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DEVELOPING countries have benefited from the opening up of financial markets around the world over the past several years. As cross-border capital flows surge, many developing countries are enjoying unprecedented access to portfolio and foreign direct investment as well as to the additional benefits that often accompany the latter, such as the transfer of advanced technologies and managerial expertise. And, with the debt crisis of the early 1980s behind them, many are also regaining access to voluntary bank lending.

But large capital inflows also carry certain risks for recipient countries. As demonstrated in the article by Nadeem Ul Haque, Donald Mathieson, and Sunil Sharma, among the most serious dangers are that capital inflows could fuel inflation and cause an unsustainable appreciation of the domestic currency. To design the types of policies that can protect countries against these potentially destabilizing effects, policymakers need to identify the forces driving the flows. Although this is easier said than done, the behavior of certain financial indicators may shed light on what is triggering capital inflows.

Another potential pitfall sometimes cited in connection with the liberalization of financial markets is that it may facilitate money laundering, which is undesirable not only because of its association with tax evasion and criminal activity but also because it distorts the economic data available to policymakers and therefore makes the conduct of monetary policy more difficult. But this does not warrant turning the clock back on financial reforms. As Peter Quirk points out in his article on money laundering, exchange controls are not the answer—in fact, they encourage the establishment of parallel markets. He demonstrates that anti-money laundering measures are compatible with financial liberalization and are needed urgently.

The liberalization of financial markets has not benefited all countries equally. A country's credit rating plays a critical role in determining whether it has access to private capital and at what cost. Nadeem Ul Haque, Donald Mathieson, and Nelson Mark explore the economic, political, and social variables that influence the credit ratings of three highly regarded rating agencies and suggest steps countries can take to rebuild their creditworthiness.

Claire Liuksila
Editor-in-Chief

Abbreviations used in this issue

ACDA  Arms Control and Disarmament Agency
BIS    Bank for International Settlements
BOO    Build-own-operate
BOT    Build-own-transfer
c.i.f.  Cost, insurance, and freight
CMEA   Council for Mutual Economic Assistance
EC     European Community
EIU    Economist Intelligence Unit
EU     European Union
FATA   Financial Action Task Force
FDI    Foreign direct investment
FSU    Former Soviet Union
GDP    Gross domestic product
GNP    Gross national product
IAS    International Audit Standards
IFC    International Finance Corporation
IISS   International Institute of Strategic Studies
IMF    International Monetary Fund
LIBOR  London interbank offer rate
OECD   Organization for Economic Cooperation and Development
SIPRI  Stockholm International Peace Research Institute
SSA    Social structures of accumulation
UFW    Unaccounted-for water
WDI    World Development Indicators
WEO    World Economic Outlook

Attention readers
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Some developing and transition countries are attracting large inflows of foreign capital that could destabilize their economies. To design policies that will enable them to guard against this danger, they need to identify what is driving the inflows.

In recent years, a number of developing and transition countries have enjoyed large inflows of foreign capital that have eased their financing constraints. Despite their obvious benefits—increased efficiency and a better allocation of capital, and associated transfers of technology—the inflows have aroused concern because of their potential effects on macroeconomic stability, the competitiveness of the export sector, and external viability. The most serious risks are that they will fuel inflation and drive the real effective exchange rate to unsustainably high levels.

Policymakers faced with the threat of overheating in the wake of large capital inflows have to make difficult decisions on the magnitude, sequencing, and timing of policy actions. These decisions need to be based on the recipient country’s economic objectives, exchange rate regime, institutional constraints, and, especially, the causes and composition of the inflows. In practice, however, it is difficult, at least in the early stages, to identify the causes and to distinguish between temporary and sustainable inflows. Judgments must therefore be made on the basis of limited information.

This article sets out a stylized framework that addresses two questions. First, which financial indicators would be most useful to policymakers in identifying the causes of capital inflows? Second, what would the appropriate policy responses be in different situations? This framework can do no more than provide general guidelines, however. Capital inflows are determined by a combination of causes that varies from country to country, and policies must be tailored to the circumstances of individual countries.

Identifying the causes

For the purposes of this article, the causes of capital inflows can be grouped into three major categories: autonomous increases in the domestic money demand function; increases in the domestic productivity of capital; and external factors, such as falling international interest rates. The first two are usually referred to as “pull” factors, the third as “push” factors.

The economic impact of capital inflows and the need, if any, for a policy response are likely to be determined by the forces driving them, as well as by the recipient country’s exchange rate regime. Under a fully flexible exchange rate system, capital inflows (regardless of what is driving them) will lead to appreciation of the recipient country’s currency, a drop in the relative price of imported goods, and a shift of consumption away from nontradables—all of which tend to alleviate inflationary pressures. Therefore, all other things being equal, the more flexible the exchange rate,
the less likely it is that capital inflows will have an inflationary effect.

Under a managed float or a fixed exchange rate system, whether or not capital inflows create inflationary pressures will depend on whether the inflows reflect an upward shift in the money demand function—that is, an increase in money demanded for each interest rate level—or are due to other factors, such as a drop in international interest rates or an increase in the domestic productivity of capital. If capital inflows are due primarily to a sustained increase in domestic money demand, they will not be inflationary. But if they increase for other reasons, the accumulation of foreign exchange reserves will lead, in the absence of sterilization, to expansion of the monetary base, heightened inflationary pressures, and deterioration of the external position.

Financial indicators that may help policymakers differentiate between inflows caused by a shift in the money demand function and those driven by exogenous factors include asset prices, monetary and credit aggregates, balance of payments data, and key international variables, such as interest rates (Table 1). Data on asset prices, both domestic and international, are likely to be more timely than data on monetary and credit aggregates and the external accounts and, therefore, more useful as indicators in this context. The usefulness of different domestic financial indicators depends on an economy's institutional structure and on the sophistication of a country's data-gathering and statistical reporting systems.

In countries with established financial and equity markets, relative asset price movements may be particularly helpful in identifying causes; it is assumed that there is less-than-perfect substitutability between domestic and foreign assets as well as less-than-perfect capital mobility between countries. An upward shift in the money demand function is likely to drive down prices of domestic bonds, equities, and real estate as asset holders reallocate their portfolios. In contrast, when inflows are fueled by lower international interest rates or increases in the domestic productivity of capital, prices of real and financial assets will probably go up.

Interest rates can be useful for determining whether capital inflows are caused by "pull" or by "push" factors. Other things being equal, inflows driven by "pull" factors will be associated with upward pressure on domestic nominal interest rates, while inflows due to "push" factors, such as a decline in international interest rates, will tend to put downward pressure on domestic interest rates. Returns to foreign investors can also provide useful information: real returns, which depend on the expected path of the exchange rate (and foreign, not domestic, inflation) can be a key determinant. The behavior of real money balances also may be informative. Capital inflows driven by money demand will be associated with an increase in money balances but not accelerating inflation (and, thus, with rising real money balances). Capital inflows generated by a decrease in international interest rates will initially drive up nominal and real money balances, but then, as inflation accelerates, real balances may decline. Domestic prices will be slower to respond in low-inflation countries than in high-inflation countries. At least initially, capital flows attracted by higher domestic productivity are likely to take place in an environment characterized by rising interest rates and domestic income; the net effect on money demand will depend on the latter's sensitivities to changes in interest rates and income. It is probable, however, that desired holdings of real balances will be reduced because of higher returns on competing assets.

Foreign-currency deposits in the banking system should decline when the domestic money demand function shifts upward and also, possibly, when international interest rates fall. However, the effect of increased domestic productivity on foreign-currency deposits is ambiguous: a greater need for domestic currency will tend to result in substitution away from foreign-currency deposits, while the income effect will work in the opposite direction.

While the composition of capital inflows can provide information about their causes, it is often difficult to distinguish between foreign direct investment flows and portfolio investment flows, especially in the short term. In general, an increase in money demand is likely to attract short-term portfolio investment, whereas other changes, such as an increase in the domestic rate of return on capital, will tend to attract longer-term foreign direct investment. In these cases, there may be long delays between the stimulus and the inflow of capital, depending, among other things, on the regulatory environment and absorptive capacity of the recipient country. Thus, an increase in the domestic productivity of capital may initially lead to larger portfolio inflows and only later attract greater amounts of foreign direct investment.
fore also necessary to consider how broader changes in economic conditions—for example, economic reforms that increase the productivity of capital and enhance growth prospects—may be driving capital inflows. Investment decisions made by market participants may also provide useful insights. Moreover, even when the message is clear, it needs to be evaluated against a counterfactual—in other words, the behavior of the indicators has to be interpreted in relation to what would have happened if the inflows had not occurred, although doing this is very difficult.

Policy responses

The appropriate policy responses will be determined not only by the causes of capital inflows but also by the degree of flexibility allowed by the domestic institutional structure and the existing policy stance. Countries that pursue relatively balanced macroeconomic policies have found it easier to deal with the disruptions caused by inflows than countries with unbalanced policies (commonly, an excessively expansionary fiscal policy compensated for by a tight monetary policy).

Some countries can partly offset the upward pressures that large capital inflows exert on exchange rates by accelerating the pace of trade and exchange liberalization, including easing controls on capital outflows. Otherwise, countries have three instruments at their disposal to deal with the possible effects of large capital inflows: sterilized intervention, fiscal tightening, and exchange rate appreciation. The optimal mix of instruments depends on the country’s institutional structure and past policies. The ability to sterilize the effects of capital inflows on the monetary base may be limited if suitable instruments are not available to the central bank and if domestic financial markets are not sufficiently developed. It may also be limited if previous intervention by the central bank has produced a large quasi-fiscal deficit—the difference between the interest earned on foreign exchange reserves and the costs of financing the sterilization. Although some countries have appropriately adopted tighter fiscal stances in the face of persistent capital inflows, fiscal policy is somewhat unwieldy for short-term demand management because of the lags associated with the formulation and implementation of specific measures. And exchange rate appreciation may be unacceptable because it makes a country’s products less competitive.

It is sometimes argued that temporary capital controls may need to be considered if the use of these three instruments is severely restricted or their effectiveness is limited. However, if capital controls are in place for a long time, they tend to become less effective with respect to flows and may hinder the development of the financial system and undermine the efficiency of resource allocation. Moreover, institutional factors can be pivotal in determining what would be an appropriate response to capital inflows. With macroeconomic stabilization and deregulation, returns to investment may rise sharply, while the banking system, which will intermediate the flows, may still have structural weaknesses and poor prudential supervision. In these circumstances, capital controls and prudential supervision measures—including restrictions on the foreign exchange exposure of domestic financial institutions—could be used to limit intermediation of the inflows by the banking system, as well as to steer foreign capital toward assets with relatively longer maturities. Capital controls can be progressively dismantled as the quality of surveillance improves and the capacity of the banking system to handle flows increases.

The matrix in Table 2 shows the appropriate use of each instrument for countries with balanced macroeconomic policies. It should be noted that many countries have attracted large capital inflows while stabilization efforts are still in progress—and some countries have received capital inflows despite poor fundamentals. For the sake of simplicity, however, the matrix does not take into account all possible initial conditions and policy imbalances.

When a capital inflow is associated with an upward shift in the money demand function (induced, say, by financial deregulation), no policy action is required because, in this case, the expansion of the monetary base will not be inflationary or threaten external viability. It may be necessary, however, for the central bank to intervene in the (relatively thin) money and foreign exchange markets to smooth fluctuations in the exchange rate and interest rates. One possible cause for concern is that banking credit is likely to expand as money balances increase. With a poorly supervised and weak banking system, the increase in commercial banks’ reserves could lead to excessive risk taking in lending activities, and measures may be needed to restrict bank intermediation.

<table>
<thead>
<tr>
<th>Instruments for managing capital inflows</th>
<th>Upward shift of domestic money demand curve</th>
<th>Increase in productivity of domestic capital (sustained inflows)</th>
<th>External factors—e.g., falling international interest rates (temporary inflows)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sterilization</td>
<td>May be needed to smooth fluctuations.</td>
<td>May be needed to smooth fluctuations.</td>
<td>Equilibrium real exchange rate need not change. Temporary nominal appreciation of the exchange rate may be warranted if there are constraints on sterilization.</td>
</tr>
<tr>
<td>Exchange rate appreciation</td>
<td>Equilibrium real effective exchange rate does not change.</td>
<td>The warranted appreciation of the equilibrium real effective exchange rate can be achieved partly through nominal appreciation and partly through increases in the prices of nontraded goods.</td>
<td></td>
</tr>
<tr>
<td>Fiscal policy</td>
<td>No policy response is required.</td>
<td>Fiscal policy tightening is generally required, especially if the absorptive capacity of the economy is limited relative to the size of the inflows.</td>
<td>If the constraints on sterilization are too severe and the external competitive position is weak, then some fiscal tightening may have to be considered.</td>
</tr>
</tbody>
</table>
Policymakers need to fashion different responses depending on whether capital inflows are likely to be sustained or temporary. For a sustained increase—due, say, to an increase in the productivity of domestic capital—policymakers have to decide how best to achieve the appreciation of the equilibrium real effective exchange rate. Adjustments in goods, factor, and asset prices will ultimately induce a real appreciation regardless of the exchange rate regime, and the policy response should not inhibit this appreciation. In economies with flexible exchange rate arrangements, appreciation of the real exchange rate can be achieved through a nominal appreciation rather than an inflation of the prices of nontraded goods. Over the medium term, a tightening of fiscal policy may be needed to control increases in domestic absorption, to prevent an excessive appreciation of the real effective exchange rate, and to contain the external deficit. A tighter fiscal stance has been necessary in countries confronted with sustained capital inflows, especially when the inflows have been large relative to the economy’s absorptive capacity and in countries with pegged exchange rates.

To limit the impact of a temporary increase in capital inflows—for example, one resulting from a decline in international interest rates—sterilization of the inflows, if feasible, is the most appropriate response, since it can limit or prevent a deterioration in external competitiveness, and some appreciation of the exchange rate might also be appropriate. However, the ability to sterilize inflows is likely to be limited and short-lived if the substitutability between domestic and international assets is high or the exchange rate is pegged. Adjustments in fiscal policy may not be necessary unless constraints on sterilization are severe and the economy’s competitive position is weak. Moreover, fiscal policy may not be an appropriate instrument in these cases, because it may involve lengthy legislative processes, and frequent changes in the tax structure and government spending might impose substantial adjustment costs on the economy.

In countries with unbalanced financial policies, short-term inflows are likely to be influenced primarily by domestic interest rates and expected exchange rate movements. Generally, the high domestic interest rates that attract foreign capital are due to a mix of loose fiscal and tight monetary policies; hence, making the appropriate fiscal and monetary adjustments to rebalance the policy mix is clearly the best policy response. Reducing interest rates while decreasing the incentive for speculative inflows, however, could stimulate domestic demand and lead to overheating. In those situations where a correction of an unbalanced policy mix is expected, the response should be similar to that for a temporary external shock—namely, sterilized intervention combined with some exchange rate appreciation. However, these measures would clearly not be effective when fundamental policy adjustments are unlikely to be forthcoming, especially if high domestic interest rates are driven by excessive public sector borrowing.

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Finance & Development / March 1997

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Money laundering can have devastating economic consequences. Fighting it should be a priority for all countries and is not incompatible with financial market liberalization.

A few years ago, a group of IMF staff went to a small island country to assess economic developments. As they walked around the capital, they noticed a surprisingly large number of small banks (more than 100 in a country of less than 100,000 people). A year later, it was revealed that many of these banks had no legitimate banking business and that the country’s government had begun to shut them down with help from bank regulators in a major international financial market.

This example illustrates two points: first, that offshore banks have been an important and visible vehicle for money laundering—the transfer of illegally obtained money through third parties to conceal its source—and, second, that there are both a need and an established framework for international cooperation in the fight against money laundering.

The framework

In 1996, the IMF was asked by the Paris-based Financial Action Task Force (FATF) on money laundering (Box 1) to prepare a study on the macroeconomic implications of money laundering. The impetus for the study was clear-cut. The IMF promotes openness of international financial markets, or “currency convertibility,” through the abolition of exchange controls. But this liberalization is sometimes perceived as dangerous, because it opens up more channels for laundering dirty money. In fact, the media have carried stories with headlines like “1992 Means a Single Market for Crime, Too—As EC customs and exchange controls fall, money laundering will flourish unless new laws are enacted” (Larry Gurwin, Global Finance, January 1990). And some governments had told the FATF that they could not implement its “40 Recommendations” for fighting money laundering because to do so would require adopting regulations contrary to the IMF’s advice for liberalizing financial markets.

The first part of the rebuttal to this argument is straightforward. The FATF’s Recommendation 23 states that, “The feasibility of measures to detect or measure cash at the border should be studied subject to strict safeguards to ensure proper use of information and without impeding in any way the freedom of capital movements.” (Emphasis added.) Monitoring for money laundering requires information on, rather than control of, the foreign exchange transactions, and the type of information required for monitoring is different from that required for exchange controls. Countries that retain exchange controls require, for enforcement purposes, information on the economic function of transactions, while monitoring for money laundering is focused on establishing the identities of transactors and the patterns of their transactions (“know your customer”). In addition, studies show that large-scale capital flight has been triggered by economic incentives created by exchange controls and nonmarket exchange and interest rates rather than by criminal activity.

The second—and more forceful—part of the rebuttal has been harder to establish: money laundering has a significant negative impact on the macroeconomy, and there are therefore good economic reasons for urgently adopting anti-laundering...
measures. Very little of the large body of economic literature on crime deals with money laundering, although much has been written about the “hidden” or “underground” economy and tax evasion.

How big is the problem?

To prove that money laundering is significant for the macroeconomy, it is necessary to show that it involves large sums relative to overall economic activity. Attempts by macroeconomists—mainly in the 1980s—to measure the underground economy had actually been measuring money laundering (although this was not specifically stated) because they looked at the displacements in time series for currency demand associated with, for example, higher taxes, and thus tax evasion. Another approach to estimation, used by the law-enforcement community rather than by economists, was to build up estimates by crime category (a “micro-economic” approach), based on street knowledge; sampling; and detailed medical, social, and financial/tax records. The result of these efforts is a very wide range of estimates of the size of underground economies, as a percentage of GDP—for example, for Australia, 4–12 percent; Germany 2–11 percent; Italy, 10–32 percent; Japan, 4–15 percent; the United Kingdom, 1–15 percent; and the United States, 4–33 percent. The large variations in estimates have led to reliance on “consensus” numbers. For example, on October 18, 1994, the Financial Times reported that, according to recent estimates by UK and US officials, the amount of money laundered annually in the financial system worldwide was roughly $500 billion—some 2 percent of global GDP. The basis for this estimate was not given; it may have been derived from an informal updating and generalization of earlier FATF micro-based estimates.

A study published last year (Quirk, 1996) differs from the earlier macro work in two respects: (1) it is cross-sectional for 19 industrial countries; and (2) it uses Interpol crime data and data on labor participation as proxies for noncriminal informal markets, in addition to the earlier tax evasion variables, to explain currency and money demand across industrial countries. Its main conclusions are as follows:

- The relationship between crime and currency demand changed direction between the early 1980s and early 1990s. An upswing in crime first led to increased demand for currency; now, increases in crime lead to decreases in currency demand. In other words, money laundering methods have changed (Box 2), moving away from the banking system and cash and toward parallel financial markets, sophisticated nonmonetary instruments (such as derivatives), and possibly barter (such as an exchange of boats and guns for drugs). If money laundering has moved to the parallel market—that is, debts and credits booked by organized criminal quasi-banks, say, over the Internet—there could be important implications for anti-laundering efforts, which have typically focused on criminal activity at the point at which the proceeds enter the aboveground economy.

Given the seriousness of the problem, there is clearly a need for better data. On the one hand, while estimates based on macroeconomic data can provide indications of both direct and indirect influences of money laundering, the inclusion of indirect influences creates uncertainty as to exactly what is being measured. On the other hand, a micro-based approach requires the creation of a very large amount of data specifically for measurement purposes. Sampling and survey approaches offer a means of extrapolating to otherwise unobservable aspects of money laundering, although care needs to be taken to ensure that a comprehensive methodology is applied in the sampling and in-depth follow-up of transactions. A consistent international methodology would offer economies of scale as well as the sharing of insights across countries.

Macroeconomic effects

Because crime, underground activity, and money laundering take place on a large scale, macroeconomic policymakers must take them into account. But, because these activities are hard to measure, they distort economic data and complicate governments’ efforts to manage economic policy. In addition, the ability to identify statistically the country and currency of issuance and the residency of deposit holders is key in understanding monetary behavior. To the extent that money demand appears to shift from one country to another because of money laundering—resulting in misleading monetary data—it will have adverse consequences for interest and exchange rate volatility, particularly in dollarized economies, as the tracking of monetary aggregates becomes more uncertain.

The income distribution effects of money laundering must also be considered. To the extent that the underlying criminal activity redirects income from high savers to low savers, or from sound investments to risky, low-quality investments, economic growth will suffer. For example, there is evidence that funds from tax evasion in the United States tend to be channeled into riskier but higher-yielding investments in the small business sector, and also that tax evasion is particularly prevalent in this sector. Fraud, embezzlement, and insider trading seem likely also to be more prevalent in rapidly growing and profitable businesses and markets, because “that’s where the money is.”

Money laundering also has indirect macroeconomic effects. Illegal transactions can deter legal ones by contamination. For example, some transactions involving foreign participants, although perfectly legal, are reported to have become less desirable

Box 2

How money is laundered

- **Smurfing** involves the use of multiple cash deposits, each smaller than the minimum cash reporting requirement.
- **Mistitling** of exports and falsification of import letters of credit and customs declarations can conceal cross-border transfers of, say, the proceeds of drug trafficking.
- **Barter**: stolen property (e.g., antiques or automobiles) can be exchanged, across national borders or domestically, for illegal substances.
- **Parallel credit transactions** can be used to avoid the formal economy, except for the final use made of the net proceeds of illegal activity to purchase legally marketed goods or services.
- **Interbank wire transfers** may not be subject to reporting on money laundering; bribery of bank officials can thus make it easier to conceal large illegal transfers between accounts.
- **Derivatives** that replicate insider trading opportunities (e.g., a synthetic version of a company stock subject to merger or takeover) can be used to avoid detection of an unusual change in a listed stock price.
because of an association with money laundering. More generally, confidence in markets and in the efficiency-signaling role of profits is eroded by widespread insider trading, fraud, and embezzlement. And, money that is laundered for reasons other than tax evasion also tends to evade taxes, compounding economic distortions. Moreover, contempt for the law is contaminating—breaking one law makes it easier to break others.

Accumulated balances of laundered assets are likely to be larger than annual flows, increasing the potential for destabilizing, economically inefficient movements, either across borders or domestically. These balances could be used to corner markets—or even small economies.

The above effects are to some extent speculative; however, the Quirk study (1996) also conducted empirical tests on the relationship between GDP growth and money laundering in 18 industrial countries for the first time. It found evidence that significant reductions in annual GDP growth rates were associated with increases in the laundering of criminal proceeds in the period 1983-90.

