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Köhler, Fischer discuss work of new department, IMF response to financial crises, including Turkey

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IMF Managing Director Horst Köhler (right) with First Deputy Managing Director Stanley Fischer.

KOHLER: In Prague, I outlined a vision of the IMF's future role that was unanimously endorsed by the members of the IMF. A central element of that vision was that the IMF should become a center of excellence for the stability of the international financial system. In the process of making this vision operational, I asked a panel of outside experts in October 2000 to provide an independent perspective on how the IMF should organize its financial sector and capital markets work. That group, headed by John Lipsky, Chief Economist of J. P. Morgan Chase, presented its report in January 2001.

Broadly, the report observed that although important improvements had been made in the past few years, the IMF's work in capital markets needed to be considerably *(Please turn to the following page)*

Workshop on financial abuse

Panelists stress role of international community in tackling money laundering

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Impact of crimes

The workshop was divided into three panels. The first, introduced and moderated by IMF General Counsel François Gianviti, included Rick McDonell of the Asia/Pacific Group on Money Laundering; Judge Jean-François Thony of the Court of Appeals of Versailles, France; and Jack Blum of the Washington, DC, law firm of Lobel, Novins & Lamont. The panel members drew particular attention to underlying crimes that had potentially adverse economic effects on countries, such as corruption by public officials. This form of financial abuse, they noted, can seriously retard economic development by raising costs to business, inhibiting foreign investment, and reducing government resources. The panelists also discussed organized crime, whose effects are similar to those of public corruption. Both activities can be severely destabilizing politically, they observed, and both activities often have their proceeds laundered offshore, including through major financial centers like New York and London. *(Continued on page 88)*

Rick McDonell

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Rick McDonell

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IMF to set up capital markets department

(Continued from front page) enhanced. Among its recommendations was the creation of a new department that would consolidate and develop further the capital markets–related functions now carried out in several of the IMF's functional departments.

After intensive deliberations among management and senior staff over the past few weeks, I concluded that the creation of a new department was appropriate. I see this decision as a critical element of ongoing efforts to strengthen the international financial architecture and ensure the necessary support for the IMF's work on crisis prevention and crisis management.

More specifically, the consolidation of the work on capital market issues in the new department is expected to deepen the IMF's understanding of financial market operations and of the factors influencing the supply of capital to member countries; provide enhanced support to the IMF's surveillance and lending operations in member countries through strengthened links between information gathering, analysis, and judgment regarding capital market developments; and enhance the IMF's conceptual capacities in addressing systemic issues stemming from developments in international capital markets.

I am confident this decision is in the interest of all IMF members. It will enhance the IMF's early-warning capabilities and, more fundamentally, strengthen its ability to help member countries in their efforts to gain access to, as well as deal with and benefit from interactions with, the international capital markets and their potential for income and job creation.

To make the new department operational as soon as possible, I have launched a search for a department director with the appropriate professional background and experience to lead this important task.

QUESTION: What would you expect this department to do in a crisis situation?

KÖHLER: I would like to stress that crisis prevention is in the foreground. This means a variety of activities and actions, particularly dialogue with the private sector and communication with investors. Last year, we set up the Capital Markets Consultative Group, which was an important first step. A crucial task of the new department will be to help strengthen our early-warning capacities. I don't think it will be possible to keep crises from happening again, but it is important to strengthen our ability to read developments in the markets and interpret and draw conclusions at an early stage. This is one of the main purposes of the new department.

QUESTION: The banks, working through the Institute of International Finance, have frequently asked the IMF to be a lot more forthcoming with inside information. To what degree will this new department be responsible for providing early warnings to investors, and vice versa?

KÖHLER: I'm sure you will understand the IMF is not an extension of the risk-management capacity of private institutions. They have to do their own assessments, but we have a common interest in the stability of the system, and we need to strengthen the dialogue between ourselves and the private sector. We can help countries build up relations with investors so that the authorities and the private sector gain a better understanding of each other and of their respective motivations and constraints so that there is less scope for surprise.

QUESTION: The IMF has been trying to strengthen its early-warning capacity for some time. Is it attempting to do more than just bring together staff who had previously been in different departments?

KÖHLER: The objective is certainly not just to reorganize. The purpose is to define a clear focus and have the professional capacity to respond to changes in the global economy—changes that are strongly driven by capital markets. But the crucial issue is to have a working unit and a management information system that allow us to draw conclusions on market developments, such as spreads, the development of interbank lines, and so on. We could then sort out whether an early warning is needed or not.

