make firms in partner countries less competitive, forcing those countries to either change or perish. External policy competition could thus be a strong force for improving the business environment rather than, as is often alleged, leading to a race to the bottom. When a country joins an international economic organization, that organization can be a second source of external pressure. We know that the European Union has fostered trade and product market reforms in its member countries and that monetary union has increased financial market reforms in the euro area. And IMF surveillance is a form of international peer pressure—at the global level—for policy improvements.

Fifth, there are reasons to believe that small interest groups tend to have more power in proportional voting systems. In majoritarian systems, a party needs to cater only to a sizable bloc to achieve a majority or the plurality needed to govern; it doesn’t have to pander to every interest group. This implies that reforms should be easier in majoritarian systems and, indeed, they are: witness the greater number of reforms implemented in recent years in the typically majoritarian Anglo-Saxon countries. The most determined reformers in these countries turn out to be those with a strong majority in parliament.

Finally, reforms don’t produce benefits all the time. In fact, as argued earlier, labor market reforms seem particularly difficult, not only because they can lead to a short-term dip in growth and employment but also because the costs fall disproportionately on some.

**Lessons for reformers**

Are there lessons from this analysis? Yes, but one should heed two caveats: every country is unique; and reformers in industrial countries have the luxury of timing their reforms, which may not be available to a country in crisis or a developing country, where the costs of the distortions may be much larger. Nevertheless, some lessons emerge:

- **Start reforms during the recovery from an economic downturn.** It is a good time because the downturn has focused people’s minds on the need for reform while the recovery promises a quicker reward.
- **Use budgetary surpluses to buy reform.** Reform is tough even in the best of times. The ability to compensate losers helps, so why not use it well?
- **Start with reforms that have more immediate benefits.** Trade and financial market reforms, for example, produce benefits even in the short run. If these are successful, they not only have a demonstration effect but may also increase competitive pressures, thus making further reform easier.
- **Secure outside support.** Signing an international agreement or joining an international club can provide the external discipline that will force the pace of reforms. For instance, Chinese banks are under tremendous pressure to clean up their act because, under the terms of China’s accession to the World Trade Organization, foreign banks will be able to compete on a level playing field in China starting in 2007.
- **Try to change your system of vote...** Sorry, scratch that one.

Happy reforming!