Policy implications

Because money laundering has such extensive adverse macroeconomic effects, macro policies must play a role in anti-laundering efforts.

Exchange controls. Anti-money laundering measures are sometimes perceived as being in conflict with exchange control deregulation, whose effect is likely to be a vast increase in the volume of international transactions—and in opportunities to disguise the sources of funds. However, economic growth and the growth of financial markets could be said to have the same effect. Moreover, exchange controls have led to the establishment of parallel markets with close connections to the underground economy. Instead of turning the clock back on economic and financial reforms, policymakers need to devise countermeasures that allow them to stay ahead of financial market developments. One such measure is to extend the reporting and monitoring framework for money laundering to less formal bodies, such as bureaux de change. Another is to ensure that information and training on anti-laundering surveillance are provided to foreign exchange dealers through such channels as the foreign exchange codes of conduct that are generally drawn up by national associations of foreign exchange dealers or banking institutions, some with technical assistance from the IMF.

Prudential supervision. In the absence of a money laundering law and accompanying measures, it is not necessarily in the direct financial interest of financial institutions to adopt anti-laundering behavior. For this reason, both the FATF and the Basle Committee on Banking Supervision have issued statements on the prevention of criminal use of their members' banking systems for the purpose of money laundering. The statements dealt with cooperation with law enforcement agencies in identifying customers and their behavior, keeping relevant records, and reporting possible illicit behavior.

Money laundering activities can corrupt parts of the financial system and undermine governance of banks. If bank managers are corrupted by the sizable sums involved in money laundering, nonmarket behavior can spread into operating areas other than those directly related to money laundering, which creates risks for the safety and soundness of banks. Bank supervisors can also be corrupted or intimidated. However, law enforcement efforts should not crowd out the traditional responsibilities of bank supervisors.

Over the past several years, the IMF has helped a number of developing and transition countries to establish effective financial market supervision. In many of the transition economies, supervisory capabilities are as yet at a basic level, affording relatively little assistance to law enforcement authorities in their anti-laundering efforts. In many developing countries, however, central banks are among the most organized and effective institutions; governments are therefore urging them to take on both support and core functions in countering money laundering. In some cases, the new emphasis has raised questions of the adequacy of training for supervisors and the extent of monitoring.

Tax collection. Of the underlying forms of illegal activity, tax evasion is, perhaps, the one with the most obvious macroeconomic impact. A government deficit is at the center of economic difficulties in many countries, and correcting it is the primary focus of most economic stabilization programs. The IMF has therefore been involved in efforts to improve the tax collection capabilities of its member countries. Although the small business sector is an important nexus of tax evasion, it also drives economic growth. It is therefore possible that many countries at a relatively early stage of economic development will be especially prone to tax evasion and the associated money laundering.

Statistical reporting. Several years ago, after an attempt to estimate flows of laundered money directly, using international banking statistics and capital accounts of the balance of payments, the BIS and the IMF concluded that although deposits covered by international banking and balance of payments statistics may include a substantial amount of drug money, this component probably accounts for only a small (but, unfortunately, significant) percentage of the totals and can therefore not be singled out.

Some early attempts to gauge the importance of money laundering relied on scrutiny of cash-to-GDP ratios, such as those reported in the IMF's International Financial Statistics. Techniques related to balance of payments calculations allow estimates to be made of aggregate capital flight from individual countries, which in some instances is thought to be associated with money laundering. Macroeconomic estimates of misinvoicing can be made by comparing domestic trade data with partner-country data from the IMF's Direction of Trade database, after factoring in errors and omissions in the balance of payments.

Legislation. In recent years, many countries have reformulated, with technical assistance from the IMF, laws governing central banking, commercial banking, and foreign exchange. It may be more appropriate to set up separate banking laws and regulations covering reporting requirements for nonprudential purposes than to include such requirements in core banking laws and regulations. Provisions covering bank confidentiality and treatment of offshore banking are particularly relevant to money laundering.

Conclusion

Fears that anti-money laundering laws and regulations will undermine efforts to liberalize financial markets, or that opening up financial markets will promote money laundering, are unfounded. Money laundering threatens economic and financial systems in many countries, and the international financial community should strongly support anti-laundering efforts.

This article is based on a 1996 study by the author, "Macroeconomic Implications of Money Laundering," IMF Working Paper 96/66 (Washington: International Monetary Fund).
Like corporations, countries are rated on their creditworthiness. What criteria do rating agencies apply, and what can countries do to improve their credit ratings?

Attempts to rate the creditworthiness of corporate borrowers have a long history. Recently, several commercial services began to compile and publish credit ratings for countries, in an attempt to estimate the risks involved in lending to them—in particular, the likelihood of a country's defaulting on its debt servicing obligations.

These credit ratings have played a critical role in determining both the volume and the spread over LIBOR (the interest rate at which London banks lend to each other) of syndicated commercial bank loans to developing countries over the past two decades. The share of syndicated loans in total capital flows to developing countries has diminished as other sources of foreign private capital for these countries have opened up. Nevertheless, the concepts of country risk and creditworthiness are no less important, as many institutional investors from industrial countries are allowed to invest only in instruments that meet or exceed a minimum credit rating standard. Credit ratings therefore determine not only whether a country is able to get loans at a reasonable cost but also whether it is able to attract other types of capital.

Countries whose credit ratings decline need to rebuild their creditworthiness by implementing policies that address the concerns of potential creditors. To identify the policies and economic performance variables on which credit ratings are based and assess how useful ratings are in determining a country's creditworthiness, we carried out an econometric evaluation of the most widely used commercially available ratings.

Raters of country risk

Which economic, political, and social factors influence credit ratings, and to what extent are these factors consistent with the theories developed by economists about creditworthiness? To answer these questions, we studied the credit ratings compiled by two magazines, Institutional Investor and Euromoney, and by the Economist Intelligence Unit (EIU), a publisher of business reports. Although the ratings of all three measure a country's ability and willingness to service its financial obligations, they are based on different methodologies and compiled by different types of experts.

The ratings are based on an evaluation of a number of macroeconomic, financial, and political variables (see table), including a country's economic growth rate, its current account balance relative to GDP, and various ratios—savings to investment, external debt to GDP, debt service payments to GDP, and interest payments to GDP. In addition, a country's vulnerability to external shocks is gauged by the degree to which it relies on a single export. A country's willingness to service its financial obligations is measured both by financial variables such as arrears on international bank loans, debt reschedulings, access to bond markets, and cost of various forms of trade credits, and by political considerations, which typically include policies toward foreign creditors, the likelihood of opposition parties, the government's capacity to implement measures needed to stabilize the economy and meet external payments, and the likelihood and potential effects of political instability.

While the criteria for assessing credit risk summarized in the table suggest a precise relationship between a country's credit rating and the political, economic, and financial variables specific to that country, the judgment of the rating analysts plays an important role, both in evaluating...
economic and political variables (e.g., drawing conclusions about the degree of political stability) and in determining how much weight should be attached to different variables within each group of factors. Thus, a fair amount of subjective judgment goes into the final evaluation.

Regional variations

Ratings by all three sources show considerable variation across countries and over time. The average ratings for different regions are shown in the chart. For the indices published by Institutional Investor and Euromoney, available since 1981 and 1982, respectively (the EIU did not issue ratings until 1989), the data suggest three distinct periods that correspond to the debt crisis, consolidation after the crisis, and the restoration of creditworthiness. During the debt crisis of the early 1980s, Institutional Investor’s and Euromoney ratings generally declined across all regions. In the late 1980s, after a period of consolidation, the ratings for countries in Asia, Latin America and the Caribbean, and the Middle East showed improvement, but those for countries in Africa and Europe declined.

The data suggest that the response of various ratings to changes in the economic situations of countries occurs at different speeds. Euromoney’s ratings improved in 1988, at the beginning of the third period, when countries began to rebuild creditworthiness, whereas Institutional Investor’s ratings did not improve until 1990.

Measuring creditworthiness

The variables to be used to explain a country’s credit rating must be consistent with the factors that the compilers of the ratings have indicated they used in assessing a country’s performance and what the theoretical literature has stressed as important in determining the capacity and willingness to service external debt.

Two different theoretical approaches underlie attempts to predict the risk of default. One approach regards default as arising out of an unintended deterioration in the borrowing country’s capacity to service its debt. The other, in contrast, views the rescheduling of (or default on) a country’s external debt as a rational choice made by the borrower based on an assessment of the costs and benefits of rescheduling or defaulting.

In the debt-service-capacity approach, the probability of default is seen as a function of the unsustainability of a given level of external debt, either as a result of short-term illiquidity or of long-term insolvency reflected in liquidity problems. It is assumed that the debtor’s budget constraint is breached, either because of short-term economic mismanagement, long-term structural problems, domestic policy, or external shocks such as harvest failures, or because of external shocks such as an increase in international interest rates, deterioration in a country’s terms of trade, and slowing growth in industrial countries.

With this approach, a number of key economic variables could serve as indicators of future liquidity and solvency problems. In any given period, for example, lower export earnings are likely to increase the likelihood of short-term liquidity problems and hence difficulties with debt servicing, whereas a decline in the growth of output could contribute to long-term insolvency problems and reduce creditworthiness. Similarly, the higher the ratio of debt to GDP, or the lower the ratio of international reserves to imports, the greater the threat of a sudden liquidity crisis and the lower the country’s risk rating. Conversely, if the balance of payments on the current account is positive, or if there is a positive terms of trade shock in the period immediately preceding the year of the rating, the creditworthiness indicator would be expected to be higher. The inflation rate can be regarded as a proxy for the quality of economic management. Thus, the higher the inflation rate, the lower the creditworthiness rating. The real exchange rate variable can be included to measure the trade competitiveness of the economy, with a highly appreciated real rate expected to affect the credit rating adversely.

The cost-benefit approach argues that, in the absence of legal institutions to enforce international loan agreements, a market mechanism emerges in the form of a threat of future exclusion from voluntary international capital flows. In the extreme case, the cost of repudiating debt is a loss of welfare for the debtor country, which would be forced into autarky or, at the very least, barter. The benefit of defaulting on debt is the windfall gain from the economy’s total outstanding debt. Consequently, any variables that make a default more advantageous for the debtor would increase the probability of a default, and variables that increase the cost of a default would reduce the probability of one.

Under this approach, a country would have four motives for incurring sovereign
Credit ratings over time: regional averages

External debt: a consumption-smoothing motive; a transaction or “reputation” motive, where the debtor has an incentive to maintain its reputation; an investment motive, arising from an expectation of relatively high domestic productivity; and an adjustment motive, arising from a measure of current account sustainability. These motives are regarded as instrumental in determining the probability of default and therefore play a fundamental role in measuring country creditworthiness. For example, countries susceptible to shocks have a greater incentive to smooth consumption by maintaining access to international markets (the consumption-smoothing motive).

The more open the domestic economy, the greater its vulnerability to innovations in the international market and the higher the costs of defaulting (the transaction motive). Higher domestic growth rates can indicate a higher domestic productivity that will make it more beneficial to remain a borrower and postpone default (the investment motive). A large current account deficit might create a concern on the part of lenders about a country's ability to service such debts (the adjustment motive).

Economic performance is measured in terms of a country's rate of growth and its rate of inflation. Our preliminary analysis of the data revealed that countries experiencing high inflation appear to have been treated differently in the ratings. To account for the differential treatment, we sorted countries into groups of “high” and “low” inflation and attempted to distinguish between the effect on the ratings of being in these categories and the incremental effect of increases in the rate of inflation.

The influence of a country's external position on its creditworthiness is measured in terms of the scale of its existing obligations and the factors affecting its ability to service these obligations. The scale of a country's external payment obligations is measured by the ratio of its external debt to GDP. As with high-inflation countries, we consider the possibility that the credit rating agencies may treat “high”-debt countries differently from “low”-debt countries. A country's capacity to service its external obligations is assumed to be reflected in the growth rate of its exports, its current account position, the ratio of its nongold international reserves to imports, and its real exchange rate.

The influence of international developments on a country's credit rating is examined in terms of two variables that capture the effects of external shocks to a country's
trade and financial flows. Shocks to a country’s trade flows are represented by changes in a country’s terms of trade. We also use the 3-month US treasury bill rate to capture the effects of external financial developments.

What the ratings reveal

While our empirical results suggest that a set of common economic variables influence the credit ratings by all three of the sources studied, there are significant differences in the relative importance attached to individual economic factors. Moreover, there is clear evidence that a country’s rating persists over time; that international factors influence country ratings independently of developments in the country; and that regional considerations and a country’s export profile often have a strong influence on a country’s rating. As can be expected, the ratings do not appear to favor either of the theoretical approaches, but draw on aspects of both.

Persistence. Of the three rating agencies, the ratings issued by Institutional Investor show the most persistence. This suggests that, in the absence of new information, the ratings remain virtually constant over time.

Country-specific factors. The domestic factors that appear to have most influenced the rating analysts are a country’s reserve holdings and current account balance in the year before the rating. While a higher real GDP growth rate had a significant, positive effect on the ratings issued by Institutional Investor and Euromoney, it had a statistically insignificant positive effect on the EIU’s rating. In contrast, an increase in the rate of growth of a country’s exports significantly raised the country’s Institutional Investor ratings, but had a smaller positive effect on Euromoney’s rating.

An interesting point is that, once developments in reserves, current account balances, exports, and GDP growth are taken into account, terms of trade do not appear to have a significant impact on country ratings.

The estimation results also suggest that the rating agencies designate some countries as “problem” countries according to whether or not they experience “high” inflation. Once a country is placed in the problem category, its rating goes down dramatically, and the rating analysts ignore small changes in inflation. Euromoney imposes the largest penalty for high inflation—a country’s rating may fall 60 to 80 points (out of 100). Moreover, countries that are not in the high-inflation group were penalized in both the Euromoney and Institutional Investor ratings when their inflation rates went up. Although we expected to find a similar pattern for high and low ratios of external debt to GDP, our analysis did not bear this out; however, Institutional Investor seemed to penalize low-debt countries when their debt/GDP ratios rose.

Regional contagion effects and structural characteristics appear to have influenced country ratings independently of economic fundamentals. Regional effects are evident in ratings by all three organizations. After accounting for the domestic and external factors, we find that Euromoney has traditionally given developing countries in Asia, Europe, and the Middle East ratings 10 to 20 points higher than it gives countries in Latin America and the Caribbean and Africa. Similarly, the EIU’s ratings tend to be highest for countries in Asia and Europe and lowest for African countries.

In our analysis, the effect of a country’s export orientation is measured relative to that for developing countries exporting manufactured goods. Euromoney and Institutional Investor appear to give significantly higher rankings to countries exporting manufactured goods than to exporters of other types of goods. In contrast, the EIU appears to give strongly negative ratings only to fuel exporters and producers of primary products.

Although it may seem that countries that borrow in the financial markets or from a diversified group of lenders should score higher than those dependent on official sources of loans, the advantage in terms of credit rating seems relatively modest, except in Euromoney’s ratings.

External variables. Although the criteria used by the three rating services focus primarily on domestic economic variables, our results indicate that conditions in external financial markets influence the ratings of all developing countries independently of the quality of domestic policies and economic performance. In particular, a 100 basis point (1 percentage point) increase in international interest rates (as represented by the US Treasury bill rate) would reduce a country’s rating in the short term by 2 points in the cases of the EIU and Institutional Investor, and 7 points in the case of Euromoney, independently of any domestic economic developments.

Conclusion

The economic fundamentals that economists ordinarily use to determine a country’s capacity and willingness to service external debt appear to play a key role in determining a developing country’s credit rating. Our analysis also shows that a country tends to retain its rating over time unless significant adverse or positive developments occur.

The most important domestic economic variables influencing a country credit rating were found to be the ratio of nongold foreign exchange reserves to imports, the ratio of the current account balance to GDP, the country’s rate of growth, and its rate of inflation. The effect of inflation on credit ratings was found to be nonlinear, with high-inflation countries being heavily penalized relative to countries with low or moderate inflation. Moreover, a country’s credit rating has often been affected by its regional location and the types of goods it exports. Although international financial market conditions are rarely mentioned as factors influencing a country’s credit rating, it was found that an increase in international interest rates would adversely affect all developing country ratings, regardless of the quality of domestic economic fundamentals.

These findings suggest that certain policies could help in rebuilding a country’s credit rating during a stabilization program. It is important to note that the persistence of country ratings means that it would normally take a long time to improve a country’s creditworthiness rating—from 5 to 10 years. However, the analysis suggests that certain measures can accelerate the process. For countries that have been experiencing a high rate of inflation, a sharp reduction in inflation would significantly improve the country’s rating. Rebuilding the ratio of nongold foreign exchange reserves to imports would also be an important step. Finally, an improvement in the country’s current account balance and a revival of growth would also appear to be important for improving the country’s rating.
Recent financial system crises in both industrial and developing countries have sparked a reexamination of how to prevent and respond to such crises. Better regulation and supervision are the key to dealing with them.

For almost four decades after World War II there was not much need for anyone but central bankers and supervisors to pay attention to the banking system. Deposit insurance seemed to be doing its job of preventing bank runs, and regulators and regulations seemed to ensure that individual banks were acting prudently. Macroeconomists periodically returned to the question of what distinguished banks from other financial intermediaries, and whether it mattered, but no major changes in thinking about policies for promoting financial sector soundness resulted.

The problem of banking and financial system soundness has shifted to center stage in the last two decades. The international debt crisis threatened the health of major money center banks; the US savings and loan crisis demanded a huge injection of public funds; and major banking crises erupted in Scandinavian countries and, more recently, in Japan. Financial crises in some Latin American countries have been exacerbated by banking system weaknesses. In the transition countries, the need to recapitalize banks puts major strains on the budget, while the weaknesses of banking systems delay growth.

These financial system crises are not only costly for the economy but also reduce the effectiveness of monetary policy. They are costly because the volume and efficiency of financial intermediation are reduced when banks are being closed on a large scale or are struggling to strengthen their portfolios. They impair the effectiveness of monetary policy because banks in trouble do not react appropriately to interest rate changes and because the central bank has to exercise caution in using monetary policy for fear of damaging fragile banks.

Domestic financial deregulation undertaken before adequate reform of prudential supervision and the regulatory framework is one major reason that financial crises have become more common. Financial innovation—producing new and little-understood instruments that outstrip the reach of regulators—is another. Undertaking external financial liberalization—the removal of capital controls—before the soundness of the domestic financial system and macroeconomic policy is assured, is a third factor in explaining crises.

In this era, as in earlier times, some banking system crises have been caused by the bursting of asset price bubbles. Inappropriate monetary policy may have contributed to the behavior of asset prices, but financial markets on occasion get carried away with enthusiasm. The worldwide real estate boom in the late 1980s was ended by higher interest rates, with serious consequences for bank lending in the United States, and especially, Japan. There is no easy answer to the question of how to deal with asset price inflation; obviously monetary policy cannot remain indifferent when asset prices seem to be moving too fast, but it cannot be directed solely at maintaining the right level of asset prices. One approach to dealing with asset prices that appear to be moving away from fundamental values is to use regulations to reduce the availability of credit for purchasing assets.

The recent financial system crises, as well as the process of deregulation, have sparked a healthy and continuing reexamination of measures to prevent crises and how to respond to them when they do occur. Better regulation and supervision are key to prevention, and central bank cooperation has gone a long way toward improving both. Regulation includes licensing requirements and the imposition of prudential standards. Supervision requires the monitoring and enforcement of these standards, a task that is rarely as easy as it sounds.

Given the complexity and the pace of innovation in modern financial markets, as well as the scope for, and difficulty of, detecting fraud or simply mismanagement, effective monitoring requires a constant process of probing, analyzing, and questioning.

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banks' activities and data. The direct resource costs can be large, and staff with the appropriate qualifications scarce, even in industrial countries, but especially in developing countries. The burden can be eased somewhat through firm bank entry policies, but the supervisory challenge remains. Supervisory authorities continue to seek better ways to monitor performance, some relying on markets, investors, and depositors to do part of the monitoring. It is fair to say, though, that we should never be confident that supervisory systems are adequate; this is an area where the IMF’s standard caution—complacency should be avoided—is always appropriate.

Payment risks

In seeking to prevent crises, central banks have also become increasingly concerned with the risks that arise in the payment system. Periodic net settlement systems may allow scope for major intraday interbank exposures to go unmanaged, and even unrecognized. This is a potentially important channel through which difficulties in one financial institution can spread quickly to others through a payment default. The problem can be addressed in part by strengthening the legal framework that applies when it becomes necessary to unwind net payments.

More fundamentally, systemic payment risk can be contained either by strengthening risk management in net systems or by introducing a real-time gross settlement (RTGS) system, at least for large transactions. To the extent that the central bank provides intraday credit to prevent gridlock in an RTGS system, the central bank itself may have to manage extremely large exposures. Issues of pricing, collateralization, and credit limits become pressing, as reflected in recent changes under the Fedwire settlement system in the United States, for example.

At one time, deposit insurance was seen as a critical element in preventing financial crises. This view was based on a diagnosis that self-fulfilling bank runs were an important propagating mechanism in financial crises. Post–World War II experience has drawn increased attention to the moral hazards of explicit deposit insurance and the insurance implicit in the “too big to fail” doctrine. Accordingly, formal deposit insurance is generally confined to individual depositors and applies only up to a maximum account balance. Implicit insurance coverage for other deposits remains, however, and there have been very few major bank failures in which depositors have lost large sums of money—though depositors in some transition economies have suffered relatively serious losses.

Banking supervision

There is an important global perspective to the setting of prudential standards, to supervision, and to strengthening payment systems. Differences among regulatory and insurance frameworks can lead to arbitrage between systems (for instance, as in the development of the Eurodollar market and offshore banking centers). International harmonization and supervisory coordination have become increasingly important as political boundaries have become less relevant to financial sector business, global banking organizations have proliferated, and economic integration has proceeded apace. In the payment area, too, the need for harmonization and coordination has increased, not least because of the very large risks involved in foreign exchange settlement arrangements.

Major progress in coordination and harmonization of bank supervision has been achieved through the Basle Committee and Concordat. The Basle standards are now applied in nearly 100 countries. At the same time, there have been parallel coordination efforts with supervisors of offshore banking centers and, because of the growing recognition of the increasingly fuzzy distinctions between banks and other financial institutions, with the International Organization of Securities Commissions (IOSCO) and insurance supervisors. Coordination has further to go in these areas.

Gaps and differences among supervisory systems nonetheless remain, as has been demonstrated in several recent, well-publicized cases. The need to deepen and, especially, to broaden international supervisory coordination is seen by many as one of the biggest immediate challenges for central banks. The IMF is willing to contribute, within the constraints of its limited resources, to furthering this process.