FISCHER: The IMF has had units dealing with capital markets in several departments. The idea is to put them together and rely on synergies to strengthen the analysis we provide. But the overriding reason why the management wants to do this is the belief that interactions between the IMF's operations and its intelligence gathering have been inadequate in some respects. We want to integrate that work completely into our surveillance work. What the Managing Director continues to emphasize is that the capital markets staff have to talk daily with the area departments about what is going on in their countries, as well as gather information from the markets.

KÖHLER: That is a very important point. For the area departments, as you know, all business is local. We need to have the area departments fully equipped and attentive to capital market developments relating to the country they work on, but the new functional department brings specialized expertise and can support the area departments better in their job.

QUESTION: How would this have helped in Turkey?

FISCHER: Turkey is an unusually difficult case because the precipitating event was hardly to be expected. But as you go forward, what you would be looking for is absolutely full knowledge of what the people in the capital markets are saying are the critical factors involved in Turkey. You want to make sure that the area department dealing

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with this issue is aware of that information and attentive to it. You have both to be aware of what is happening and to have the analytic insight to decide precisely what the real issues are in these cases.

This is happening to a considerable extent in Turkey. The IMF has moved a long way since 1994, when we just didn't see the Mexican crisis coming in the capital markets. I don't think we are in that position now, but we could strengthen our efforts considerably by having a dedicated group working on these issues every day and reporting to management and the area departments.

QUESTION: Would this have made a difference in 1994?
FISCHER: I think, yes. The problem is that not every crisis is unforeseen. Sometimes crises come because the people who have to take action—usually the governments—are not going to take action. You can foresee, and you can warn. That doesn't mean that we will ultimately have the power in every case to persuade governments to do what needs doing. But we should certainly be in the position to give them the necessary information, which in some cases in the past we were not.

QUESTION: Did you consult with the U.S. Treasury on this new reorganization?
KÖHLER: We consulted with the U.S. Treasury, also with the Japanese Finance Ministry, and informed and discussed it with the Executive Directors. This process was launched even before the new U.S. administration took office. The U.S. Treasury is supporting this decision. It is in line with their thinking.

QUESTION: Do you plan to station someone on Wall Street or in London?
KÖHLER: The idea of the Capital Markets Consultative Group was also to reach out to regions. We are close to New York, but we are reaching out to Asia and Latin America. In January, I met with Asian financial institutions in Singapore. I will be traveling to Latin America in June or July and will invite Latin American financial institutions. I will probably also do this in Madrid during the second half of this year.

This demonstrates our systematic attempt to reach out to the private sector. For instance, we are working on standards and codes and want to know what they think about standards and codes. We are also working to make the Contingent Credit Lines operational, and I will ask private sector people how they feel this facility should be used, and we will draw our conclusions.
FISCHER: The IMF does have people in Tokyo and London attached to the current Capital Markets Group in the Research Department. We haven't made any decisions as to whether to station people in other cities.

QUESTION: Critics have said that the IMF should have foreseen that Turkey's pegged currency wasn't going to hold. Was there a surveillance failure or a problem of a completely different nature?
KÖHLER: What happened at the political level was not foreseeable. That is decisive. In November, when we supported Turkey after intensive discussions, there was a credible program that had good chances to be successful.
FISCHER: I think I can say, without fear of contradiction, that we knew exactly what the markets were saying about Turkey. We analyzed all of those issues and we knew about those concerns. This was not a failure of knowing what the risks were. This was a series of political difficulties that took a program that had a very good chance of succeeding and made it less likely to succeed. And then, when there was still a good chance of making it succeed, those political problems just did it in.

QUESTION: Will this new department have the capability to send out red flags in situations like Turkey's, where the situation does seem precarious?
KÖHLER: This new group will not and should not have the capability or the objective of replacing private sector risk assessment and management. We want to be clear that private sector creditors have to bear the risk of their decisions. This new initiative does not replace their own judgment. But there is a common interest—via transparency, via judgment of indicators—in having early warnings.

QUESTION: Mr. Fischer years earlier cited the underlying tension between open information and possibly provoking a crisis. How do you resolve that issue?
FISCHER: There are circumstances when you can make information public, and it is helpful to make it public. There are also circumstances when you could precipitate a crisis. We have to judge in each case. We never have information that we withhold from governments about the dangers of what they are doing or the underlying difficulties we see. We consult with the capital markets, and we advise countries on how to react and what needs to be done to improve the situation.

I can still see circumstances in which it will not be appropriate for us to send a message to the market. For instance, if we discover a major bank in a country is exceptionally weak, publishing that information will precipitate a run on the bank. Giving that information to the government is a responsible action.

There could be other cases when we think fiscal policy is going off track. Issuing a public warning is helpful in getting the problem corrected. I don't think we would have the capacity to say, whenever we find a problem we are going to tell everybody. We will have to make a judgment as to whether going public helps or doesn't help in a particular case. ■

The full text of the press briefing is available on the IMF's website (www.imf.org).