Lender of last resort

When crisis prevention fails, the central bank, as lender of last resort (LLR), has an obligation to help deal with the consequences, at minimum current and future cost. Dealing with significant failures of individual institutions or groups of very fragile institutions requires a well-developed strategy. Intervention, in the form of closure, merger, or some form of rehabilitation, needs to be decisive and determined. Owners and managers of the failed institutions need to incur substantial losses. At the same time, the strategy should seek to ensure that the central bank is not drawn unnecessarily into lender-of-last-resort financing of troubled banks and exposure to major credit risks. Rather, the costs of any publicly funded financial support should be borne and recognized explicitly, generally in the budget. These expenses may become very large when much of the banking system is affected. Generally, the budget is charged with the interest costs on the resources put into recapitalizing and restructuring financial institutions. The issue of limiting monetization may also arise when the central bank directly or indirectly funds payouts made through formal deposit insurance schemes.

In discussing the central bank’s role as lender of last resort, it is important to distinguish between a system-wide crisis and an individual bank problem. In the systemic case, no other than the central bank can provide additional base money quickly in the event of a confidence-related shock to the demand for it. In this context, LLR lending does not conflict with monetary policy objectives, since it is a response to a shift in the demand for base money. Here all Bagehot’s maxims apply.

Where individual bank problems are the issue, there is no presumption that access to the central bank’s LLR facility is appropriate. If access is allowed, it should be well

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rather than inadvertently creating perverse incentives in a way that contributes to failures, but let them be small. As a matter of principle, and in order to reduce moral hazard, owners and managers of large, as well as small, banks need to bear substantial costs when an institution fails. But policy and practice differ on the extent to which depositors/investors should also bear costs. Supervisors must be guided, but not seen and believed to be guided, by the principle of maintaining the integrity of the system as a whole rather than that of individual institutions.

Neither of these two issues—the balancing of the costs and benefits of supervision and regulation, and incentive compatibility—can in any sense be solved. Rather, the central bank has to take them into account in each situation and as the economy evolves. No doubt, solutions such as narrow banking will continue to be proposed. But the narrow banking solution will not work, for the incentive for each narrow bank will be to shade the edges and become a real bank. Further, it is not credible to maintain that the central bank will fail to come to the rescue of nonbank intermediaries if their failure threatens major financial disruption. Financial innovation by the private sector, designed in part to avoid regulations, will not cease. Nor will the political pressures that emerge in any situation where so much is at stake as in the financial system.

Thus, central bankers can rest assured of the problems for governments and central banks. The moral hazard problem is a key aspect of incentive compatibility. This problem may arise even in countries without formal deposit insurance. The "too big to fail" presumption often lurks in the background—and there is no question that large failures can create extremely difficult situations for governments and central banks. Hence the supervisor's prayer: let there be failures, but let them be small.

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Recent data on countries' military spending indicate that a sizable peace dividend has been achieved since 1985. How much have countries cut, and how have they allocated the resources this has freed up?

A recent IMF study published some years ago (Hewitt, 1991) found that world military spending declined by 1.3 percentage points of GDP between 1985 and 1990, with declines in all regions and for both industrial and developing countries. More recent data show that this downward trend continued during 1991–95. Utilizing WEO data for 130 IMF member countries, we estimated that worldwide military spending declined from 3.6 percent of world GDP in 1990 to 2.4 percent in 1995, with most of the savings taking place in the transition economies and the industrial countries (Chart 1). The reduction was widespread; 90 of the 130 countries included in the study trimmed the share of military outlays in GDP during the period, while only 40 maintained or increased them.

On a regional basis, military spending fell everywhere except in the Western Hemisphere; there were especially sharp cuts in the transition economies (5 percent of GDP) and the Middle East and Europe (1.7 percent of GDP), but more modest reductions (less than 1 percent of GDP) in the industrial countries, and in Africa and Asia.

Overall, the WEO data indicate that in the decade since 1985, military spending has declined by nearly 3 percentage points of GDP. This implies a "peace dividend" in 1995 of some $345 billion, if actual military spending is compared with what it would have been if the 1990 ratio of military spending to GDP had prevailed, and as much as $720 billion using the 1985 ratio.

Other sources, which exclude data from the former Soviet Union, showed similar results, although the magnitude of the decline was smaller because of differences in country coverage and definitions of military expenditure. These data are derived from the International Institute of Strategic Studies (IISS), the Stockholm International Peace Research Institute (SIPRI), and the United States Arms Control and Disarmament Agency (ACDA). Between 1990 and 1994, ACDA data for 103 countries show a decline in military spending of 0.7 percent of GNP; SIPRI data for 68 countries show a decline in spending of 0.6 percent of GDP; and IISS data for 90 countries show a decline of 0.4 percent of GDP.

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The peace dividend

How have the resources saved by reducing military outlays been used in countries where military spending has declined? One might expect that at least some portion of the peace dividend would be used to increase nonmilitary spending, while the remainder would be returned to the private sector through a reduced fiscal deficit and/or lower taxes. For countries in which military spending has increased, the relevant issue is the extent to which higher military spending has crowded out other spending, increased the fiscal deficit, or led the countries to raise taxes.

Analysis by country group. Our study compared the experiences of a group of developing and transition countries during 1985-92. Out of 80 countries in the sample, 51 (of which 5 are economies in transition) reduced military spending during this period. Countries that reduced military outlays cut them by an average of 2 percent of GDP while simultaneously cutting nonmilitary outlays by 1.6 percent of GDP (Chart 2). Nonmilitary current outlays were cut by only 0.1 percent of GDP in these countries, with the remainder coming through cuts in capital expenditures and net lending. Because the decline in total expenditure exceeded the fall in revenues, these countries experienced a reduction in the central government's budget deficit as a share of GDP.

The process by which a country determines its levels of military and other spending is complex, making it difficult to isolate the impact of the peace dividend on other fiscal variables. Nevertheless, based on the available data, it appears that reductions in military spending have not been primarily associated with increases in other spending. Rather, the peace dividend has largely returned to the private sector through lower deficits and, in some cases, lower taxes. If military spending had not declined in these countries, other spending would presumably have declined even more than it actually did and/or there would have been greater crowding out of private sector activity, either through higher taxes or increased fiscal deficits.

The 29 developing countries in the sample that increased their military spending as a share of GDP behaved in the opposite way to those that cut military outlays: military spending rose in the context of higher nonmilitary and total spending, and there were sharp increases in the deficit. This suggests that military spending may have crowded out private sector investment. Also, despite higher total spending, capital spending and net lending declined, suggesting that higher military spending may have crowded out public investment as well. The decline in investment is broadly consistent with a number of studies (for example, Knight and others, 1996) indicating that military spending may retard economic growth over the medium term.

Individual country experiences. Additional insight into the impact of changes in military spending can be gained by looking at the experiences of individual countries. We examined data for 2 groups of 10 developing countries that had the largest increases and decreases (in terms of percentages of their GDPs), respectively, in military spending during 1985-92. Comparable data were examined for two smaller groups of industrial countries with large percentage increases or decreases.

We can infer how the peace dividend was used by looking at changes in the composition of countries' spending. Most of the 10 developing countries with the largest cuts in military spending were able to maintain their levels of social spending (social security, health, education, and housing), even in the face of sharp declines in total expenditure. In fact, on average, such spending rose 2.1 percentage points of GDP during 1985-92 for the seven countries for which data are available. Some economists have argued that there is scope for raising social spending in many countries and that such spending can have a high social rate of return. Our analysis suggests that reducing military spending may allow countries to maintain or increase social spending, despite the need for sharp overall spending cuts. Of course, it is impossible to say—at this level of aggregation and without a detailed sectoral analysis—whether a shift from military to social spending improved the efficiency and equity of public spending in these countries.

In addition, fiscal deficits declined in 7 of the 10 developing countries with the largest cuts in military spending during 1985-92, and in no case were cuts in military outlays accompanied by cuts in total expenditures. The results are mixed for the industrial countries. Of the 5 industrial countries with the largest cuts in military spending during 1985-92, three increased both their nonmilitary and total spending, while in two others, cuts in military outlays were accompanied by cuts in total expenditures. All three countries that increased their nonmilitary spending also increased their spending on health, education, and housing, suggesting that there was some diversion of military spending to the social sector as part of the peace dividend.

Disaggregated data are not available for countries that reduced total expenditures. The 10 developing countries with the largest increases in military spending during 1985-92 had an average increase of 2.7 percentage points of GDP in such spending. In 6 of the 10 cases, the shares of total spending and nonmilitary spending in GDP rose. For those countries, military spending accounted for an average of 18 percent of the total increase in spending. In each of the three cases for which data are available,
social spending rose, by an average of 9.4 percentage points of GDP, suggesting that social spending was not substantially crowded out by higher military spending, while spending on economic services (to support central government activities in agriculture, energy, mining, transportation, communications, and other economic services) declined. In addition, the central government's deficit increased in five of the six countries whose shares of both total spending and nonmilitary spending in GDP increased, suggesting that higher military and social spending may have primarily crowded out private investment.

For the four remaining countries, however, large increases in military spending were associated with declines in the shares of nonmilitary and total spending. In each of these countries, total revenue declined sharply as a share of GDP, presumably contributing to the need to reduce spending. The brunt of the adjustment was borne by capital spending and net lending, which fell dramatically, by an average of more than 11 percentage points of GDP. Current spending, in contrast, increased on average. Thus, military spending appears to have crowded out public investment in these four countries, perhaps with negative consequences for future growth. In three of them, the deficit rose as well, with potential implications for private investment. Military spending as a share of GDP rose in only two industrial countries over the period. In both, the increases were small and were part of much larger increases in total spending and in the deficit that were driven largely by higher social spending.

**Resilience of military and social spending.** Focusing on a sample of countries experiencing large increases or decreases in total spending, our results indicate that military spending during 1985–92 has not been resilient to either fiscal tightening or expansion, contrary to the findings in the literature for earlier time periods. In particular, countries that have implemented fiscal adjustment appear to have largely protected the social sector, while their military spending has borne a substantial part of the burden of adjustment.

In the table, we see that in more than half of the 51 countries for which complete data on total, military, and social spending are available, total spending as a share of GDP declined over 1985–92. For these countries, military spending declined, on average, by 1.7 percentage points of GDP, contributing some 28 percent of their total budget cuts. Military spending declined by proportionally more than total spending, falling by an average of 1.5 percentage points of total spending over the period. This result contrasts with that for social spending, which increased its share of total spending by more than 6 percentage points of total spending.

Military spending declined by proportionally more than total spending, falling by an average of 1.5 percentage points of total spending over the period. This result contrasts with that for social spending, which increased its share of total spending by more than 6 percentage points of total spending. These results again suggest the existence of a peace dividend, as reduced international tension may have allowed countries to rely more heavily than in the past on cuts in military outlays to achieve fiscal tightening. For those countries that reduced military spending as a share of GDP during 1985–92, this reduction's contribution to achieving fiscal adjustment was even more significant.

In these countries, total spending fell by an average of 3.6 percent of GDP, with falling military spending accounting for more than half of the decline. A fairly similar picture emerges for the developing countries with the 10 largest reductions in military spending as a share of GDP; in these countries, military spending fell, on average, by 6.7 percent of GDP, about half of the average reduction in their deficits.

Our results for countries increasing total spending are qualitatively similar to those found in previous research, with increases in spending going disproportionately to nonmilitary and, in particular, to social spending. For the 22 countries increasing their total expenditure, military spending was virtually unchanged as a share of GDP, leading to a decline in the share of military outlays in total spending of almost 2 percentage points. The share of social spending in total spending rose by 0.4 percentage points.

In short, during 1985–92, military spending became a somewhat lower priority for countries, declining, on average, by 1.7 percent of total spending, while social spending increased its importance in the budget, rising by an average of 3.8 percentage points of total spending. Countries increasing their total spending as a share of GDP only maintained military spending as a share of GDP, while those cutting their total spending as a share of GDP tended to reduce the share of military spending relatively sharply.

**Conclusion**

Recent data on military spending indicate a sizable peace dividend has been achieved since 1985. Results suggest that countries that have made sharp cuts in military spending typically have also reduced nonmilitary spending as well as their fiscal deficit, thereby potentially encouraging private investment. There is indirect evidence that military spending cuts have also allowed countries to maintain or increase their social spending in the face of total spending cuts. In contrast, countries that have increased their military spending have also increased their other spending and sharply increased their deficits. Higher military spending may also have crowded out private investment and, for some countries, public investment. These results underscore the role that reducing excess military expenditure can play in securing economic growth.

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This article is derived from the authors' paper, "Worldwide Military Spending, 1990–95," IMF Working Paper No. 96/64 (June 1996).

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How Indochina's Economies Took Off

JOHN DODSWORTH

Favorable structural factors, combined with strong policies, helped Indochina's economies avoid a Soviet-style output collapse in their transition to a market-based system.

FEW ECONOMIES in transition to market-oriented systems have achieved relative macroeconomic stability more quickly than those in Indochina or have matched the strong growth rates these countries recorded during stabilization. In the late 1980s and early 1990s, Vietnam, the Lao People's Democratic Republic (Lao PDR), and Cambodia embarked on rapid disinflation that took them from the edge of hyperinflation to single-digit inflation rates in 1996. Virtually in step with this disinflation, these countries averaged annual GDP growth rates of 6 to 8 percent and strengthened their external positions.

What policies and conditions shaped this remarkable performance, and why has Indochina's path to stabilization differed so markedly from that of other transition economies?

The good stabilization results obtained in the Indochinese countries, as compared with those in other transition economies, reflect, in part, structural factors that allowed Indochina's economies to respond quickly to new policies. The most important of these factors were:

• Differences in economic structure. Unlike the European transition economies, the three economies of Indochina were dominated by private, family-based agriculture, and the state-owned industrial sector was relatively small.

• Although the “shock” of the 1991 disruption in aid from and trade with the Soviet bloc was quite significant for Vietnam and Cambodia, its impact was mitigated, particularly in Vietnam, by the earlier introduction of important economic reforms.

• Geographical location may also have been important. The Indochinese countries benefited from being close to rapidly expanding Asian economies that were eager to invest in neighboring low-wage economies.

• In contrast to many transition countries in Eastern Europe, the Baltics, and the other countries of the FSU, the private sector continued to play a role in Indochina even prior to the reforms, and central planning was, in practice, not fully entrenched.

• Finally, for Vietnam, the coming onstream of domestic oil production and large inflows of foreign direct investment also facilitated a relatively smooth transition.

This is not to argue that all of the initial conditions were favorable. On the contrary, the Indochinese countries were all emerging from extended periods of war and isolation. Each was also faced with extreme poverty, rudimentary infrastructure, and weak administrative capacity. At the outset, the countries attracted very limited international aid and had negligible foreign reserves.

Against this background, the Indochinese countries implemented tough macroeconomic policies that were basically similar. Initially, stabilization policies in all three countries comprised a mix of flexible exchange rates, high interest rates, limitations on state enterprise credit, and government expenditure reduction. This policy mix, in part, reflected the extensive nature of informal markets, which coexisted with the machinery of central planning and which became increasingly important as reforms took hold. Policymakers’ recognition of the pervasiveness of informal markets and the need to work with them rather than against them was a key element in the Indochinese countries’ success.

Background to reform

Prior to the reforms, the Indochinese countries faced budget deficits similar to (or even larger than) those in other transition countries (see chart). The true extent of these deficits was hidden, as government revenues consisted largely of transfers from state enterprises that themselves benefited from government subsidies, while expenditures were understated by the use of overvalued official exchange rates, arbitrarily low accounting prices, and the practice of paying workers in consumer goods instead of wages. Most of the early reform efforts—including price liberalization, exchange rate devaluation, and monetization of in-kind payments—raised measured budget deficits drastically. The situation was also made worse initially as wages were raised, in part, to monetize fringe benefits. The government wage bill rose rapidly as a share of GDP in Vietnam and Lao PDR until 1989, and in Cambodia well into the 1990s. At the same time, tax systems as such were very rudimentary, and initial reforms led to a deterioration in the financial performance of the state enterprises, reducing their budgetary transfers.
With the withdrawal and eventual termination of external assistance from the Council for Mutual Economic Assistance (CMEA) countries, the resulting large deficits were financed mainly through the printing press, and inflation escalated to triple-digit levels in each of the countries. High inflation gave a further push to informal markets and worsened the situation in the official sectors. The banking systems that existed in each of the countries had never been well established, and the lack of trust in domestic currency was reflected in flight to foreign currency and gold, and in minimal use of commercial bank accounts.

**Stabilization and growth**

There are two distinct phases of stabilization policies in the Indochinese experience. The immediate policies to bring down inflation from very high levels were based on flexible exchange rate regimes combined with drastic reductions in government outlays and high real interest rates. After dealing with inflation, each country entered a second stage with policies aimed at achieving exchange rate stability, although none of the three has yet adopted a pegged exchange rate. In this second stage, greater emphasis has been placed on mobilizing revenue and rebuilding government current and capital outlays. Measures are also being taken to develop the banking system and encourage the use of domestic currency.

**The early phase.** The initial conditions of high inflation, increasing dollarization, low international reserves, and limited international assistance severely constrained the scope for action. The marked decline in individuals' willingness to hold domestic currency progressively narrowed the base of the inflation tax, and this made the inflationary impact of the growing fiscal deficits worse. Inflation, in turn, contributed to further overvaluation of official exchange rates, and there was an increased diversion of foreign exchange receipts into the parallel market. Because administration was weak, foreign exchange controls could not be enforced and both the public and private sectors met the bulk of their foreign exchange needs from the parallel market. While fiscal measures were clearly needed, there was no dependable tax base, and budgetary adjustment was necessarily focused on cuts in expenditure, including curtailment of subsidies to state enterprises and reduction in real public sector wages.

These actions were supplemented by curbs on public services and capital spending.

Using the exchange rate as an anchor to bring down inflation—as tried in many transition economies—was not considered a feasible option in the Indochinese countries. The parallel market exchange rate was recognized as the main operational rate within the economy, and the governments of the Indochinese countries could not hope to establish a credible fixed exchange rate that would eliminate parallel market premiums and anchor their policies. Indeed, any attempt to fix the official exchange rate was thought likely to have an immediate adverse impact on foreign exchange receipts in the official market, in part because it would raise expectations of renewed foreign exchange restrictions. Without adequate reserves, the governments would be unable to defend the official rate and would lose policy credibility once the parallel market premium reemerged.

Instead, a flexible exchange rate policy was adopted that accepted the parallel rate as the dominant rate in the economy and linked the official exchange rate to it. Policy focused initially on narrowing the gap between the official and parallel rates by devaluing the official rate in response to depreciation in the parallel market. The rate of depreciation of the parallel rate was, in turn, taken as the main indicator of whether financial policies were sufficiently tight. Thus, the main burden of inflation reduction rested on fiscal and public enterprise adjustment. At the same time, there were few, if any, indexation mechanisms working in the Indochinese economies, and, by holding in check the public sector wage bill, the governments (particularly Vietnam) were able to effect an overall decline in real wages.

The policy of following the parallel market was one of the few practical alternatives available, given the limited institutional capabilities, negligible reserve levels, and the tremendous changes taking place as these countries moved to more market-oriented systems. Underlying the policy was the assumption that the parallel market rate would provide a reasonable guide to a real equilibrium rate for the economy and would not itself be a source of additional inflationary shocks. In the Indochinese countries, once initial stabilization policies took hold, the parallel market exchange rate tended to be relatively stable, reflecting the extensive nature of these markets. An important complementary measure in this respect was the relaxation, early in the reform process, of foreign exchange controls, which made transactions easier and reduced the distortive effects of risk premiums.

A further crucial policy element during the first stage of stabilization was the adoption of positive real interest rates during periods of high inflation. This policy was important in curbing further currency substitution in Lao PDR and Vietnam, but it...
was not relevant in Cambodia, where domestic currency was used almost entirely for cash transactions and no domestic deposit base developed. With high domestic interest rates, time and savings deposits denominated in domestic currency increased rapidly. The use of a high interest rate policy, together with the introduction of popular treasury savings certificates, also facilitated a switch from bank to nonbank financing of the budget deficit. As inflation began to subside, the government reacted relatively quickly by reducing nominal interest rates, which smoothed the adverse impact of excessively high real rates on enterprise profitability. The countries also avoided any massive build-up of unrecoverable debts in the banking system, though the profitability of the state-owned banks did suffer from the combined effect of high lending rates and enterprise closures.

As in other transition economies, government revenues declined at the outset of reforms as the countries moved toward a modern tax system instead of relying on transfers from state enterprises. Thus, the only course open to the Indochinese countries to achieve fiscal adjustment was to cut expenditures, mainly by lowering real labor costs, eliminating subsidies for consumers and state enterprises, and reducing capital outlays. Even though public sector layoffs were significant, the budgetary impact of severance packages was small, since state enterprises carried out most of the layoffs (notably in Vietnam) and, unlike European transition economies, neither the government nor state enterprises offered much in the way of social services. As for subsidies, in Vietnam, practically all subsidies for consumers and exporters (about 5 percent of GDP) were eliminated in 1989 in the context of price and exchange rate liberalization. A similar policy was adopted in Lao PDR, where all current budgetary subsidies were eliminated beginning in March 1988. Fiscal adjustment was supported by stricter control of bank credit to the state enterprises. This approach included allowing unprofitable enterprises to shed labor, close down, or merge with more profitable ones.

Fiscal stringency initially hit spending on public investment and social services hard. Capital expenditures fell to extremely low levels (1–3 percent of GDP) in both Cambodia and Vietnam. In Lao PDR, however, although there was also a decline, assistance from OECD countries had begun at an earlier stage, and capital outlays were maintained at 5–6 percent of GDP. Social services—including basic education and health care—also suffered. For example, annual spending per capita on health and education in Vietnam was suppressed to about 5,000 dong in 1989 prices (about $1) from the late 1980s until 1991. The quantity and quality of services thus regretfully deteriorated, undoing a good part of the impressive progress Vietnam had made previously. This deterioration was, fortunately, short-lived. In subsequent years, Vietnam’s expenditures on education and health services increased, financed by sharp improvements in revenue performance and higher fees for public services. After the 1990–92 shock, improvements in education and the delivery of health care were documented at the grassroots level.

**Consolidation**

As inflation was gradually brought under control and parallel market premiums were eliminated, the policy mix was changed, although maintaining financial stability—especially keeping inflation low—while sustaining rapid economic growth was still the main goal. The policy emphasis in the second stage has been on achieving exchange rate stability through tight financial policies. Fiscal policies, while still emphasizing avoidance of domestic bank financing, have focused on raising revenues in order to rebuild social services and expand capital outlays. Monetary conditions have generally been kept tight, and policies have increasingly focused on promoting the use of domestic currency, particularly in Vietnam and Lao PDR. Monetary policies have also been important in promoting the use of the official foreign exchange market. Specifically, the exchange system in Vietnam moved closer to a market regime with the introduction of trading floors for foreign exchange in November 1991, followed by the establishment of an interbank foreign exchange market in October 1994. As the official market expanded and captured a greater proportion of foreign exchange receipts, the official rate has more closely reflected underlying market conditions. In Lao PDR, an increasing number of banks and foreign exchange bureaus authorized to deal in foreign exchange have also helped bring a larger share of transactions into the official market. Despite these reforms, however, the parallel market still attracts the bulk of remittances and some export receipts, making it difficult to formally peg the exchange rate. Indeed, an attempt to peg the exchange rate in Lao

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**Foreign exchange markets**

After the initial period of following the parallel market, the official and parallel markets were unified in all three Indochinese countries. Official rates have generally been kept within 1 percent of the parallel market exchange rate, and liberalization of controls on the use of foreign exchange has significantly reduced the incentive to channel foreign exchange into the parallel market. Moreover, all three countries have generally been able to maintain a remarkably stable nominal exchange rate vis-à-vis the US dollar in both the parallel and official markets. Thus, although the exchange rate was not used as an explicit anchor during 1992–95 in Indochina, stable rates have been used as a guide for gauging the effectiveness (and recalibrating) of financial policies. New institutional arrangements have also been important in promoting the use of the official foreign exchange market. Specifically, the exchange system in Vietnam moved closer to a market regime with the introduction of trading floors for foreign exchange in November 1991, followed by the establishment of an interbank foreign exchange market in October 1994. As the official market expanded and captured a greater proportion of foreign exchange receipts, the official rate has more closely reflected underlying market conditions. In Lao PDR, an increasing number of banks and foreign exchange bureaus authorized to deal in foreign exchange have also helped bring a larger share of transactions into the official market. Despite these reforms, however, the parallel market still attracts the bulk of remittances and some export receipts, making it difficult to formally peg the exchange rate. Indeed, an attempt to peg the exchange rate in Lao

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**The policy of following the parallel market was one of the few practical alternatives available.**
PDR in 1995 led to increased diversion of foreign exchange receipts to the parallel market and forced an eventual devaluation of the official rate.

**Fiscal consolidation.** In contrast, with the first phase of adjustment, the emphasis in the second phase has been on strong revenue performance while containing current expenditure (Cambodia and Lao PDR), or even increasing spending for social purposes (Vietnam) and capital outlays (Lao PDR and Vietnam). The buoyant revenue performance mainly reflects sustained efforts to install modern tax systems and improve tax administration, coupled with the dynamic output growth, the rapid expansion of foreign trade, and financial improvement of the public enterprise sector.

**Credit policy.** Tight monetary policies have continued during the second stabilization phase in the Indochinese countries. Moderate growth rates of the money supply, broadly defined, have been achieved mainly through the virtual cessation of government budget financing, continued hard budget constraints on state enterprises, and keeping real interest rates at positive levels. However, all three countries continue to face problems arising from the effects of currency substitution on the stability of the measured demand for money and a general lack of monetary policy instruments with which to control increasingly sophisticated banking systems.

The rapid expansion of commercial banks—evidenced by the opening of a large number of joint venture banks and branches of foreign banks—and increased public confidence in the banking system have led to a significant degree of financial deepening, which is generally measured by the share of broad money in GDP. This share has risen significantly in Vietnam and Lao PDR since 1991. The beginning of a similar trend has been observed in Cambodia since 1993. However, currency substitution, once it has taken place, is extremely difficult to reverse. Thus, despite the moderation of inflation, continued positive real interest rates, and stable exchange rates, only partial progress has been made toward de-dollarization.

**De-dollarization.** The future pace of de-dollarization is critical for the formulation of stabilization policies. This reflects the fact that, while the overall demand for money may be expected to change only gradually over time, there may be sharp changes in the measured demand for money as domestic money replaces dollar currency holdings. The progress of de-dollarization is difficult to project, since it shows up only indirectly as an increase in the foreign assets of the banking system and an increase in measured broad money. Although the shift from dollar notes to domestic money would not affect the balance of the overall demand for and supply of money, a practical viewpoint, such shifts mean that a planned increase in the money supply can become tighter than anticipated if de-dollarization from currency notes occurs. On the other hand, if there is a reverse shift from domestic money to dollar currency holdings—which may have been the case in Lao PDR in 1995—then the monetary program becomes looser than originally intended.

This has practical implications for exchange rate policies. As indicated above, the Indochinese countries retain market-based exchange rate systems with financial policies aimed at achieving relative stability of the exchange rate. In this context, their governments may need to be ready with a variety of policy responses if, for instance, international reserves are accumulating at the current exchange rate at a faster pace than planned. If the increase is assumed to result from de-dollarization, then the recommendation would be to accumulate additional reserves and allow additional monetary expansion as this would not have inflationary consequences. This appears to have been the situation that developed in Cambodia in 1995, when international reserves rose strongly, causing measured broad money to increase by 45 percent while prices rose by only 3-4 percent.

Among the three countries, only in Vietnam does there appear to be a reasonably firm relationship between measured broad money and prices. In the other two countries, substantial shifts from dollar currency holdings to domestic money (or in the reverse direction) can be expected to take place. In addition to the complications of formulating and quantifying monetary policy, the Indochinese countries need to develop new monetary policy instruments. With private sector credit becoming increasingly important, and with banking systems becoming more extensive and diversified, reliance on instruments such as central bank refinancing and moral suasion has proved insufficient to control overall credit expansion. For this reason, explicit bank-by-bank credit ceilings were adopted by Vietnam in early 1994 and by Lao PDR in June 1995. Using such direct instruments, however, has led to a buildup of excess reserves in the commercial banks and spurred fresh disintermediation from the banking system. Efforts to put in place more efficient indirect instruments of monetary management have therefore been given priority. In each of these countries, initiatives are under way to strengthen government securities markets and to relax administrative controls over interest rates.

**Next steps**

Since the initial periods of rapid disinflation, each of the Indochinese countries has done well in keeping inflation under control and maintaining relatively stable exchange rates. Tight financial policies have been helped by successful efforts toward revenue mobilization through revamped tax systems, and fiscal deficits have been covered mainly in a non-inflationary way, by drawing on external assistance and nonbank domestic sources. Monetary policies have also been restrained, with the notable exception of Lao PDR in 1995, when attempts to expand credit and hold the exchange rate stable immediately gave rise to the reemergence of dollarization and a parallel market premium.

Although reforms are far from complete, the experiences of the Indochinese economies should not be interpreted as supporting a “gradualist” approach to adjustment. On the contrary, the countries adopted comprehensive adjustment policies, which helped achieve both favorable growth and disinflation results within a relatively short period, thus challenging the view, held by some observers of the experience of the transition economies, that gradual liberalization is necessary to avoid an output collapse.

For the future, stabilization policies in the Indochinese countries will have to come to grips with a new environment that will require different policy responses and the development of more efficient and sophisticated policy tools. In particular, the countries will have to deal with the overheating problems that accompany strong growth; at the same time, they will have to take into account substantial inflows of external assistance and foreign capital, uncertainties over de-dollarization, and increasing integration into the world economy.
In theory, the sum of world current account balances should be zero. In practice, it never is, and discrepancies can be large. Where do they come from, and what can be done about them?

The sum of current account balances—surpluses/deficits of countries and international organizations—should, in theory, be zero for the world as a whole (the same principle applies to the global capital and financial accounts). However, in practice, inconsistencies in the ways individual countries compile their data, and errors and omissions in the data, lead to statistical discrepancies.

The statistical discrepancy in the global current account has been large enough, at times, to be a cause of concern to the IMF, because it may distort the data that provide the basis for the projections in the WEO exercise as well as for the IMF's surveillance activities. In the early 1980s, the IMF organized a working party to investigate the principal sources of statistical discrepancies and to recommend ways to improve statistical practices.

In 1982, the statistical discrepancy in the world current account exceeded $100 billion—the equivalent of 2 percent of total world current account credits and debits. It narrowed in the 1980s, but again reached $100 billion in the early 1990s before declining to about $80 billion annually during 1993-95 (see chart). In 1995, the discrepancy was equivalent to only 0.5 percent of the sum of world current account credits and debits. However, this decline masked growing discrepancies in some of the components that go into the totals.

**Investment income**

The IMF's 1987 current account study focused on investment income transactions—which include, among other things, interest and dividend earnings and payments—where the discrepancy between recorded credits and debits had increased considerably in the early 1980s. The discrepancy between investment income credits and debits (excluding reinvested earnings from direct investment) has steadily increased since then to become the largest contributor to the overall discrepancy in the world current accounts. It reached $166 billion in 1995, which is equivalent to 7 percent of recorded income credits and debits (see table).

The current account study concluded that the most important factor in the growth of the discrepancies in global investment income data in the early 1980s was the emergence of a large body of cross-border assets recognized by the debtor countries but not by the creditor countries, coupled with higher interest rates after 1979. The study found that the reported data on capital flows for 1977-83 showed a cumulative net inflow of nearly $300 billion (apart from reinvested earnings), indicating that countries receiving capital were in a better position to measure the flows than the countries where the creditors resided. This bias in the recording of financial flows continues today; at the world level, recorded inflows (liabilities) exceeded outflows (assets) by $122 billion in 1995 (see chart), which is largely related to the recording of portfolio and other investment transactions, excluding direct investment. This surplus of recorded inflows (liabilities) in the financial account is consistent with the sign of the discrepancy on investment

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income transactions, where debits exceed credits.

In December 1989, the IMF's Executive Board authorized a second working party to do a follow-up study of global balance of payments statistics, this time to evaluate statistical recording practices relating to the measurement of international capital flows. Using the international banking statistics compiled by the BIS, the two IMF working parties determined that a substantial part of the global discrepancies in data on investment income and nonbank capital flows was attributable to cross-border activities with nonresident banks. The two groups determined that the BIS statistics were a useful source of information that compilers could use to improve their balance of payments estimates. They recommended that national compilers systematically compare national data on nonbank capital flows (and associated stocks of foreign assets and liabilities) with BIS banking statistics and, where appropriate, use these statistics in compiling balance of payments estimates. By applying appropriate yields to the outstanding positions, compilers are able to derive estimates of interest receipts and payments vis-à-vis banks abroad. The IMF's Statistics Department and its Committee on Balance of Payments Statistics are working with the BIS to refine the international banking statistics to improve these results. Work is also under way to make these statistics more widely available to compilers and to provide compilers with methodological information that will make use of these statistics in balance of payments compilation easier.

A second initiative that could help reduce the large discrepancy in the global financial account and also improve investment income estimates is the 1997 Coordinated Portfolio Investment Survey, which is being organized under the auspices of the IMF in connection with the work program of the IMF's Committee on Balance of Payments Statistics. The Coordinated Survey is the first of its kind in the history of the IMF and it is designed to provide comprehensive information on cross-border holdings of foreign claims (bond and equity securities), which the IMF will disseminate to its member countries. More than 30 countries have indicated that they will participate in the survey.

Merchandise trade

In recent years, merchandise trade has accounted for the second largest discrepancy in the world current account. This discrepancy has increased from less than $20 billion per year, on average, in the 1980s, to $115 billion in 1995—just over 1 percent of gross trade flows. Unlike the other components of the world current account, global data on trade flows show an excess of recorded credits (see table). One reason is the introduction in 1993 of a new trade reporting system in the EU as a consequence of the single European market. On January 1, 1993, Intrastat—a survey of businesses that engage in trade with other EU member states—was introduced to replace the customs-based recording system employed before 1993. The published trade statistics on intra-EU trade show that exports exceeded imports by about $65 billion in 1995 (up from about $40 billion annually in both 1993 and 1994). Eurostat and many other users believe this discrepancy reflects an underestimation of intra-EU imports. Countries are looking into ways to improve the quality of the outputs from the system. Consideration is also being given to a “one flow” system, where the figures collected by one country are used by the partner country as its source of information.

Services

Historically, recorded debits from international services transactions have exceeded corresponding credits. Overall, discrepancies have been relatively small in recent years, but they have widened considerably in certain sectors, notably transport and distribution services (mainly freight and other services). The 1987 current account study determined that while all countries can readily compile the amount paid to foreign-operated carriers to cover freight on imports, several economies with large maritime interests (notably Greece, Hong Kong, and those of Eastern Europe) do not report the corresponding freight earnings.

Current transfers

Lastly, the global balance of payments data on current transfers also show a persistent excess of recorded debits over credits, amounting to $44 billion in 1995. A significant component of this imbalance may be government transfers, such as official aid disbursements, which recipient countries may have difficulties valuing.

References:
International Joint Ventures in Developing Countries

ROBERT MILLER, JACK GLEN, FRED JASPERSEN, AND YANNIS KARMOKOLIAS

International joint ventures offer attractive opportunities, yet they frequently perform unsatisfactorily. Why do they run into trouble, and what can partners and managers do to maximize the chances of success?

Joint ventures between domestic companies in developing countries and foreign companies have become a popular means for both managers to satisfy their objectives. They offer, at least in principle, an opportunity for each partner to benefit significantly from the comparative advantages of the other. Local partners bring knowledge of the domestic market; familiarity with government bureaucracies and regulations; understanding of local labor markets; and, possibly, existing manufacturing facilities. Foreign partners can offer advanced process and product technologies, management know-how; and access to export markets. For either side, the possibility of joining with another company in the new venture lowers capital requirements relative to going it alone.

As attractive as joint ventures might seem, however, they frequently perform unsatisfactorily and are comparatively unstable. This seems to be true even when the partners are two companies from the same industrial country; international joint ventures seem to be more vulnerable still. In a study of the latter (Killing, 1982), for example, 36 percent were rated by participants as having performed poorly—a high proportion indeed. An obvious set of questions therefore arises: If international joint ventures are established to exploit the...
complementary features of each partner, why are the partners frequently disappointed with their joint performance? What problems cause them to be unstable? Can these problems be alleviated to improve these ventures’ prospects for success? On behalf of the International Finance Corporation (IFC), we surveyed joint ventures between domestic companies in developing countries and foreign companies based in industrial countries to try to understand the difficulties that arise in negotiations leading up to a joint venture agreement and those that arise during the venture’s implementation and operation. About 75 joint ventures in 6 countries were included in the study.

**Negotiating agreements**

The managers we contacted expressed mixed feelings about the formal joint venture agreement, with some managers viewing it as a critical element in defining the longer-term relationship and others discounting its significance. The latter group tended to stress that no agreement can work without the good will and dedication of both partners, a point that may be true but that does not diminish the importance of a well-crafted working agreement. The former group, which included the vast majority of managers contacted, believed the agreement to be an essential building block in structuring the joint venture. On the one hand, an indication of the seriousness managers attached to such agreements was that nearly 85 percent of the agreements required at least 6 months, and about 20 percent took more than 18 months, to negotiate. On the other hand, the survey found no relationship between the length of time required to complete an agreement and the partners’ ultimate satisfaction with the venture’s operation.

Two issues were clearly more important in joint venture negotiations than others. First was the equity structure (noted by four-fifths of respondents), which was also viewed as the most difficult issue to negotiate. Control of a joint venture is not something surrendered easily, although, as noted below, majority ownership does not necessarily confer control of all aspects of a joint venture’s operations. Second was the set of conditions for technology transfer, almost always from the industrial country partner. Important aspects include defining precisely what technologies (possibly including technologies not yet developed by either side) are to be covered in the agreement and the terms under which they are to be made available to the venture.

Both sides are aware that payments for technology are an important means of transferring benefits from the venture and of indirectly maintaining control, which inevitably leads to prolonged discussion of technology transfer. Technology providers are interested in protecting their intellectual property and, therefore, want to set limits on where and how the technology can be used by the joint venture and to place restrictions on who controls derivative technologies, no matter where developed. The developing country partners hope to set bounds on the royalties and fees they will have to pay providers, especially as the technology becomes older, and to broaden the joint venture’s control over its use.

There are other problems that frequently arise during negotiations: **Valuation problems.** Each partner brings financial and other assets to the joint venture, and it is often not easy to determine what these assets are worth. One side may bring a going business, which may not have equity shares traded on a secondary market. Or technology may already be incorporated into a product that is to be produced and sold by the venture. What are such assets worth? Such problems are among the most difficult to sort through in negotiations.

**Transparency.** Getting accurate data upon which to base valuations and other decisions can be very difficult in some countries, especially where accounting standards are quite different from international standards. Transparency is a particular problem in former command economies, where, until recently, there have been no real markets for outputs, supplies, or financial instruments.

**Conflict resolution.** Many joint venture agreements spell out how disputes between partners are to be resolved. These provisions are important, since disputes are virtually inevitable in a relationship as complex and dynamic as a joint venture. At the extreme, conflicts can lead to the desire of one partner or the other to dissolve the enterprise, so provisions detailing procedures to be followed in the event of a dissolution are obviously necessary.

**Division of management responsibility and degree of management independence.** There is some evidence that protection of a joint venture’s management from parent company interference is an important determinant of the venture’s success. Attempts by parent companies to micromanage an enterprise that may be thousands of miles away are doomed to failure. A better strategy is for them to set up clear operational parameters and then let the venture’s management succeed or fail on its own.

**Changes in ownership shares.** How should the ownership structure be changed as a joint venture matures? Although most partners agree that they should address this issue early on, rather than waiting for a crisis to occur, it remains a sensitive one. Developing country partners, especially, can be leery of such provisions, which they see as potential death warrants—that is, as vehicles that industrial country partners may, for one reason or another, use to take full control.

**Dividend policy and other financial matters.** Dividend policy goes to the heart of why companies enter into joint ventures, with some companies hoping to expand and gain market share rapidly while others are striving to achieve quick increases in cash flows that they can use to support other operations. Potential conflicts between these differing objectives are best handled when the joint venture agreement is being negotiated.

**Marketing and staffing issues.** Because marketing is so critical to the joint venture’s success, it should not be surprising that it can be a difficult matter to negotiate. From the viewpoint of the local partner’s management, maintaining control over distribution channels and marketing is one way in which its continuing contribution to the joint venture can be assured. Such a view, however, may conflict with the plans of the multinational company (MNC) partner, which may see the joint venture as only part of a larger strategy to enter the developing country market. Similarly, insistence by the MNC partner on control of key positions in the joint venture may be seen by the local partner, first, as overly expensive and, second, as an effort to marginalize it.
Operational problems

Once joint ventures are in operation, they may experience various problems, some of which might have been foreseeable at the time the agreement was negotiated, others of which could not.

Problems related to multinationality. Many joint ventures undertaken in developing countries involve large MNCs that participate in a variety of other joint ventures and run wholly owned subsidiaries elsewhere in the world. The developing country firms that are their joint venture partners, though they may be quite large by local standards, are often dwarfed by their MNC partners. One possible source of difficulty, for example, is the differing basic objectives of the two types of firms. An MNC may hope that the joint venture will operate in a way that will be optimal from the standpoint of its entire global network, not merely within the local market on which its domestic joint venture partner usually focuses. These differing objectives can lead to a variety of disagreements, including the following:

- **Export rights.** Typically, the MNC would prefer not to allow the joint venture to export products, which may be of inferior quality (compared with those it manufactures elsewhere), into markets already served by other manufacturing points in its own system. It therefore favors insertion of strict export limitations into the agreement in such situations. The developing country partner, however, often has quite different ideas, looking to the venture as a natural vehicle for expanding into foreign markets. In most of the agreements we examined, exports were restricted in one way or another (see Boxes 1 and 2).
- **Tax issues.** An MNC generally wishes to minimize its worldwide tax burden. This objective can dramatically affect its relations with a joint venture, especially when the latter either imports parts and components from the MNC or, as is usual, exports products through the MNC parent. The MNC may manipulate transfer prices—that is, the prices charged by one part of the MNC when transferring them to another part—to lower its taxes, a strategy that is not necessarily in the interests of the local partner—a problem frequently mentioned by local partners in our interviews with them.
- **Dividend and investment policies.** The MNC partner may have global investment programs that involve transferring of funds from one region to another. It might, therefore, prefer to receive dividends from the joint venture instead of reinvesting earnings, a position not necessarily compatible with that of its domestic partner. The opposite situation—in which the MNC partner is content to delay dividends in favor of faster expansion, and the local partner demands—also occurs on occasion.

- **Differences in partner size.** The local partner is likely to be considerably smaller than the MNC partner, a difference that can have important consequences for operating the joint venture. MNC managers note, for example, that early, rapid expansion of the venture can require substantial capital infusions that the developing country partner may not be able to provide. It is also true, however, that the joint venture may be far more important to the smaller partner than to the MNC partner; several managers we spoke with noted that the joint ventures they were involved in seemed to be unimportant to the MNC and to have received too little of its attention. The MNC might assign managers to the venture on a rotating basis, allowing too little time for them to become truly effective there.

Ownership and control problems.

One problem that frequently arises in the management of joint ventures occurs when an owner's attitude changes. For example, the local partner might be a closely held family corporation in which the driving force behind formation of the venture has come from the family patriarch, often the founder of the company. Not infrequently, the partner's commitment to the venture changes materially when the patriarch is succeeded by other family members who may not share his original interest. Similar attitudinal shifts can occur in MNC partners when their management, or even their ownership, changes (see Box 2).

There may be other control problems:

- **Product line disputes.** The interests of the two partners diverge over time, with one desiring to extend the current product line while the other demurs.
- **Material and component sourcing.** Local, and possibly cheaper, sources of components can emerge, but the MNC partner, which has been supplying them, remains adamant about continuing the supply relationship unchanged.
- **Technology utilization.** The MNC partner withholds some technologies, to the perceived detriment of the joint venture. Or new technology extensions developed within the venture are prevented from being used more widely by the MNC partner's management.
- **Cultural problems.** Joint venture management often are drawn from different cultures, and misunderstandings can occur for that reason alone. MNC executives assigned to a joint venture can be seen by local nationals as "arrogant" or "narrow-minded" individuals who are not able or willing to comprehend the nuances of the culture where the venture's business is
When joint venture partners disagree

The need for care in negotiating and, when necessary, renegotiating joint venture agreements can be illustrated by briefly describing cases from the International Finance Corporation (IFC) study in which serious disagreements arose between the partners. In one case, a large foreign company that had failed in an attempt to become established in India retreated by forming a joint venture with a local company with roughly comparable products. All worked smoothly until recently, when new management in the foreign partner called for a new strategy that would, once again, involve trying to establish the company on its own. The negotiated agreement between the joint venture partners prevents such an attempt, however, because it reserves to the joint venture any local product manufacturing and sales. No resolution to this dilemma had been found at the time of the IFC's study.

In a second case, a provision in the agreement setting up a joint venture in Turkey to manufacture automotive components called for all export sales to be made through the foreign partner, and this eventually became a constraint for the joint venture. The venture, which made products carrying the foreign company's well-known brand, originally made products for only the domestic market. As time went on, however, the venture's products became internationally competitive, both in quality and in price, and there was perhaps a natural inclination to take advantage of this competitiveness by beginning exports to Europe. Unfortunately, the foreign partner's headquarters and main factories were in Europe, and it had little interest in displacing its own production with Turkish-made items, despite what appeared to be clear cost advantages. Time may change the foreign partner's viewpoint and provide a stronger incentive for modification of the joint venture agreement, but in the meantime, the venture's ability to expand its sales beyond Turkey's borders will remain tightly circumscribed.

Conclusions

Joint venture relationships are often fragile and both difficult to negotiate and, once negotiated, to hold together. Yet many do succeed and, indeed, thrive. Some of the lessons learned in this study are as follows:

- Although no joint venture agreement can serve as a substitute for the commitment of the partners, even deeply committed partners can expect to have conflicts. A suitable agreement, therefore, is a vital component of a successful relationship. Such an agreement does not have to be an overly legalistic document to provide the basis for overcoming these future conflicts in an orderly manner.
- The agreement is best considered as a "living" document, in the sense that among its provisions should be procedures for changing the agreement. Partners need to realize at the outset that their respective comparative advantages in the joint venture can change over time. Such ventures, after all, necessarily entail power relationships. Wise partners make sure that their companies are vital to the venture's success over the long run. It is not sufficient for firms to depend on their intimate knowledge of government affairs or familiarity with local financial markets if they wish to have continuing relevance to the joint venture, since the perceived value of these contributions is bound to erode over time; more substantive advantages—technology, distribution channel control, export control, etc.—will be required.
- Technology transfer is one of the more sensitive and difficult issues confronting joint venture management. Although the relevant provisions of the venture agreement provisions are important in establishing an operational framework, technology is one area where formal provisions cannot serve as an adequate substitute for good will and understanding between the partners.

Agreements need to contain fairly detailed provisions covering dispute resolution and, in the event of failure to reconcile differences, the exit mechanism to be employed in terminating the joint venture. Negotiation of such provisions should not be avoided because of an optimistic belief that good relations will be maintained over the life of the venture, since trying to resolve disputes in an ad hoc fashion can be highly problematic.
Gender bias in tax systems reflects prevailing social norms. Many industrial and some developing countries are reforming their tax systems to reflect changing attitudes about men’s and women’s roles in society.

TAX SYSTEMS reflect a tapestry of decisions, made over many years. These decisions have been influenced by a variety of factors, including social attitudes about the respective roles of men and women. As a result, many tax systems exhibit gender bias—they treat men and women differently in ways that can negatively affect their decisions on whether and how much to work, their personal consumption habits, and their overall tax liability. While it is easier to detect gender bias in personal income tax arrangements, gender bias—explicit and implicit—may be present in other taxes such as consumption taxes and import duties. Gender bias may also be found in the way payments are linked to the receipt of benefits under social insurance programs.

Prompted by changing attitudes, many countries in recent years have reformed their tax systems to reduce gender bias (see Box 1). In the 1980s, for example, several Western European countries reformed their personal income tax laws to eliminate provisions that explicitly discriminated against women. More generally, in industrial countries the personal income tax system based on joint filing by members of the same family unit has given rise to a discussion over how the income tax treats the incomes of secondary earners (generally assumed to be women) and the incentives the income tax has on their work patterns, child bearing, and other behavior.

But reform has not been confined to the industrial countries. Although developing countries as a group have generally been slower to implement reforms than the industrial countries, some have also begun to change their tax systems to address gender bias. As in the industrial countries, these efforts have generally focused on the personal income tax.

Yet, in examining the issue of gender bias, we should not forget that apparent bias may be acceptable in some societies because it accommodates typical social arrangements or encourages certain generally desirable social behavior. In these societies, such provisions are not discriminatory but simply reflect prevailing norms. Moreover, there may be grounds for discriminating between men and women in the tax code that are related to, for example, life expectancy, such as in the tax treatment of pensions and annuities.

Men, women, and income tax

Gender bias may be both explicit and implicit. Explicit forms are specific provisions of the law that treat men and women differently. They are relatively easy to identify, since they depend largely on the language used in the tax code or tax regulations. Implicit forms of gender bias are provisions of the law that, because of typical social arrangements and economic behavior, tend to have different implica-

Box 1

Eliminating gender bias

A number of countries have taken steps to eliminate gender bias in the personal income tax—for example:

- France (1983) moved from requiring only a husband’s signature on family tax returns to requiring that both spouses sign.
- Ireland (1993) moved from joint filing in the name of the husband with an option for separate assessment on labor income for the wife, to an option for the wife to be the “primary taxpayer.”
- Malaysia (1991) moved from a tax system in which the income of a married woman was attributed to her husband unless she elected separate assessment, to a system in which husbands and wives are treated as separate taxable units with an option for joint treatment.
- The Netherlands (1984) moved from granting a higher tax-free allowance to a married man than to a married woman, to an equal basic tax allowance.
- South Africa (1995) moved from applying a higher rate schedule to single persons and married women than to married men, to a unified schedule.

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tions for men and women. It is much more difficult to identify implicit gender bias, because it depends in large part on value judgments as to desirable social and economic behavior, which may vary considerably from society to society and from one time period to another (see Box 2 for an example of the latter).

Explicit and implicit bias

Explicit gender discrimination is more typically found in the personal income tax than in other taxes, because the income tax applies to individuals or family units and therefore more easily accommodates different treatment for men and women. Explicit discrimination can be found in the rules governing the allocation of shared income (such as nonlabor income and income from a family business); the allocation of exemptions, deductions, and other tax preferences; in tax rates; in who files the tax return; and in who pays the tax. It is easiest to detect implicit gender discrimination in the personal income tax, compared with other taxes, since it directly affects labor supply and other behavior.

Income taxes may be global or schedular. Under a global income tax, income is aggregated and typically only one schedule of tax rates applies to it. In contrast, under a schedular system, each type of income faces a different schedule of tax rates. Global income taxes have typically been the source of gender bias and the focus of efforts to eliminate it, particularly in industrial countries. Explicit gender discrimination in a pure schedular income tax is not very common, because the tax liability is established with respect to a particular source of income rather than a particular taxpayer. In countries with a global personal income tax, gender bias may take several forms, including the way in which nonlabor or business income and tax preferences are allocated, tax rates, and the responsibility for complying with the law.

Types of discrimination

The way in which nonlabor income is allocated often entails explicit gender discrimination. Typically, under a system of individual filing, the wage income of married couples is attributed to the worker, while nonlabor income poses a more complex problem since it must be allocated to one or the other spouse. There are, however, several gender-neutral ways to allocate this income, such as attributing all of it to the higher earner, allocating the income equally between the spouses, allowing couples to allocate the income in whatever way they choose, or allocating the income to the spouse with legal ownership of property that is not jointly held.

Many tax codes using individual filing contain explicit gender bias in that they allocate all nonlabor income to the husband regardless of the circumstances. This practice is derived from the English common law tradition in which all income earned by a married couple was assumed to be the property of the husband. This contrasts with the civil law tradition, more prevalent in Latin countries, in which income earned by a married couple during the course of their marriage was considered “community property” (i.e., the property of both spouses). The allocation to the husband may raise the tax on this income, if the husband pays tax at a higher marginal tax rate.

Family business income is also attributed in many countries to the husband regardless of the respective roles of the spouses in the business. While shifting income from a family business to the spouse who pays tax at a lower marginal tax rate is a common means of tax avoidance, there are administrative solutions to this problem that do not require attributing all of the income to the husband.

The allocation of deductions, exemptions, and other tax preferences is another way in which explicit gender discrimination occurs in a system of individual filing. Typically, countries give exemptions or deductions for various purposes, for dependent children, a nonworking spouse, and so on. Under a system of individual filing, these exemptions and deductions must be allocated across spouses. In some countries, the nature of the exemptions and deductions that taxpayers may claim varies according to whether the taxpayer is a man or a woman. This allocation may also affect the tax liability.

Another form of gender discrimination is that countries may levy different tax rates on men and women, with a higher rate being applied to married women, as was done, for instance, in South Africa until 1996.

In some countries, a form of gender discrimination is a requirement that a joint tax return be submitted in the name of the husband; thus, a wife has no separate existence as a taxpayer. For example, until 1990, the British income tax provided for the husband alone to file the joint tax return, as did the French income tax until 1983. Switzerland continues this practice today.

Secondary workers

A system of joint filing with a progressive marginal rate schedule, such as exists in the United States, may discourage secondary workers, because the tax on their income starts at the highest marginal tax rate of the primary income. This so-called “marriage tax” under a system of joint filing has been typically viewed as discriminating against women, although it would, of course, apply equally to a husband if he were the secondary earner.

Studies of income taxation have long taken gender into account by explicitly considering the differences in the labor supply behavior of men and women, and their implications for public policy. These studies suggest that the labor supply response of married women, who are often assumed to be the secondary earners, to the income tax is greater than that of married men. This implies that to minimize the efficiency cost of the income tax, everything else being equal, married women should be taxed at a lower rate than married men.

Steps to reform in industrial countries

In Europe, the issue of gender neutrality in tax systems rose to prominence in the 1980s. A 1984 report of the European Community (EC) (see reference) examined whether EC tax systems were neutral with respect to women’s labor force participation. The main concern was that secondary earners faced a high marginal tax rate under a system of joint filing that would create a disincentive for women to work.

The report concluded that European tax systems had an adverse effect upon married women’s tax burdens in several areas, including joint taxation; granting of allowances or tax reductions a priori to the husband; the lack of an allowance or deduction for the costs incurred in child care and domestic help when both spouses work outside the home; the inability of women to declare their own income for tax; the responsibility for the nonpayment of tax by the other spouse; and limitations on the amount of income that can be paid to an “assisting wife” by a husband.

The report recommended a system of totally independent taxation to achieve equal treatment of men and women and, at the very least, to allow separate assessment as an option. A number of European countries, including France, the Netherlands, and the United Kingdom, have reformed their tax systems to eliminate explicit gender discrimination.

To some, the idea that gender neutrality in personal income taxation requires independent taxation of husband and wife might seem radical. Certainly, explicit discrimination can be eliminated without independent taxation of spouses. But it
is debatable whether the elimination of implicit discrimination requires independent taxation. In contrast to the conclusions of the EC report, many hold the view that the family is the preferable unit of taxation because of the nature of joint consumption within the household. They do not see any inherent conflict between gender equality and joint taxation. Some studies that have examined the treatment of the family under the income tax laws of industrial countries found that there are wide variations as well as areas of similarity. Presumably, these differences reflect value judgments of the different societies about the way they view the family, or they may simply reflect historical inertia.

The US personal income tax has never contained any explicit gender discrimination (except for, at one time, a small difference in child care allowances). Nevertheless, the issue of the appropriate treatment of family income has frequently been the focus of debate, and the tax code has changed over time in its treatment of the couple vis-à-vis the individual. Today, the US tax code provides a clear advantage to a one-earner couple, compared with a two-earner couple. In some cases, the tax code is advantageous to married couples compared with single taxpayers, but, in other cases, is disadvantageous to the former, depending on how the earnings of the spouses are split.

**Developing countries.** Gender discrimination also appears in the tax systems of many developing countries. The most common form is to attribute the income of a married woman to her husband and to levy the tax in the husband's name for any nonschedular income taxes, though a separate assessment of a wife's employment income is allowed in many cases.

Reform has been taking place in some developing countries. For example, until recently, the South African tax system used different rate schedules for married persons, single persons, and married women, applying a higher rate to the latter two categories. These rates were unified in 1995. In Malaysia, the tax system was changed in 1991 from one in which the income of a married woman was attributed to her husband unless she elected for separate assessment, to a system in which husbands and wives are treated as separate taxable units. The wife's income is still reported on the husband's tax return, and joint assessment is still allowed.

Some developing countries have explicit provisions in the income tax code that distinguish men from women so as to accommodate typical social arrangements or to encourage certain social behaviors. Although some observers feel these provisions are not discriminatory and simply reflect prevailing societal norms, others believe these practices legitimate a secondary role for women.

Some developing countries explicitly discriminate in favor of women. For example, Singapore's tax system is unique in the nature of explicit gender differentiation it builds into the income tax in the form of child relief. A basic child relief is available. In addition, a married woman is entitled to additional allowances for children if she has elected to be charged to tax in her own name and has passed at least three subjects in one sitting at the examinations for the General Certificate of Education or has obtained an equivalent or higher educational qualification—a provision whose objective appears to encourage well-educated women to have children. The tax code in Pakistan discriminates in favor of women by allowing a basic exemption that is higher for a working woman than a man, and the tax code in India also contains provisions favoring women.

**Other taxes**

Taxes on goods and services, such as the value-added tax and retail and excise taxes, tend not to show explicit gender bias in that the tax liability is established with respect to the purchase or production of a commodity. The same is true of taxes on foreign trade, such as customs duties. In practice, however, these taxes are not gender neutral and may have certain implicit biases.

There are many ways in which implicit bias could manifest itself in a consumption tax. One way is through the choice of goods and services covered by the tax. Implicit biases may result from different consumption patterns by men and women of these goods, though the exact nature of these implicit biases is difficult to establish. The issue is, in fact, more complicated, since such goods are usually purchased within the context of a household containing both men and women.

Excise taxes tend to have a more obvious implicit bias than broad-based consumption taxes. For instance, excise taxes are typically levied at a high rate on alcohol and tobacco, which are disproportionately consumed by men. Therefore, excises might be viewed as having an implicit bias against men, though, again, in a household context, if other members of the household reduce their consumption of other goods so that men can maintain their consumption of taxed goods, this might lessen the bias against men.

Preferential treatment of particular consumers or producers also might imply gender bias, but, as with preferential treatment of specific goods and services, a lack of neutrality would be difficult to establish. For instance, if nonprofit institutions typically provided services that benefited the
poor disproportionately and the poor consisted mainly of female-headed households, then, implicitly, preferential treatment of nonprofit institutions would be biased toward women and children.

In many countries, import duties are a critical component of the tax system and clearly influence the pattern of economic development. One little-studied issue is whether typical patterns of import duties tend to favor industries that employ primarily men or women. Import duties in industrial countries that discriminate against low-technology goods may tend to be biased against women, because they often account for a large share of factory workers in low-income countries. Import duties in developing countries that discriminate against low-technology goods may tend to favor industries that employ primarily men or women. Import duties in industrial countries that discriminate against low-technology goods may tend to be biased against women, because they often account for a large share of factory workers in low-income countries. Import duties in developing countries that discriminate against low-technology goods may tend to favor industries that employ primarily men or women. Import duties in developing countries might shift development in ways that favor or disfavor women. Similar issues might arise with the tax code.

Grounds for gender bias?

Are there legitimate grounds for discriminating between men and women in the tax code? Perhaps the most pervasive argument used to provide a justification for distinguishing between men and women in the tax code for some purposes is differences in average life expectancy between men and women. For instance, in the US tax code, a deduction is allowed for charitable contributions that take the form of a contribution of property that is effective upon the death of the taxpayer though the taxpayer retains the use of that property and its income until his/her death. At the time of the contribution, the taxpayer is allowed to take a deduction for the present discounted value of that contribution, based upon the taxpayer’s remaining life expectancy. For instance, a woman donating property at the age of 60 might have a life expectancy of 25 years while a man might have a life expectancy of 20 years. Thus, she would discount the donation over a 25-year horizon, and he would do so over a 20-year horizon. Similar issues arise in relation to incomes from pensions and annuities. Men could be required to receive a larger proportion of the total value each year, starting with the age of receipt, since their life expectancy is shorter. Differences in average life expectancy between men and women might also provide an argument in favor of applying different social security tax rates to men and women, providing different benefits for similar contribution histories, or using a different formula for linking tax payments to benefits.

Conclusion

Public finance has only recently fully acknowledged the importance of gender bias in public policies. Gender bias in tax systems is therefore a fruitful area of inquiry. Many nations have tried to eliminate explicit and implicit gender bias in tax systems while others have made little progress. Variation in cultural norms will undoubtedly continue to lead to differences of view as to what constitutes discrimination and the need for change.
Governments are drawing on private initiative and capital to address the deficiencies of water and sewage systems and the need for new facilities. What has their experience been and how can they encourage private investment?

In developing countries, the water and sewage sector is generally financially and operationally weak. A World Bank study of municipal water projects in these countries found that revenues collected by utility companies cover only 35 percent of the cost of water. Unaccounted-for water (UFW)—the difference between net production of water and paid consumption—is in the range of 40-60 percent for many developing country utilities, compared with 10-20 percent for efficiently managed utilities. High rates of UFW reflect leakage as well as inability to bill and collect payments. Public water systems also tend to be overstaffed, often with 10 to 20 employees per 1,000 connections, compared with 2 to 3 employees per 1,000 connections required for efficient operations.

The disregard for commercial pricing and operational principles in the water sector has also prevented utilities from serving the poor. The rationale for continued subsidies has been undermined by findings that the poor often pay 10 times more for water than wealthier households because the poor do not have access to subsidized piped water and instead must rely on private vendors. The continued underpricing of water and wastewater services sends the wrong signals about the growing scarcity of water and the costs of meeting public health and environmental goals by investing in sewage collection and treatment.

The World Bank has estimated that developing countries’ annual financial requirements for water supply and sanitation stand at $60 billion over the next decade. Yet the sector’s fundamental problem arises less from the shortage of financial capital than from the lack of accountability in managing financial and operational resources. Water enterprises generally face weak internal (organizational) and external (regulatory) incentives to perform. The great challenge governments face is to improve these incentives.

Private capital and initiative can help accomplish operational efficiency and investment objectives if two stringent requirements are met: (1) projects must generate revenues that cover operating costs and debt-service payments, and earn a competitive rate of return on equity, and (2) risks that are internal (for example, construction and operation) and external (for example, regulatory and foreign exchange) to a project must be identified and clearly allocated to the parties that are in the best position to mitigate them. With their own capital at risk, lenders and investors have strong financial incentives to ensure that a project is built on time and within budget, and is operationally efficient. Uncovered political and regulatory risks require government attention—in particular, efforts to create and maintain a stable and predictable contractual environment—if projects are to attract private capital.

Is the water sector different?

Like other infrastructure sectors, water and sanitation is characterized by large, sunk investments with long payback periods. But in contrast with the telecommunications and power sectors, there is little or no scope for introducing direct competition in any of the main operational segments—treatment, transmission, or distribution. The sunk investments and natural monopoly characteristics make the water and sanitation sector vulnerable to political expropriation and contracting problems. Also, the mismatch between domestic-currency revenue and international borrowing can create serious foreign exchange risks. Water and sanitation assets have additional institutional and economic features that differentiate them from assets in other infrastructure sectors and pose obstacles to achieving economic feasibility and proper risk allocation. These include the following:

- Increasing demand for public health services and a cleaner environment imply...
A variety of approaches

There is no one correct model for privatizing water and sanitation services, and there has been considerable diversity among countries’ practices (Table 1). A private sponsor may take over an entire utility system (including the production, transmission, and distribution of the service). Alternatively, the utility’s various segments can be split up (unbundled), with, for example, bulk water supply and water and wastewater treatment separated from the distribution to retail consumers.

Privatization of the sector has been limited in some countries, such as Chile—which has been in the vanguard of privatization in other sectors—and the United States, where all other utility services are, for the most part, privately provided. In contrast, certain African countries—Côte d’Ivoire and Guinea, for example—have long traditions of private participation in water and sanitation. Recently, Argentina and Malaysia have been at the forefront of developing countries in privatizing water services; in the developed world, the United Kingdom has led the way.

In some countries—Australia, Chile, and Thailand—governments have used corporatization strategies to transform water and sanitation systems into financially independent enterprises that operate along commercial lines. Especially in Chile, corporatization has been combined with short-term service contracts with private service providers—such contracts can be used to delegate responsibility to the private sector for providing a narrow service (for example, meter installation). Broader responsibilities for the operations and maintenance (O&M) of a treatment facility or an entire water or sanitation system may be transferred to a private company with a fixed-fee O&M contract. With a lease contract, a private company is delegated responsibility for operations and tariff collection, but not capital financing.

Management and lease contracts have one major shortcoming: they do not assign full commercial risks to the operator—in particular, private capital investments are not at risk.

Long-term arrangements—build-operate-transfer (BOT) contracts for specific water supply/treatment projects (see box) and full-utility concessions—bring not only private management but also private investment. Projects under BOO/BOT contracts sell specific services to a municipal utility. In contrast, all facets of the system, especially distribution to consumers, become the private operator’s responsibility under a full-utility concession. Assigning all the commercial risk to the private sector heightens performance incentives—but a predictable contractual environment is required to successfully attract private capital.

Case studies

Several examples illustrate how these alternative approaches work in practice, indicating both the potential for success and the nature of problems they encounter.

Guinea, a West African nation with a low per capita income, has achieved solid improvements in its water systems under a lease contract with a private operator. A subsidy arrangement was used to ease the transition to higher tariffs. Recently, however, coordination problems with the government have resulted from lack of clarity in the allocation of commercial risks. The high tariffs have also resulted in serious nonpayment problems.

Mexico City provides an example of an incremental approach. The government awarded 10-year management contracts for each quadrant of the city to four separate private companies. In three phases, the contractors are responsible for undertaking a census of the users and installing meters, billing and collecting tariffs, and rehabilitating the system. They are paid fixed fees by the government. Once the system is financially and operationally in order, the government is expected to award concessions. The devaluation of the peso in December 1994 caused serious financial strain—since operator fees and equipment...
Some countries have taken the bigger step of awarding concessions for operating an entire utility system. In Argentina, the city of Buenos Aires delegated the management and investment responsibility for its water and sanitation systems to a private consortium.

Under the terms of the 30-year concession, the consortium will invest $4 billion in upgrading, rehabilitating, and extending the systems. In three years, the private operator has brought dramatic operational and financial improvements through reduced UFW and higher bill-collection rates. This successful outcome can be traced to the significant steps the Argentine government took to ensure that the concession would be financially viable: raising tariffs prior to privatization, assuming the state water companies' liabilities, financing a voluntary retirement program, providing a guarantee that the concession company could cut off service to consumers for nonpayment, and creating an independent regulatory authority to prevent politicization of the concession. Soon after the award of the concession, however, tariffs had to be raised ahead of schedule because the government agreed with the operator's view that the physical state of the systems was worse than anticipated.

In Malaysia, the government signed a novel and ambitious 28-year concession with a private consortium to upgrade, rehabilitate, and extend the entire country's sewerage system. Although the estimated $2.8 billion contract was awarded in 1993, progress has been slow, primarily because of significant public and commercial backlash from tariff collection and tariff increases. Malaysia's experience points to the unique risk allocation issues raised by private provision of retail sanitation services in instances where these services have never been centrally provided before, the legal right to cut off service for nonpayment is absent, and sewerage and water services are billed separately.

A step beyond concessions is the full privatization of utilities' assets, which brings with it both the benefits provided by the assumption of full commercial risk and the discipline exerted by capital markets. The $5 billion public share offering of 10 regional water authorities in England and Wales in 1989 is the most prominent example of this approach. The British government's decision to sell these assets was influenced by a number of factors, including the $40 billion investment program the water authorities needed to undertake to meet the EU's environmental standards; the confidence in the new independent regulatory structure, and the existence of highly developed local capital markets. While successful in many respects, the privatization in England and Wales has been criticized for leading to rapid and substantial increases in tariffs and an absence of metering. More gradual privatizations are going on elsewhere—in Thailand, the East Water Company is expected to be listed on the Bangkok stock exchange during 1997.

Financing private investment

Financing of BOT/BOO and full-utility concessions has followed the limited-recourse project finance model, which means that before providing debt finance, lenders appraise a project's ability to generate cash flow rather than the sponsor's balance sheet. The key mechanisms for attracting private capital are the underlying contracts and security agreements that identify a potentially secure revenue stream. The financial structure, sources of financing, and terms of lending for projects depend primarily on the risk and cash profiles of the project (Table 2).

BOT/BOO projects. As for traditional independent power projects, the cash flows for BOT projects are contractually predetermined, often with government backing. Though construction risk exists, the absence of market risk—and, hence, the relative certainty of payment—means that BOTs/BOOs can be financially attractive and structured with more debt than full-utility concessions, whose cash flows may be less predictable. Also, construction risks can be mitigated when a discrete facility already generating cash flows is taken over for expansion by the private sector. This was the case of the 20-year BOT in Johor, Malaysia, that covers responsibility for operating an existing treatment water plant and financing its expansion. As a result of the attractive cash flow profile of the project, the state government's strong commitment to privatization, and the availability of long-term local finance at reasonable rates, financing for the $284 million project was raised in record time—three months after the concession was signed.

Full-utility concessions. Full-utility concessions can also be attractive to lenders, since existing revenue streams can be used immediately to service debt, thereby mitigating construction risk. In addition, over time, an established utility can benefit from both a steady flow of revenues from a diversified customer base and, if it integrates horizontally, from a diversified asset base. By creating a more robust balance sheet, these revenues may permit the utility to obtain financing internally as well as to use capital markets to sell long-term debt.

Managing project risks

The considerable uncertainty regarding the asset value and the costs of rehabilitation and expansion in the water sector indicates that the regulatory risks faced by lenders and investors can be significant. Where the contractual and payment responsibility falls on financially weak municipal governments rather than on sovereign governments, political and regulatory risks are accentuated, and credit risks are created. Also, because water and sanitation projects rarely generate foreign

**BOT/BOO projects: A step forward or a diversion?**

Build own-transfer (BOT) or build own-operate (BOO) contracts shift the responsibility for financing, building, and operating discrete facilities, such as water or wastewater treatment plants, from the government to the private sector. These contracts are particularly attractive for countries with an urgent need to treat water or sewage but little capital to finance projects. Australia, Malaysia, Mexico, and, recently, China and Thailand have adopted this approach. From the perspective of government officials, BOT/BOO contracts have two attractions: they are efficient mechanisms for rapidly organizing private capital and management to provide a narrow set of priority services, and they do so in a way that does not affect the overall utility system's organization and employees.

As this perspective suggests, the problem with BOT/BOO contracts is that they do not and cannot address a utility's fundamental operating deficiencies—leaks in the water distribution system, overstaffing, and poor tariff collection—and thus are not capable of transforming financially weak utilities into strong ones. Often because of these very same problems, many state-owned water utilities are not creditworthy, and consequently the implementation of BOT/BOO contracts requires a third party to provide credit support. Hence, by diverting attention from more fundamental problems, the use of BOT/BOO contracts may delay much-needed system-wide improvements.
exchange, financing projects with foreigncurrency-denominated debt exposes lenders to foreign exchange risk—the risk that exchange rate depreciation may prevent the timely repayment of hard currency debt. Consequently, finding long-term debt at reasonable interest rates can be especially difficult for water and sanitation projects.

Project risks have been managed or mitigated in different ways. First, to address sovereign risks, debt for privately financed water projects has tended to originate from commercial banks, export credit agencies (ECAs), and multilateral institutions (for example, the IFC was a source of direct experience in Buenos Aires) owing to their ability to assess and mitigate these types of risks. Investors participating in capital markets are generally not able to do this, although established sewer and water projects should soon be able to tap capital markets. Second, lenders, as well as the government, gain comfort from the fact that equity is provided by experienced operators.

Finally, third-party and sovereign government credit support has been used to address municipal nonpayment risks. In Guadalajara and Puerto Vallarta, Mexico, credit enhancement provided by the federal development bank BANOBRA was instrumental in the successful financing of two BOT wastewater treatment plants. Similarly, in the $800 million BOT project in Izmit, Turkey, the weak credit position of the city required the Turkish government to stand behind the local government’s obligation to purchase water from the private bulk water producing company. And in Buenos Aires, the government of Argentina’s guarantee to pay compensation if the concession should be terminated early was the chief form of security for lenders.

Reducing risk

Sound due diligence, effective incentives, and credit enhancements are not sufficient. Ongoing mitigation of risk requires clear, predictable, and fair rules to secure long-term private capital at reasonable rates. For full-utility concessions and BOT/BOO contracts, the rules governing private participation are embedded in the concession agreement. This document acts as security for the significant amounts of capital and effort that project developers and lenders put at risk. Consequently, the credibility of this document—whether it can uphold the expectations of both parties—turns on the ability of a country’s legal institutions to enforce contracts and arbitrate disputes fairly.

Three of the most important risks that concession agreements address are the timing and level of the investment program, how and when tariffs will be adjusted, and valuation of assets in case of early contract termination. Better information and sound renegotiation and adjustment procedures are two important responses to these forms of uncertainty. Transparent and competitive bidding procedures have been shown to be efficient mechanisms for discovering information on appropriate performance targets, selecting qualified operators, and setting the right tariff levels.

The contractual and regulatory risk faced by private investors and operators increases as the level of involvement by private initiative and capital increases. Thus, the continuity and predictability of the contractual and regulatory framework is more critical for full-utility concessions than for BOTs (and for asset sales than for full-utility concessions). Countries with more developed administrative capacity, such as Argentina and the United Kingdom, have established independent regulatory authorities to achieve these important objectives. While the long-term solution is greater transparency and adequate adjudication mechanisms, in the near term, addressing these risks may require continued participation of multilateral and bilateral organizations through their assistance with the design of policy and regulation, and their provision of debt finance and partial risk guarantees.

Conclusion

Successfully attracting and securing long-term private capital in developing countries’ water and sanitation sectors depends on the simultaneous development of a number of institutions, including creditworthy local governments, independent regulatory agencies, and deeper and broader local capital markets. Nevertheless, depending on the political and economic realities facing a given water or sewage system, a variety of approaches are available to help it become an operationally efficient and financially self-sustaining commercial enterprise.

A few broad conclusions can be drawn from the limited but growing number of projects that have been structured with private capital:

- government political and financial commitment are essential;
- a contractual and regulatory structure that minimizes uncertainty and provides flexibility in renegotiation and operational autonomy is required;
- transparent competitive tendering is an important tool with which to generate information on asset values, tariff levels, and qualified operators;
- full-utility concessions and asset sales provide the broadest scope for operational and financial improvements; and
- where concessions and asset sales are not possible, utilities can be corporatized or operations and management contracts awarded to improve services and revenue streams in preparation for privatization.

This article is derived from the authors forthcoming World Bank discussion paper, “Private Capital in Water and Sanitation.”
Many economists have long believed that income disparities increase in the early stages of development, making the poor relatively worse off. Recent research suggests that an unequal distribution of income can hamper growth. What does the evidence show?

Economists have long sought to understand the links between economic growth and income distribution. The main issues, listed below, have important policy implications for developing countries:

- In countries with low levels of development, does economic growth result in a more unequal distribution of income, and is it necessary for per capita income to reach a certain minimum level before income inequality begins to decrease?
- Do countries with unequal income distributions experience slower economic growth than more egalitarian countries?
- Should governments consider adopting redistributive policies to improve the situation of the poor?

Why the links matter

Different assumptions about the links between growth and inequality produce different outcomes for the poor, as illustrated in Chart 1. The base scenario, represented by the top line, assumes an egalitarian economy where the poorest group's share of total income does not change over a 60-year period. In this case, economic growth (we assume a rate of 4 percent a year) would raise the incomes of the poor.

The second scenario (represented by the middle line in Chart 1) is based on the famous Kuznets hypothesis, first formulated by Simon Kuznets more than 40 years ago. This hypothesis suggests that, at low levels of per capita income, inequality increases with rising per capita income and decreases only in the later stages of development—resulting in an inverted U-shaped relationship between per capita income and income inequality—based on a model where individuals migrate from a low-wage rural sector with little inequality to an urban sector characterized by high income inequality and high average income. In this scenario, the poorest group's share of total income would decrease as economic growth takes off and would not be restored to initial levels for 60 years; as a result, the poor's per capita incomes are lower by an average of 10 percent over two generations.

Recent research has also identified a negative relationship between initial inequality and subsequent growth (see Deininger and Squire, 1996). The scenario represented by the bottom line in Chart 1 assumes a significantly higher level of initial inequality—20 points higher in terms of the Gini coefficient. (The Gini coefficient, a measure of the extent to which actual income distribution in a country differs from a hypothetical uniform distribution, goes from 0, for absolute equality, with each individual or household receiving an identical share of income, to 100, which indicates that one person or household receives all the income.) In this scenario, the rate of annual income growth would drop to 2.7 percent, and, at the end of our hypothetical 60-year period, the per capita income of the poor would be less than half of what it would be in a more egalitarian distribution. This would be true even if the Kuznets hypothesis did not hold.

Such large differences in outcome have far-reaching implications for government...
policies. However, these simulations draw on available empirical analysis, much of which suffers from an important shortcoming—it is based on a very limited amount of data, and these data are often of unacceptably low quality.

The data

To be acceptable, data on income distribution need to satisfy three criteria.

They should be based on nationally representative surveys rather than synthetic estimates built up from national accounts data and general assumptions regarding the distribution of income across occupations or in other countries at a similar stage of economic development. Such synthetic estimates, prevalent in early studies, are unacceptable, since they presuppose the existence of the relationships that are to be tested in subsequent empirical analysis.

They should cover the entire population rather than subsets, such as urban or rural dwellers. Partial coverage, which is often misleading, is particularly common in Latin America, where many countries collect information only for the urban population. In Peru, for example, the Gini coefficient for rural households is 32, compared with 42 for urban households. In South Africa, the Gini coefficient for the white population is 48, compared with 62 for the whole population.

They should encompass all types of income, including nonwage income and income from household production. As tax records and labor force statistics are more commonly available than detailed data from household surveys, many of the figures used in the literature refer to wage or taxable income. We found that this generally overstates the Gini coefficient by about 15 points and, to the degree that data on wage income in the early years are complemented with data on total income in later years, may give the appearance of a spurious decrease in inequality. Own production is particularly important for low-income groups in developing countries. Even in Greece, in 1974, household production (e.g., of vegetables and clothing) accounted for more than 70 percent of the income of the lowest decile of the population. Whether or not own consumption is included will, therefore, have considerable impact on the inequality measure obtained.

Although the above criteria are easily agreed upon in principle, applying them consistently to the available data reduces the number of “acceptable” observations to a point where meaningful empirical analysis is no longer possible. To overcome these constraints, we adopted a two-pronged strategy.

On the one hand, we expanded the data set on income distribution by adding new observations from primary survey data, official statistical publications, and research papers. This enabled us to increase the number of acceptable observations. It also yielded 56 countries for which 4 or more consistently defined observations are available, thus for the first time allowing at least some inferences regarding changes over time of income distribution within countries. However, it did not solve the problem of limited data availability for the 1960s, which makes it difficult to assess the impact of initial income distribution on subsequent growth.

To deal with this shortcoming, we complemented our data on income inequality with information on the distribution of land holdings, which provides a better measure of initial distribution. Information on the distribution of land in 1960 is available for a much larger number of countries (73) than is information on the initial distribution of income (12). It is attractive also from a conceptual point of view, because it gives us a solid indication of asset distribution and thus enables us to make inferences regarding access to formal credit.

What do the data reveal?

First, income inequality is much greater in Latin America and sub-Saharan Africa, which have Gini coefficients in the upper 40s, than in East and South Asia, which have Gini coefficients in the middle-to-upper 30s. The OECD countries, in general, have relatively egalitarian distributions of income, with Gini coefficients around 30, while the Eastern European countries have historically had very low Gini coefficients. Measures of inequality tend to be quite different across regions but to remain relatively stable within regions and individual countries, regardless of the considerable changes in aggregate income that have taken place.

Second, land distribution and income distribution are not the same. India, Indonesia, and Korea are all characterized by Gini coefficients for income in the 30s, but the coefficients for land distribution are 63, 55, and 35, respectively. Similarly, Thailand, Tunisia, and Peru all have Gini coefficients for income in the 40s, but the coefficients for land distribution are 45, 64, and 93, respectively. This suggests that tests of the negative relationship between initial inequality and subsequent growth may yield different results depending on whether initial inequality is measured in terms of income or land.

Third, aggregate measures of distribution may hide movements in the incomes of different groups. Thus, the observation that overall inequality may remain relatively stable over time can be consistent with considerable change in the shares of total income received by individual groups. And since we are primarily interested in assessing the impact of economic growth on the
poor, it is important to complement the analysis of overall changes in income with a more detailed assessment of the welfare of the bottom quintiles of the population.

**Results**

The new data provide a basis for more detailed research on these issues and also allow us to answer the three questions posed at the beginning of this article.

**Does inequality increase in the early stages of development and then decline, as predicted by Kuznets?** The Kuznets hypothesis has spawned a vast empirical literature, much of it driven by concern that development hurts the poor. Empirical analysis of this issue has been hampered not only by the quality of the underlying data but also because what is really a relationship over time has, for lack of data, usually been tested using cross-country evidence. Researchers have used variations in per capita incomes across countries to represent increases in per capita income over time within a country. Using our data, we are able to test for the Kuznets curve within countries and find no evidence of a linear trend in only a few countries. Even when it exists, the trend rarely conforms to the Kuznets hypothesis.

We can take the analysis one step further to make more direct inferences regarding the relationship between growth and poverty. Examining the relationship between overall growth and changes in the incomes of the bottom quintile of the population during 10-year periods, we find little systematic relationship between overall growth and changes in inequality. Periods of growth are associated with an increase in inequality almost as often (43 cases) as with a decrease in inequality (45 cases). In contrast, we find a strong systematic relationship between overall growth and growth in the income of the poorest quintile; the latter increased in more than 85 percent of 91 cases. This would suggest that even when inequality has worsened, its negative effect on the poor has been more than outweighed by the positive effect of growth.

**Do more egalitarian countries grow faster?** If economic growth does benefit the poor, then a focus on factors that increase growth would be warranted from an equity perspective as well as from a development perspective. Recent empirical work indicates that there may be a negative relationship between initial inequality and future growth. If confirmed, this would imply that unequal economies will experience lower rates of growth and, in general, lower rates of poverty reduction.

To investigate the effect of initial inequality on long-term growth, we look at determinants of growth rates for 1960–92. Because acceptable data on income inequality prior to 1960 are scarce, we use country averages of observations for the entire period. We also use the distribution of land, for which more observations of acceptable quality are available before 1960. While the results confirm a negative link between initial income inequality and subsequent growth, they suggest that this relationship is not very strong. By contrast, initial inequality of assets, as measured by the distribution of land, exerts a significant negative effect on subsequent growth (Chart 2). Only 2 of the 15 developing countries with a Gini coefficient for land distribution in excess of 70 grew more than 2.5 percent annually during 1960–92.

What are the mechanisms through which an unequal initial distribution of assets or income might affect subsequent growth? One possible mechanism is political—that is, poor people may vote in favor of redistributive taxes that reduce investment incentives. If this were the case, one would expect higher taxes and lower investment in democratic—but not in undemocratic—countries with a more unequal distribution of income. The evidence does not support this theory, however. Clearly, other forces are at work.

A second possible mechanism is that the effects of inequality—primarily of assets—are transmitted through financial markets. Access to credit is conditional on ownership of assets—for example, land—that can be used as collateral. If certain investments in physical or human capital (for example, in basic education) are affected by individuals’ access to credit markets, then the distribution of assets in an economy, in addition to the mean income, will determine how many individuals are able to undertake such investments. In more unequal economies, fewer individuals would be able to make such investments, resulting in lower stocks of human and physical capital and, as a consequence, lower growth.

Two pieces of evidence provide support for this line of argument. First, although initial (land) inequality is an important factor reducing future growth in developing countries, it does not have a significant
Effect in OECD countries. In the latter, poverty is rarely a reason for non-attendance of primary schools; per capita incomes are higher, so that even relatively poor households can finance a broader range of investment without recourse to credit; and land is less important as a form of collateral. Second, we find that initial (land) inequality is significantly and negatively related to the average educational attainment in the population. Thus, the evidence suggests that credit markets, not the political system, should be seriously considered as a mechanism through which inequality slows economic growth.

Should policymakers seeking to reduce poverty redistribute existing assets or create new ones? Our analysis shows that the poor generally benefit from growth-enhancing policies, specifically investment. It also suggests that, given the growth-reducing effect of initial inequality, the poorest groups in a country may benefit from redistribution. What is the relative importance of accumulation compared with redistribution?

Initial land inequality has a significant impact on income growth for all population groups except the top quintile. But investment, which is associated with significantly higher income growth for all groups, appears to have an even greater impact on the income of the poor. Although increased investment coupled with a redistribution of assets would appear to provide the greatest benefits to the poor, pursuing a redistributive strategy at the expense of investment could actually decrease the income of the poor. Therefore, in situations where redistribution of assets is either not feasible for political reasons or too costly, creation of new assets would be a more promising avenue for improving the welfare of the poor.

Conclusion

Using a new and improved cross-country data set on inequality to examine the dynamics of growth and poverty reduction, we reached three main conclusions. First, policymakers should certainly pay attention to the distribution consequences of different policy options, the fear that economic growth on its own will have a systematic negative effect on the distribution of income is unfounded. Second, unequal distribution of assets, more than of income, can be an impediment to rapid growth, implying that redistributive policies that enhance people's access to credit markets and, thus, their ability to invest could contribute to growth. Third, although redistributive policies have the potential to benefit the poor both directly and indirectly, they will do so only if redistribution does not jeopardize investment—this may be one explanation for the observation that, in the past, redistributive policies such as land reform have often failed to help the poor. If countries want to implement redistributive policies, their ability to devise mechanisms that would at the same time maintain or increase investment incentives may well determine whether such policies help with poverty reduction.

References:
Banking Crises in the Baltics
ALEX FLEMING, LILY CHU, AND MARIE-RENEE BAKKER

Banking crises in the Baltic countries have threatened the nascent recovery of their economies. But their banking sectors have emerged generally stronger as a result of the experience.

The Baltic Republics of Estonia, Latvia, and Lithuania are in the vanguard of the transition economies. The first fruits of their reform programs are now being seen in the revival of growth. But there are a number of factors that have threatened to derail the fledgling recovery. All three republics have experienced serious banking crises, which have set in train a process of structural change in their banking systems, and have, in some instances, had adverse political and economic repercussions.

The Baltic countries inherited the Soviet monobank system under which specialized state banks serviced specific branches of the economy. All three countries moved quickly to establish a two-tier banking system with the central bank at the core. None of the Baltic countries had personnel skilled in modern banking practices or an appropriate legal, regulatory, and supervisory framework. Moreover, a strategy had to be devised to handle the remnant of the Soviet banking system. At the same time, the Baltic countries had to face the twin challenges of encouraging the new private banking sector while ensuring that its growth took place in a prudent manner.

Initially, the three countries took different approaches. In Estonia and Lithuania, the specialized Soviet-era banks were reconstituted as state banks and then gradually or partially privatized. In Latvia, in contrast, the Savings Bank was reconstituted as a state bank but the branches of the remaining Soviet-era banks were privatized. Remaining banks were merged, rehabilitated, and then offered for privatization.

All three countries have had extremely liberal policies toward the licensing of new commercial banks. A large number of banks, it was thought, would quickly generate the competition needed to drive down deposit and lending rates and provide the lending needed to support the emerging private sector. Many new private banks were established by enterprises to gain access to a preferential and much cheaper source of funding than was available from existing banking institutions. Little thought was given initially to the implications of this policy for bank soundness and supervision.

How the crises arose
Banking crises, mainly involving private banks, surfaced in Estonia in 1992, in Latvia in early 1995, and in Lithuania in late 1995. There were many causes, some of which—systemic in nature—had been eating away at the fabric of these banking systems for some time. For example, falling inflation was a prominent factor in all three countries, which helped make borrower distress more apparent while simultaneously squeezing banks' intermediation margins. But in each country, different events led to the crises and different triggers brought them to a head.

In Estonia, the proximate causes of the crisis were the freezing of the assets in Moscow of two important Estonian banks, and the drying up of cheap credit from the central bank, which had previously provided Estonian banks with significant profits and liquidity. In Latvia, the waning of highly profitable trade-financing opportunities, as well as general mismanagement and corruption, set the stage for the crisis. It was set off by the central bank's requirement that banks be properly audited using International Audit Standards (IAS) principles. Bank profits in Lithuania were also...
compressed owing to the contraction of lucrative trade financing opportunities. Moreover, the government pressed some banks (both state-owned and private) to lend to the public sector to finance quasi-fiscal expenditures. Leaks of the results of on-site examinations of two banks, showing deep insolvency, led to runs on those banks and liquidity shortages.

**Underlying causes**

Broadly, there were four systemic factors underlying the crises: poor regulation and supervision, poor accounting and excessive taxation, an inadequate legal infrastructure for lending, and pervasive corruption coupled with weak banking skills and management. The stresses and strains of the economic transition and stabilization also exposed the banks’ underlying weaknesses. To some extent these factors are interrelated. For instance, the transition environment has unleashed profiteering in many segments of society, including the banking industry. While much of it reflected entrepreneurial zest, some of it spilled over into illegal and unsavory activities. In some instances, weaknesses in bank regulation and supervision created incentives for corruption.

The transition from central planning to a market-based system also exposed the structural deficiencies in the banking sector and the regulatory environment. The very tight macroeconomic policy framework pursued in all three countries created an environment that was not propitious for an emerging banking system. Banks, their customers, and bank supervisors were unable to monitor and control the risks inherent in the new policy environment.

**Bank regulation and supervision.**

A contributory factor to all three banking crises was the failure of banking regulation and supervision. In Latvia, deficiencies in the regulatory framework itself contributed to the crises, although there were also some weaknesses in implementation. In Lithuania, the culprit was deficiencies in the implementation of regulations—enough when bank supervisors had identified problems, they were not acted upon. In Estonia, the legal, regulatory, and supervisory framework was very underdeveloped at the time of the crisis, but it was less important as a cause of crisis than in the other two countries.

The licensing and regulatory regimes in the three countries did not discourage the entry of foreign banks. The Lithuanian central bank may nonetheless have discouraged foreign banks from entering the local market. Arguably in Estonia—where nine foreign banks have entered the market in recent years—banking discipline may have been more quickly embedded in the system.

**Accounting and taxation.** Initially, banks in the Baltics continued to use the old Soviet Gosbank chart of accounts. In Estonia, banks were required to use IAS for the first time in 1995, although the better banks had begun doing so in 1993. In Latvia, the introduction of IAS accounting and reporting requirements began in 1994—indeed, this requirement precipitated the country’s banking crisis. In Lithuania, a number of changes in bank accounting and prudential rules have been introduced gradually over the last three years, but full IAS compliance was expected only as of January 1, 1997. The initial absence of and unfamiliarity with IAS-based accounting systems in the Baltics has made it more difficult for bank managers, shareholders, and supervisors alike to accurately gauge the solvency and liquidity problems building up in individual banks. Even though most of the Baltic banks were quick to have international auditors undertake IAS audits, these audits have not served as the early warning signals they were intended to be and often have been ignored altogether by the supervisors.

Perhaps more important, while all three countries moved quickly to introduce loan-loss classification and provisioning rules, in practice these rules were often not applied (loan-loss provisions were not actually booked), as the tax rules did not allow any deduction for loan-loss provision expenses. The distinction between supervisory and tax accounting was an unknown concept in the Baltic countries, making it unattractive for banks to actually book loan-loss provisions. While the better banks nevertheless used profit-and-loss data after hypothetical provisioning to determine dividend payouts and the more corrupt ones actively used this loophole to drain funds through large dividend payouts from nonexistent profits, all banks—prudent and imprudent alike—were taxed on fictitious profits as a result of this deficiency in the tax regime. The problem was rectified only relatively late in the transition in Estonia and in Latvia, and Lithuania introduced a scheme at the end of 1994, which was to be phased in over three years.

**Legal infrastructure.** In the Baltic countries, there was initially no legal framework to support bank lending. There was no appropriate legislation relating to bankruptcy and collateral; well-functioning property title, mortgage and pledge registries; or, more generally, a market for land and real estate. Another important omission was corporate governance and accountability for banks that specified the duties and responsibilities of bank shareholders, supervisory board members, and managers. This allowed shareholders to manipulate supervisory board members and, through them, managers to serve their own interests. All of these factors—most of which have been or are being addressed—contributed to the riskiness of bank lending.

**Corruption and weak management.** In all three Baltic countries, some banks were created as captive funding mechanisms by groups of enterprises and individuals—raising funds directly from the public was cheaper than borrowing from banks. In other cases, owners and managers tried to make quick profits by making high-risk loans or by assuming large open foreign exchange positions. This behavior was encouraged by the knowledge that the supervisory authority was inexperienced and understaffed, and lacked effective enforcement powers. The lack of skills among bank managers and other staff also led to poor decision making.

**The policy response**

All three countries were, for the most part, ill prepared for the banking crises that erupted. Their immediate responses differed significantly. In Estonia, the government announced very quickly that there would be no bailout. Although Estonia’s currency board arrangement did allow the central bank to provide credit in a banking crisis, the central bank and the IMF took the view that the large scale of an eventual bailout would be inflationary and would undermine the fixed exchange rate. Thus, the central bank liquidated one bank whose problems were primarily caused by mismanagement. Two other banks, which suffered liquidity problems owing to the freezing of their assets by the Moscow
Vnesheconombank, were merged, and ownership was taken over by the government. The central bank instituted a licensing review and strengthened supervision. A new Law on Credit Institutions was passed in December 1994, increasing the central bank's supervision and enforcement capabilities, and requiring all banks to develop internal auditing departments and to be audited annually by external auditors. Starting in 1995, all banks were required to use IAS for their financial statements.

In 1995, Latvia's central bank initially provided a modest amount of liquidity support for a large private bank that was at the center of the banking crisis, but when it became clear that the bank's negative net worth had reached 7 percent of GDP, no further support was provided. Drawn-out negotiations between the central bank (which lacked formal enforcement powers) and the bank in question ensued, which allowed the latter's managers and owners to strip the bank of its assets. Finally, the bank was declared insolvent and the central bank took over its management.

The Latvian authorities had to deal not only with the immediate management of the crisis but also with the crisis of confidence in the banking sector at large. Urgent changes in the legal, regulatory, supervisory, and institutional framework were made. To restore confidence in the banking sector, the government promised to compensate household depositors who lost funds in failed banks with an initial amount of up to Lat 500 ($1,000) per depositor. During the subsequent three years, depositors were to receive an additional Lat 100 ($200) per year. However, with a new government in place and given the tight state budget, compensation now will most likely depend on recoveries from assets in banks under liquidation. A new Commercial Banking Law—much more detailed and inclusive than the 1992 statute—was enacted in October 1995. The central bank subsequently hired additional supervisory staff, moved to tighten prudential regulations, required banks to establish internal control departments, and arranged for external accounting firms to supplement the work of its own on-site examiners.

In Lithuania, the crisis unfolded over a longer period of time and involved a larger number of banks (both private and state-owned) than in the other two countries, yet the authorities' response was less decisive than in Latvia and Estonia. The Lithuanian government initially provided unconditional support to troubled banks without removing their managements or suspending shareholders' rights, thereby signaling that there would be few if any penalties for imprudent behavior. The policy response to the full-blown crisis that occurred later initially appeared more forthright. This time, however, the government's hands were partially tied by the passage by parliament of a number of emergency pieces of legislation, as well as a new deposit insurance law.

The emergency legislation required the government to lift moratoriums on private banks, which had been imposed earlier, and to ensure that no depositor lost money. In addition, legislation was passed allowing the government to extend up to Litai 300 million ($75 million) in guarantees for interbank borrowing to address liquidity problems in other banks. This scheme was conceived as a substitute for the lender-of-last-resort function of the central bank, which could provide only very limited liquidity support under the currency board arrangement. The scheme did not specify, however, which banks would be eligible for such assistance, again sending a signal to the banking community that government support would not distinguish between prudent and imprudent banks. Parliament also adopted a law requiring the government to provide compensation retroactively to individual depositors in all smaller banks in bankruptcy of up to Litai 2,000 per person ($500).

Notwithstanding these constraints, the government, with the assistance of the World Bank and the IMF, subsequently drew up a detailed bank restructuring plan, which to date has only been partially implemented. This plan envisaged full recapitalization and renationalization of the majority state-owned banks, liquidation or a combination of existing shareholder and government support for private banks, and the transfer of bad loans to a newly created government-owned asset-management institution. Longer-term measures to further strengthen banking legislation, regulation, and supervision, as well as to improve corporate governance in the banks, are also envisaged in the bank restructuring plan. The new government, which was elected in October 1996, is currently in the process of formulating its own policy in the area of banking.

**Lessons learned**

A number of conclusions can be drawn from the Baltic countries' experiences. They may have implications for banking reform in other countries of the former Soviet Union, especially smaller ones. However, owing to the very specific nature of banking sector distress in transition economies, these conclusions should not be seen as having across-the-board validity for banking crises in more developed economies.

Some banking distress is inevitable. Banking distress is inevitable in countries that have had no recent experience of market-based banking. This comes from the confluence of risk factors that put pressure on the fledgling banking sector. However, it also arises from some of the structural features of the emerging banking systems in the countries of the former Soviet Union, in particular, the existence of a plethora of poorly capitalized banks that are vulnerable because their capital is small and that, because of their size, have not reaped the benefits of portfolio diversification. Also, new banks are often too small to afford the investment in infrastructure that is needed to offer modern services. State-owned banks are invariably overstuffed, and this drives up their operating costs when their salary levels are not adjusted to the higher levels in the private banking sector. These factors and the high-risk nature of bank lending in these countries have fostered high intermediation margins, and the high lending rates this has generated have further added to borrowers' debt servicing difficulties.

Banking distress may be desirable. In the initial stages of transition the risks associated with lending in transition economies combine to overwhelm many banks. Furthermore, the intensification of bank regulation—particularly minimum capital regulations and increasing competition—force these banks toward merger or liquidation. Banking difficulties therefore emerge. Such difficulties are, however, a common feature of the structural transition of the banking system and can lead to a much-needed consolidation of overly fragmented systems. Also, when countries' banking systems are still very small...
compared with GDP, the resulting costs of banking crises to depositors—compared with the earlier losses imposed by hyperinflation—are fairly limited.

Banking crises in transitional economies can die down relatively quickly. While banking crises erupt quickly, they can subside equally quickly. This reflects, in part, the fact that depositors in the Baltics have become accustomed to banking distress. The more sophisticated ones spread their deposits across many banks to diversify risk. Banking crises are quickly discounted, as evidenced by the sharp rise, and the subsequent sharp fall, in interest rates following the crises in Latvia and Lithuania. Moreover, the three banking systems have shown resilience, reflecting the fact that each country had a core of solvent banks that anchored the system. This resilience suggests that the banking authorities should take a tough stance in dealing with problem banks.

Firm and prompt policy response is needed. Any support provided to banks in difficulty should be conditioned on stern action with respect to the banks concerned (such as the removal of managers, liquidation of the shares of existing owners, etc).

Corruption should never be rewarded. Banks in which severe fraud and corruption are rife should be liquidated early, before they become “too big to fail.” Their shareholders should lose their rights, and their managers should be removed. Banks that have a particular market niche and can be shown to be viable in the longer term can, in principle, be restructured but only under new management and ownership.

Banking crises should be anticipated. While banking distress is inevitable, banking crises should be avoidable if the banking supervision process is geared toward close monitoring of the largest banks, which pose the greatest risk of creating systemic problems. This requires a willingness on the part of the government to refrain from using the banking sector for political and social purposes and to allow bank supervisors to properly discipline the banking sector. Failure to take prompt action when banking distress is uncovered can lead to even greater losses in the longer run, as a number of countries have learned.

Supervisors should send strong signals about appropriate behavior. Heavy emphasis should be placed on tightening on- and off-site supervision to send a strong signal to bankers about the penalties for inappropriate behavior. Banking regulations should not just be “on the books” but should be applied forcefully. The importance of this as a signaling device to bankers prone to fraud and corruption should not be underestimated. Signaling can play a very important role in imposing discipline in banks during the transition years. This applies not only to the intensity of supervision but also to the government’s approach to dealing with banking difficulties when they arise.

Conclusion

Banking distress is likely to be a feature of transition in the countries of the former Soviet Union for some time to come. Governments in these countries should prepare themselves now—by strengthening their supervisory capacity and readying themselves for tough implementation decisions—to deal with the inevitable. Even if banking crises do materialize, they likely will not have such severe effects on the economy as a crisis of similar proportions might have in a more developed, traditionally market-based economy.
When the last chapter of the economic history of the twentieth century is written, it will likely be about economic integration and globalization, a trend that is benefiting developing and industrial countries alike.

OVER THE past decade, developing and industrial countries have forged new links through trade and financial flows. The developing world's growing integration into the global economy is examined in the World Bank's forthcoming World Development Indicators 1997 (WDI), along with other promising trends observed in many developing countries—strong growth, success in reducing poverty, and improved living standards. Overall, the outlook is bright. But many challenges remain. Economic reforms are far from complete; billions of people still live in dire poverty; and growing energy demand threatens the environment.

Economic integration
Since 1950, global trade has grown faster than output. After stagnating in the 1970s and 1980s, trade has boomed in the 1990s, led by the rapid growth of East Asian exports (Chart 1). Merchandise trade grew dramatically, but trade in services grew more sharply; the latter's share in world exports rose from 15 percent in 1980 to 18 percent in 1995. The strong growth of international trade is due to the liberalization of markets worldwide, the achievement of the Uruguay Round and other multilateral agreements over the course of the past several decades. Tariffs have been falling, and, perhaps even more important, nontariff barriers are being dismantled.

The World Bank's *World Development Indicators 1997* provides a broad view of the world economy, the people who live and work in it, the environment that both provides natural resources and absorbs much of the waste, and the ongoing structural transformation of developing and high-income economies. This year, the *WDI* includes a new section on the interaction of states and markets and expanded coverage of the links—trade, investment, and official flows—that characterize global integration.

The World Bank has published the *WDI* every year for almost two decades as a statistical appendix to the *World Development Report*. This year, for the first time, the *WDI* is a free-standing publication; it has been enlarged to include more than 75 tables of data and is accompanied by a CD-ROM that contains most of the underlying time-series data. Along with expanded coverage of economic, social, and environmental indicators, the new *WDI* contains more extensive descriptions of the indicators and a candid discussion of their limitations.

No statistical compendium can capture the full complexity of the world economy. The *WDI* is intended to expand the scope of our quantitative understanding of the development process while recognizing the limitations of the data on which that understanding is based. Thanks to collaboration with the World Bank's many partners, including the IMF, the United Nations and its specialized agencies, and private suppliers of data, it is now possible to provide a more accurate and comprehensive assessment of the challenges ahead.

In some developing countries, trade liberalization has been accompanied by rapid financial integration, as inflows of foreign private capital, particularly foreign direct investment (FDI), have soared. Although the story is now familiar, the statistics are still dramatic. In 1990, FDI brought $24.2 billion of investment to developing countries; by 1995, this figure had increased almost fourfold, to $91.8 billion. FDI and portfolio flows combined are now four times greater than aid flows from high-income countries.

Technological change has spurred economic integration, both by decreasing the cost of information and by increasing the speed of information transmission. Modern telecommunications have allowed the creation of worldwide, round-the-clock financial markets; firms that operate networks of global suppliers and subsidiaries; and new service industries that deliver their products electronically. However, supply and demand in the communications sector are very much a function of income. The number of telephone lines rises rapidly with GNP per capita (Chart 2), and the number of Internet users is highest in Western Europe and North America.

**Economic trends**

Certain economic trends are emerging for the developing world: for example, agriculture continues to decline in importance while the share of manufactured exports in GDP is rising. The fastest-growing sector—in high-income and developing economies alike—is services.

Growth has been greatest in economies that have opened themselves to world trade, welcomed private investment, achieved macroeconomic stability, and allowed an incentive system of prices and taxes to encourage structural transformation. Over the past decade, the fastest-growing economies were in Asia. Between 1990 and 1995, developing economies' GDPs grew, on average, by 3.1 percent annually; the average annual growth rate was 10.3 percent in East Asia and 4.6 percent in South Asia, compared with only 2.3 percent in the high-income countries.
A handful of developing economies are emerging as potential giants. In 1995, the 10 largest—Argentina, Brazil, China, India, Indonesia, Mexico, Pakistan, Russia, Thailand, and Turkey—accounted for 59 percent of the developing world's GDP and 44 percent of its exports, and 11 percent of world GDP. By contrast, the economies of sub-Saharan Africa accounted for 10.4 percent of the world's population but only 1.1 percent of world GDP.

There is some evidence of a changing public-private balance throughout the world—in many Asian countries, fiscal deficits have declined, while investment-to-GDP ratios have increased (Chart 3). And the size of the public sector, as measured by the ratio of central government expenditures to GDP, has decreased, particularly in Asia and Latin America. Nevertheless, bureaucrats are still in business. Despite more than a decade of divestiture, state-owned enterprises remain ubiquitous. Indeed, their presence has shrunk significantly only in the former socialist economies and a few middle-income countries.

Social indicators

Economic growth means little if it does not result in an increase in human well-being. There is reason for optimism on this score. Social indicators have improved in some regions. Average infant mortality rates for low- and middle-income countries have been halved, from 105 per 1,000 live births in 1970 to 52 in 1995. But these averages mask regional and gender disparities. Infant mortality remains above 90 per 1,000 live births in sub-Saharan Africa and 70 per 1,000 in South Asia. Primary school enrollments have declined in some African countries, and enrollment rates are typically lower for girls than for boys. Although many developing countries have succeeded in reducing poverty, more than 1.3 billion people still live on less than a dollar per day; another 2 billion are only slightly better off. And inequality of incomes remains a political and economic concern (Chart 4).

The environment

People depend on the environment for their welfare, and the welfare of the environment depends on the people who live and work in it. Growth at the expense of the environment or of the health of a nation's population is unlikely to be sustainable. Deforestation, degradation of water supplies, and air pollution affect the quality of life and productivity of the economy. While economic development is frequently seen as a cause of environmental degradation, the truth is that only with accelerated economic development and a better understanding of the ways in which economic activity affects the environment can environmental problems be solved. In recent years, there have been signs of progress. Carbon dioxide emissions per capita have fallen in high-income countries (Chart 5), and energy use has become more efficient (as measured by GDP per unit of energy used). But there is much work to be done. If, for example, in the course of development, the low- and middle-income economies expand their energy use to match levels in high-income countries (Chart 6), there will be huge economic and environmental consequences.
How does the OECD answer the question posed in the title?

The predictable answer is that if governments pursue good policies and make tough choices, the risks of a capital shortage can be minimized, but if governments fail to take appropriate steps and leave festering problems unaddressed, the consequences could be dire indeed. Two possible paths are traced out. In a virtuous-circle scenario, it is assumed that private saving rates in the industrial countries are not affected by demographic changes and are maintained at roughly current levels, while public saving increases sharply as governments rein in social spending. Some of this additional saving in the industrial countries flows to developing countries, where it helps to fund infrastructure development, promotes economic growth, and earns high rates of return. These high returns then serve to bolster the incomes of aging and retiring populations back in the industrial countries, and everyone comes out a winner.

In a vicious-circle scenario, industrial countries fail to control their social spending; there is a sharp global imbalance between ex ante investment and saving; interest rates spike upward; and both the industrial and developing worlds are trapped in an investment-starved phase of slow growth. In this unfortunate scenario, the authors speculate, economies would be more vulnerable to shocks and capital market volatility would be heightened.

This interesting set of papers by OECD staff members and some outside experts, such as Barry Bosworth and Axel Börsch-Supan, was prepared for a 1995 conference on the risks of a global capital shortage. Most of the papers address the issue in a straightforward manner by studying the supply of, and demand for, saving. The supply of saving is typically described as being determined by demographic factors; income growth; pension practices; and, of course, government saving; while the demand for saving—investment spending—is seen as a function of such factors as labor force growth and total factor productivity.

By analyzing the way forces such as the aging of a country's population or government budget deficits affect these two factors, inferences are drawn about the risks that the ex ante demand for savings might greatly outstrip the supply. The authors speculate about possible ranges by which investment demands might outstrip supply—a figure of $400 billion–$500 billion is mentioned a couple of times.

Actually, the book could usefully have focused even more on the behavior of the global real interest rate to summarize the way that these supply and demand forces have collided in the past and are likely to in the future. For example, what is the global real interest rate today compared with what it was in, say, the 1960s? If public budget deficits in the industrial countries are not reduced, how much might the rate increase? It would be nice to know what an investment-saving imbalance might mean in terms of market feedback.

There is still a lot that we do not understand about the saving process, such as why the private saving rate declined noticeably in the 1980s and how saving rates are likely to change as populations age. Bosworth argues that private saving rates will not decline much because of the aging of populations in most industrial countries. In many ways the least understood aspects of the saving puzzle are what will happen in the developing countries. Will saving rates in East Asia decline noticeably when growth slows there as expected over coming decades? Will saving rates in Eastern Europe perhaps rise smartly with income growth? Overall, the papers are rather optimistic about medium-term saving prospects in the developing countries, concluding that the saving there should hold up well. But the book's authors seem to wonder whether after, say, 2010, governments in developing regions might be under growing pressures to increase pensions and raise living standards, and might therefore experience the same sorts of budget problems currently facing industrial countries. By devoting special chapters to developments in these non-industrial regions, Future Global Capital Shortages certainly makes useful contributions that a volume devoted only to saving in the industrial countries could not.

The policy messages of the book are clear. First, current government spending trends in industrial countries are unsustainable, and policymakers need to reduce budget deficits now, before the additional burdens created by aging populations hit. Second, tax systems may also need to be overhauled to make saving more attractive. Finally, a number of financial reforms are needed to make sure that developing countries can efficiently handle the expected increased inflows of capital. Above all, their markets must be sufficiently liberalized to ensure that they can respond to market signals.
A
er two decades of devastating
economic decline, sub-Saharan Africa has
finally shown signs of economic recovery.
Real GDP growth in the region (excluding
Nigeria and South Africa) rose to an aver-
age of some 5 percent during 1985–96.
While this economic recovery is, of
course, most welcome, even with this
higher growth, the gap between Africa and
the rest of the developing world has
continued to widen. Moreover, if economic
growth does not accelerate further, no vis-
ible positive impact on the living stan-
dards of a large majority of Africans can
be expected for some time. African policy-
makers and the donor community, among
others, are therefore very interested in
finding out whether the recent economic
recovery is only transitory or represents
the beginning of Africa’s much-awaited
economic renewal.

Agenda for Africa’s Economic Renewal

offers valuable insights to readers who
may be seeking an answer to this ques-
tion. It provides, in its opening chapter, a
lucid summary of an emerging consensus
on what accounts for Africa’s poor eco-
nomic performance and identifies key
elements of the strategies for economic
renewal. The book then offers a collection
of papers on each of these elements:
macroeconomic stability, state capacity to
govern, human capital, agricultural
transformation, industrialization, and
political reform. Although the overall
quality of the chapters is somewhat
uneven, they are generally well written.
In particular, the paper by Deborah
Brautigam (“State Capacity and Effective
Governance”) and that of E. Gyimah-
Boadi and Nicolas van de Walle (“The
Politics of Economic Renewal in Africa”)
deserve careful reading.

The central theme of the proposed
strategy is to enhance “state capacity for
development” and other institutions. Such
capacity, it is argued, is needed to formu-
late and implement sensible macro-
economic policies and to provide basic
public goods, such as an adequate infra-
structure, the necessary regulatory fram-
ework, secure property rights, and an
effective legal system. Bottlenecks in agri-
cultural transformation need to be
removed, in particular to reduce transport
and other transaction costs, and to facili-
tate technological innovations. Universal
free provision of basic health and educa-
tion needs to be ensured, and other public
policy actions, without which “invest-
ments in human resources will be
inequitable and inefficient,” need to be
taken. In addition, trade and industrial
policies that will encourage “African own-
ership” of industry and minimize “dein-
dustralization” in the short run need to
be pursued.

The authors propose a three-pronged
approach to building such state capacity.
First, a competent and effective civil ser-
vice should be established through
reforms that do not aim simply at down-
sizing but rather at rebuilding profession-
alism and a sense of mission. Second,
given that Africa’s civil service capability
is likely to remain limited in the near-
term, public services that can be handled
by the private sector should be privatized,
and policy interventions should be limited
to high-priority areas. Third, democratic
political reform—which could, over time,
improve economic management, increase
government accountability, and reduce
corruption—should be pursued.

The authors’ emphasis on capacity
building is clearly appropriate, but it
needs to be complemented by strategies
aimed at integrating Africa into the glob-
alization process, thus allowing it access
to the full benefits to be derived from
world trade, foreign direct investment,
and other private financing. The need for
fuller integration is clear: although net
private external financing flows to devel-
oping countries rose from $29 billion in
1988 to $191 billion in 1995, the amount of
such flows going to sub-Saharan Africa
decreasd from $7 billion to $6 billion over
the same period.

While the implications of globaliza-
tion for Africa are highlighted in the book’s
opening chapter, unfortunately not all of
the policy changes advocated by the
authors are consistent with the task of
facilitating the integration of Africa into
global trade and capital markets. For
example, import tariffs are still consider-
ably higher in Africa than in the rest of the
world. More ambitious trade liberaliza-
tion—rather than the “slower, more realis-
tic pace that would give enterprises the
time to adjust” advocated by Sanjaya Lall
and Frances Stewart in their chapter—is
necessary. Moreover, the “massive debt
reduction for Africa” recommended by
Ibrahim A. Elbadawi may be neither nec-
necessary nor desirable for many African
countries, such as Kenya and Zimbabwe,
that enjoy a high ratio of tax revenue to
GDP and have access to private capital.
While such debt reduction is warranted
for some countries, a blanket applica-
tion of this measure might adversely affect
those countries that could otherwise
receive large private capital flows. In many
African countries, privatization, rather
than a massive debt reduction, is an appro-
riate measure to complement declining
aids resources; fund education and health;
strengthen infrastructure, such as telecom-
munications and power systems; and facili-
tate rapid industrialization.

What, then, is the prognosis for Africa’s
economic renewal? The authors stress
throughout the book that to put in place
the necessary ingredients for sustaining
and accelerating economic growth will be
a long-term process, a conclusion that
may follow logically from their emphasis
on capacity building. Their assessment of
Africa’s economic prospects is captured in
the two concluding sentences of the book:
“In the meantime, rapid growth of the
kind witnessed in East Asia is not likely
to be attainable by most countries in the
region. With effective leadership, however,
sustainable macroeconomic stability and
slow but steady growth are possible.”

This may be a realistic assessment, but it
is a disappointing conclusion for those of
us who believe in and work for Africa’s
lasting economic renewal.

Hiroyuki Hino
Poverty versus population.
Everyone would like there to be fewer poor people, but there is tension between fewer people and less poverty. Kaplan is obsessed with population, but he never mentions any solid evidence (because there is none) that population growth per se is a cause or even an exacerbating condition of poverty. Kaplan unwittingly reflects the tensions inherent in the racist and eugenic roots of the modern anti-natal movement. Certainly, if all poor people were forcibly sterilized, the growth in the absolute number of poor people would decline, but this would hardly be a reflection of concern or respect for the poor. Despite the fact that Kaplan himself comes from a country whose population has increased sixfold since 1870 (a demographic fact to which many attribute its preeminence on the global stage), he does not seem to understand an African official's intense resentment of proposals to condition aid on birth rate reductions.

Culture versus commerce.
Kaplan has been sufficiently freed from the threat of a hungry belly to be an aesthete, which reflects itself in a preference for beauty over functionality, order and plan over hustle and bustle, and the life of the mind over making money. Kaplan refers disparagingly to the growing urban areas he visits as "unplanned" or "sprawling." A thriving neighborhood that had sprung up around a site he read about in an old travelogue made the site "banal." He recognizes the tension between intellectual elites like himself and the people who actually work for a living, but cannot help but side with the California-educated returned Iranians over the houzzars, the unlettered men whose entrepreneurial energies make the world go round—for money.

Citizen versus technocrat.
Kaplan seems frustrated that he can't understand everything without knowing anything. After preparing himself to understand the world by reading old travelogues, Conrad, Lawrence, and Jessica Matthews, he concludes, "the more I saw of the world the less I felt I could fit it into a pattern," and realized he would have to be "content with half-knowledge." He apparently didn't consider readings in science, economics, agronomy, political science, or technology necessary to enable him to understand the big questions.

Scientifically created capability so dominates nature that both nature and science become invisible to most people riding in the linos generally have no idea how it all works. Only this ubiquitous invisibility could fool one into believing that differences among people or cultures observed through casual travel could reveal answers that have eluded serious scholars for centuries. There is a limit to lay knowledge and journalistic queries and Kaplan reaches it.

Nevertheless, Kaplan has written a lively, interesting, and engaging travelogue of contemporary times. It is a refreshing antidote to the doubly distanced reports on conditions in developing countries that are produced through official channels. But this laudable, well-meaning, and influential book remains both deeply ambivalent about development itself and glaringly naive about basic development issues.

Lant Pritchett

Dirk Vandewalle (editor)

North Africa: Development and Reform in a Changing Global Economy
St. Martin's Press, New York, 1996, xviii + 286 pp., $49.95 (cloth).

This collection of essays makes a useful contribution to understanding the political economy of development and reform in Algeria, Libya, Morocco, and Tunisia. The various authors are guided by the "Social Structures of Accumulation" (SSA) approach (outlined in the initial chapters by Karen Pfeifer and Dirk Vandewalle), which emphasizes that economic development takes place within an evolving economic system and that supporting institutions provide the stability and predictability necessary for production and investment to proceed. The SSA approach is contrasted with the "Washington Consensus" approach, which "emphasizes 'orthodox' macroeconomic policy, trade
liberalization, some form of privatization, deregulation, a general move toward increased reliance on market forces, and further integration with the world economy. The subsequent case studies and analysis do not shed much light on whether these two approaches are mutually exclusive, but they do provide clues as to "what public institutions are needed to frame private activity and maintain social cohesion while economic change is taking place," which practitioners of the Washington Consensus approach may also find interesting.

A brief historical overview by Pfeifer recalls how, after they achieved independence, the new Maghreb countries adopted a development strategy emphasizing a dominant role for the public sector. As things turned out, this strategy could not fully meet the expectations of equity and higher living standards it had aroused, because of growing inefficiencies in the public sectors as well as external shocks. Its serious shortcomings—which varied between countries—and North African countries' considerable success in extending production and diversification triggered growing challenges to the state's legitimacy from various social groups, including trade unions, Islamic protest movements, participants in the parallel economy, and an emerging managerial class. Consequently, economic and political reforms began to transform the Maghreb states in the 1980s, and by the early 1990s all of them except Libya had adopted economic strategies consistent with the Washington Consensus approach, an outcome considered puzzling "in light of the high social costs and rather modest results of short-term macroeconomic stabilization efforts and medium-term adjustment." Pfeifer also fears that further opening these economies to foreign trade and investment may make them more vulnerable to international business cycles and force them to depress wages and taxes to attract foreign investment.

The chapter by Will D. Swearingen highlights the complete reversal of agricultural policies (except in Libya) during the 1980s in response to poor performance and fiscal pressures. Producer prices imposed by official marketing agencies were raised or liberalized; food subsidies were cut; and Algeria started to reprivatize the state-farm sector. Production increased (most dramatically in Morocco) but was in all countries outstripped by population growth; further extension of cultivation will likely run into environmental constraints.

The chapter by Azzedine Layachi on reform in Algeria argues that successful reform will require the state to enhance its legitimacy through further democratic opening. This analysis is complemented by a review of economic discourse in Algeria in the chapter by Deborah Harrold. A well-focused chapter by Christopher Alexander on Tunisia traces the evolution of labor unions, which, after sometimes turbulent relations with the state and employers following the break with the socialist strategy in 1969, eventually accepted the basic premises of economic reform and have successfully focused on issues related to wages and the workplace since 1989. An interesting review by Vandewalle of developments in Libya—integrating historical, sociological, and economic analysis—concludes that the state was never forced to create or improve the institutions necessary to "regulate, to dispense law, to define and enforce property rights, and to tax and collect information," which, in turn, are required to establish markets and make liberalization and privatization possible. While the first oil boom during the 1960s created the need for some central structures, the main role of the state—whether under the monarchy through 1969 or the Jamahiriya since—is seen as having been one of distributing rents with a view to preserving sufficient support for the government.

Two essays discuss the relations of the Maghreb with Europe, which has remained the region's dominant economic partner. Political stability, immigration, and environmental issues have emerged as important common concerns requiring concerted efforts from both regions. However, while Europe has become increasingly unified with strong common institutions, efforts at Maghreb regional integration have been ineffective (Vandewalle). The chapter by Gregory W. White presents a narrative of recent relations between the EU and Morocco that also attempts to provide evidence of an extension of the state's role to include marketing the country to foreign investors to achieve such domestic objectives as employment creation.

The concluding chapter, by I. William Zartman, returns to the basic SSA theme: the state and society need to continuously—and, from time to time, through revolutions, social pacts, or critical elections—negotiate and adapt the institutions that maintain law and order, manage and resolve conflicts, and ensure production and investment. Morocco and Tunisia are seen as currently pursuing mutually reinforcing political and economic liberalization, with Algeria likely to follow. As for Libya, the debate is seen as remaining wide open as to the timing and sequence of political and economic reforms.

Klaus Enders
Concern about downward pressures on exchange rates arising from speculative capital flows led to restrictions on capital outflows in France and other countries. In the late 1960s, large capital flows to such countries as Germany prompted them to restrict capital inflows in order to preserve domestic stability. Restrictive impulses were particularly strong in countries experiencing macroeconomic instability (France and Italy), and those with good records of macroeconomic performance (such as Germany) led the way in liberalizing capital movements.

The second lesson is that under fixed exchange rate arrangements, full liberalization of capital movements entails a willingness to cede a degree of autonomy over financial policies. The early experience with the Treaty of Rome is particularly instructive in this regard. The Treaty embodied the objective of freedom of capital movements, but this was subordinated to the need to ensure the proper functioning of the Common Market. This escape clause proved to be a major limitation as countries imposed restrictions in an effort to obtain a measure of monetary policy autonomy under the Bretton Woods system. More generally, countries were unwilling to accept the limitations on their autonomy to formulate and implement financial policies that free capital movements would have required.

The third lesson is that a benign external environment and cyclical phase are more conducive to capital liberalization. Bakker discusses how the economic shocks of the early 1970s contributed to a turning away from capital liberalization, even in countries like Germany, which traditionally had supported it.

In addition, acceptance by a critical mass of countries of the benefits of liberalization is an important prerequisite for the success of any multilateral approach to achieving this objective. In Europe, the United Kingdom and France’s decisions to reverse themselves and favor freedom of capital movements in the late 1970s and early 1980s, respectively, tilted the balance toward full liberalization of capital movements.

In two areas, the book advances positions that appear to need further substantiation. The first is that freedom of capital movements exerts a disciplinary influence on macroeconomic policies. In the European context, this view was challenged by the Dutch, who argued early on that unhindered access to low-cost external borrowing in countries with sound macroeconomic policies and low inflation would further undermine discipline in countries with high inflation and relatively large fiscal deficits. More recently, the experience of Mexico and concerns about overheating in some Asian countries suggest the need for caution about the disciplinary effect of capital liberalization on macroeconomic policies.

The second is that capital controls are ineffective. This remains a hotly contested topic on which there is no consensus in the literature. While the weight of evidence provided by the European experience favors the author’s position, the tendency of some countries (for example, Spain) to revert to restrictive measures and the Delors Commission’s call for regulating destabilizing capital movements in the aftermath of the 1992-93 EMS crises argue for reserving judgment.

Overall, Bakker’s book provides an insightful historical perspective on the important topic of capital liberalization, and it remains to be seen whether the European experience will support the views of those calling for extending freedom of capital movements more broadly.

S. Kal Wajid

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As the weaknesses of the public pay-as-you-go (PAYG) pension systems adopted after World War II become known, many countries are turning to other models to ensure adequate retirement incomes for their aging populations. Richer, demographically mature countries are searching for ways to reduce the costs of their public systems and place them on a sustainable financial basis as their labor forces contract because of the aging of the baby boom generation. In the face of very rapid demographic change, developing countries are also seeking alternatives in order to avoid high pension costs. In China, for example, the share of the population over 60 is projected to double in about 30 years, which could pose a large dependency burden on working households unless a major saving effort is undertaken. Partial or total privatization of retirement programs is gaining support as one solution to these problems. Those seeking to enter the debate by learning the most common features of private pension systems in high-income countries can productively consult Private Pension Policies in Industrialized Countries, a very accessible survey of this topic.

What exactly is a private pension? What is meant by privatization? The authors recognize that these terms have been used very loosely to cover a wide range of retirement schemes and policies. Their definition of a private pension plan is as follows: “an employer-provided or an employee group-sponsored plan that provides retirement benefits for private sector workers” (page 3). To their credit, they apply this definition generously, including programs such as Chile’s (which is not employer sponsored but privately managed and covers both public and private sector workers) and France’s (which is basically a mandatory public PAYG system subdivided by occupational groups that survives through mandatory cross-subsidization across groups). While about a dozen systems are referred to in different chapters of the book, the bulk of the discussion is on the systems in the United States, the United Kingdom, and Japan. Participation in these systems is voluntary (that is, the employer or employer group is not required to offer a plan), and the policy implications of this approach to providing pensions dominate the book’s discussion. Special attention is devoted to the “contracting out” approach to privatizing pensions now being used in Japan and the United Kingdom, where employers can place a portion of their mandatory contributions to the public pension system into privately managed, fully funded ones.
Social safety net policies (particularly pension policies) tend to be idiosyncratic, reflecting each country's history and values. There is no consensus today on what policies governments should follow to prevent old-age poverty, and the implications for economic growth, development, and poverty reduction of pursuing different approaches to providing income security for the old are widely debated. Even if a consensus existed among industrialized countries, its application to other countries would not be simple owing to their differing demographics, economic characteristics, and values. The strength of Private Pension Policies in Industrialized Countries is the authors' distillation of these idiosyncratic systems into a set of very understandable comparisons focusing on a standard set of characteristics (coverage, funding and asset management, regulation and risk-sharing, tax policies, portability, and interaction with the labor market). Especially useful is the discussion of the "contracting out" approach, since this is often suggested as an alternative to the Latin American approach to privatization for countries that wish to reduce the role of government in providing old-age security. The financial aspects of policies are relatively underdeveloped in this survey, since the focus of the book is primarily on regulation.

The weakness of the book is that it contains no original social science research on behavior of individuals or aggregates. Current research is not surveyed critically. This is unfortunate, given the effort the authors spent on learning the institutional details of a number of systems. For example, it would have been much more interesting if the survey of the taxation of pension benefits and contributions in several countries had analyzed whether these differences actually were related to labor force coverage or whether other features of the system were more important. Gender issues are also underdeveloped in the book, despite the well-known fact that the differences in life expectancy and labor force participation between women and men can lead to very different retirement income outcomes, depending on the pension policy regime. However, since at least one of the authors is a very prolific writer, perhaps another, more analytical work will be forthcoming.

Louise Fox

For long relegated to the abstruse universe of the specialist, central banking has now come to the forefront of the economic policy debate, and central bankers have accordingly taken a far more visible role among the community of economic policymakers. These developments reflect the importance for an economy's performance of the maintenance of sound money. And with them came the trend toward the establishment of central bank independence and accountability that is currently under way. Recent experience in a wide variety of countries with banking and financial sector difficulties, in turn, has added to the renaissance of central banking by underscoring the critical role of sound banking for economic stability and efficiency. Because of their oversight responsibility with regard to the health of the banking system, increased attention has also been given to central banks.

Dr. Rosa Lastra's book represents a major contribution in all these domains. The volume examines thoroughly the subject of central bank independence, bringing together information and analysis in all its various and complex dimensions as an instrument for the protection of the soundness of money (Chapter 1). It also covers the subject of banking regulation and supervision in a setting where the boundaries between banks and other financial institutions are becoming blurred and where markets are more and more global. The issues are examined in a national context in a tour de force, all-encompassing survey (Chapter 2). This examination is supplemented by a comprehensive discussion of international banking regulation, focused on the work of the Basle Committee on Banking Supervision and on a review of banking policy in the EU (Chapter 3). The institutional setting for the soundness of banking is thus examined in all its depth. This book is clearly necessary reading not only for specialists on the subject but also for those with a general interest in financial issues and developments.

Manuel Guittán

This book, which consists of a collection of Leszek Balcerowicz's previously published research papers, provides an interesting overview of the economic considerations and convictions that have guided him before, during, and after his stay in office as finance minister and deputy prime minister in the critical period of Poland's economic transformation. The three main sections of the book closely reflect Balcerowicz's own "transformation" from a scholar interested in studying the performance of alternative economic systems and institutions, into the principal architect and power broker of Poland's transformation to a market economy, and then into the accomplished opposition politician, scholar, and advisor that he is today. In all of his writings, economic systems, institutional and economic change,
human behavior, and the interactions among these take center stage.

The first section, "Socialism versus Capitalism," consists mostly of papers written in the 1980s. It is devoted to analyzing the main problems of socialist economic systems (like shortages or lack of incentives for innovation), exploring options for reforming socialism, and reflecting on the compatibility and performance of different political and economic systems. A main conclusion Balcerowicz arrived at early in his career as a scholar was that in light of the grave economic problems Eastern Europe faced at the time, the search for market solutions would inevitably go beyond those that could appropriately be described as "socialist." A second, closely related conclusion that emerges from these earlier writings is that "to be successful... reform must have a special dynamic its first step has to be very big," and that this has to include "fundamental changes in the property rights and ownership structures, and in the foreign trade regime." All of these conclusions, of course, foreshadow the reforms he initiated in Poland during 1989–91.

The second section, "From Socialism to Capitalism," is a collection of papers written after the author left office in 1991 and offers his thoughts on transformation processes in Eastern Europe. These processes fall into three main categories: macroeconomic stabilization, microeconomic liberalization, and institutional restructuring. The spirit of these papers mirrors that of Balcerowicz's earlier writings as a scholar, but they carry the added weight of having been written by a successful policymaker.

He suggests that the region's policymakers have no alternative but to adopt disciplined monetary and fiscal policies if they seriously intend to stop hyperinflation and stabilize the economy. Balcerowicz also argues that these policies need to be complemented by strict wage control, which are necessary not only to break the inflationary momentum but also because institutional biases in socialist economies tend to favor workers. Similarly, he suggests that in order to abolish shortages and elicit a strong supply response, it is essential for Eastern European economies to undertake a radical liberalization of prices and foreign trade, which, in turn, will entail unifying their exchange rates and making their currencies convertible.

I found the third section, "Polish Economic Reform: 1989–93," to be the most interesting one. In particular, the concluding paper, which offers Balcerowicz's personal reflections on Poland, provides fascinating insights into how that country's stabilization and transformation was managed on a day-to-day basis, and how it was possible to maintain control of this overwhelming task.

This section also offers some of the more personal reasons for Balcerowicz's "anti-gradualism": clearly, what induced him to adopt this approach was not just his conviction that "radical is less risky" in undertaking a stabilization program or that people are more likely to change their attitudes and behavior if they are faced with radical change they consider irreversible but also the specter of being called a failed reformer.

In this context, he mentions Argentina's Raúl Alfonsin, who, he argues, came into office "as a very popular politician but lost both the popularity and the stabilization." In contrast, Balcerowicz says, his own unsentimental perspective may have helped him to decide in favor of "those policy options that were associated with the higher risk of being rejected by society but which, if implemented, promised to bring better economic results than those that were socially less risky but economically less promising." A main conclusion to be drawn here is that what makes for a successful economic stabilization and transformation is not just policymakers' guiding economic principles and convictions but also their personalities and strength of character.

Gerd Schwartz
Global integration

The article by Milan Brahmbhatt and Uri Dadush, “Disparities in Global Integration” (Finance & Development, September 1996) summarizes many valid aspects of economic development. Today there can be no question of the advantages of participating in the move toward global economic integration.

A crucial component of integration not mentioned in the article is the role of pre- and post-shipment export credits, guarantees, and insurance, and the important role played by the World Bank in catalyzing support for viable export credit agencies. After having helped establish or improve export credit agencies (ECAs) in over 60 countries, we have found that to avoid subsidizing exports, ECAs must have adequate capital for investment earnings to cover start-up costs; ECAs must be professionally managed; and they must be independent of other governmental activities. Also, ownership of ECAs need not affect a country’s export performance. In some countries, privately owned ECAs reinsurance their political risks with governments.

Small and medium-sized firms in many countries are often denied access to finance. Absence of an ECA means the smaller firms must choose between risky open account sales and costly letters of credit. In Central and Eastern Europe and the former Soviet Union, the World Bank is helping emerging economies to develop their financial infrastructure, including export finance support programs that enable them to earn much of the foreign exchange needed to pay for essential imports and to service external debt. This will contribute to an important area of economic development, paying dividends in future years to the developing and transition economies.

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Development and food security

While the article by Wendy S. Ayres and Alex F. McCalla, “Rural Development, Agriculture, and Food Security” (Finance & Development, December 1996) highlighted some interesting points, such articles make one wonder if the Bank will ever recognize that it cannot keep up with the growing needs (and demands) of an escalating population by simply implementing “fixes” such as improving irrigation efficiency, extending infrastructure, increasing agricultural research, expanding employment generation opportunities, and reducing car emissions, no matter how successful these efforts are made out to be.

Such fixes simply provide a little breathing space in which to act. But, if during this time, little is done to start restraining rather than catering to the excessive population growth and consumption that are already stressing our environment, these actions will be of little use.

A more menacing aspect of these fixes is that they artificially prop up the world economy and leave the impression that “business-as-usual” is addressing the problem. However, when one or more of these critical props eventually begin to fail—be it caused by a blight affecting a widely promoted high-yielding variety of rice or exhausting an essential aquifer—the global system will start collapsing. And the longer these fixes are implemented before addressing the excessive consumption and population growth issues, and the more dependent we are on these props for survival, the more disastrous this eventual collapse will be.

With a commitment and progress toward a sustainable scenario, there is hope. But if instead of acknowledging and addressing these critical issues, large international financial institutions like the Bank continue to play the development game, to boast of their short-term successes at implementing fixes, to maintain the rhetoric about keeping pace with population growth, and to even hold out the promise of eliminating poverty at the same time, they are simply encouraging Darwinian forces to eventually “resolve” these issues for us.

Allen R. Inversin
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Banking reform

"Banking Reform in Transition Economies" by Michael S. Borish, Millard F. Long, and Michel Noel (Finance & Development, September 1995) discusses an essential element in the move to a market-based economic system. For an emerging market economy to compete in today's global marketplace, considerable thought must be given to how to structure the banking system to promote economic growth and national wealth.

A banking system should not simply be an instrument utilized by the government to carry out a state plan. This is a recipe for slow growth. An independent central bank, with legislation to operate as the controller of monetary policy, the protector of foreign payments, and the monitor of the banking system is an essential element in a market-based system. Central bank officials should not be appointed for political reasons.

Banking does not develop in isolation—the amalgamation of the banking and securities markets, and the emergence of a global marketplace, are complex and demand a level of expertise not likely to be available in emerging market economies. Information technology, which is playing an increasingly important role in international financial settlement and risk management, is highly capital intensive. Few, if any, domestic institutions could afford the investment necessary to compete in international markets without substantial state support. Association with a foreign bank would obviate the need for such support by providing the domestic bank with economies of scale, sophisticated computer systems, industry expertise, access to world capital, and foreign exchange and securities markets. This is why privatization must be encouraged in open market economies.

There should be integration and synergy between budding bankers. Bankers should be encouraged to discuss ideas and to look for a way to come up with solutions to problems that they face separately.

Regulators must ensure that banks' corporate structure is not intended to conceal illegal transactions. Insider dealing should be dealt with severely and a system of deposit protection introduced to safeguard investors against bad investments by banks. The savings and loan crisis in the United States provides a salutary lesson on the consequences of failing to do so.

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Claire Linkelis, Editor

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