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Workshop on financial abuse held at IMF

(Continued from front page)

Link between financial crimes

Policies designed to combat money laundering, according to the panelists, may also prevent and uncover other financial sector crimes. In particular, they said, financial intelligence units originally designed to uncover money laundering by examining data from banks and other financial institutions can also play an important role in detecting such crimes as check, credit card, and advance fee fraud. The panel members noted that financial intelligence units from different jurisdictions can also expose patterns of crime across borders by sharing information among themselves.

Timothy Lemay

The second panel, also introduced and moderated by Gianviti, consisted of José María Roldán Alegre, President of the Financial Action Task Force (FATF) of the Organization for Economic Cooperation and Development, and Timothy Lemay of the United Nations Office for Drug Control and Crime Prevention (ODCCP). They discussed the FATF's efforts to identify "noncooperative countries or territories" whose efforts to control money laundering have been inadequate. Of the 15 jurisdictions it has identified as noncooperative, most, according to the panelists, have made progress in passing laws or regulations to address deficiencies. At the June FATF plenary meeting, they said, 7 of the 15 jurisdictions will probably be removed from the noncooperating list.

John Kitchen

Panel members also stressed the importance of bolstering the fight against crime by attacking the laundering of proceeds from crime. The largest amount of laundered proceeds arises from narcotics trafficking, prostitution, and terrorism. Policies to deter and prosecute these underlying crimes, they cautioned, cannot be divorced from efforts to prevent and uncover the laundering of the criminal profits.

Panelists also focused on the importance of providing technical assistance to jurisdictions in designing and implementing effective anti–money laundering policies and observed that both FATF member countries and the ODCCP are playing a central role in providing such assistance. The IMF and the World Bank, the panel members noted, may have an important role to play in providing additional technical assistance in this area.

François Gianviti

Adequacy of control environment

The third panel, introduced and moderated by Hassanali Mehran of the IMF's Monetary and Exchange Affairs Department, included Stephen M. Hoffman, Jr., of the U.S. Federal Reserve Board's Division of Banking Supervision and Regulation and John Kitchen, formerly of Coutts & Co. They provided an overview of risk-focused supervision, which gives special emphasis to the adequacy of the control environment. Financial institutions, especially in a global financial system, must maintain the value of their business franchise, which, in the context of financial abuse and money laundering, means paying attention to their reputation and to the legal risks inherent in their banking business.

The panelists also voiced a number of concerns. First, while there is no physical limit to the policies, procedures, and compliance measures that a regulator could force on an institution to control any risk, there is a point at which the costs incurred in controlling the risk will outweigh the benefits. Therefore, if institutions are required to meet standards of financial reporting and record keeping to guard against money laundering, fraud, or other crimes, the requirements and risks need to be properly balanced.

A second concern is that bank supervisors are increasingly expected to contribute to domestic and international law enforcement efforts—whether for money laundering, organized crime, or tax evasion. In time, these investigative or law enforcement functions could change the tone of the dialogue that supervisors have with the banks they oversee. One potential danger, they noted, is that such a change in the relationship could affect supervisors' ability to discharge their broader legal mandate to ensure the safety and soundness of the banking system.

Panelists also discussed the important role of offshore financial centers in the global financial system. They noted that the offshore industry emerged in the late 1960s in response to changes in U.S. tax law that levied withholding tax on certain interest payments. The result was the offshore euro capital markets, which are now a valuable component of the international financial system. A similar development, it was noted, occurred in the insurance industry. However, panelists pointed out that many of these offshore banks and insurance companies evolved into fully staffed offices providing a broad range of services.

Other objectives served by offshore centers, they observed, include tax mitigation for U.S. multinational corporations through the use of offshore foreign international sales corporations. Funds management and the shipping industry were also objectives.

In closing remarks, Gianviti and Manuel Conthe, Vice President of Financial Sector Operations at the World Bank, noted that panelists had raised a number of issues that were important in the fight against financial crime and that also related to the role of the IMF and the Bank in such a fight. They drew attention to several obstacles that hindered effective international anti–money laundering efforts, including

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diverse views among countries as to what constituted a predicate, or underlying, crime to money laundering and the difficulty of coordinating law enforcement responses among countries. They also noted that the adverse effects of money laundering could vary greatly among countries, especially between the country where the underlying crime is committed and the country where the proceeds are laundered. However, they suggested that the adverse economic effects of serious crimes—including, in particular, organized crime and crimes against financial institutions—required a firm response from the international community. ■

IMF Legal Department

Stand-By, EFF, and PRGF arrangements as of February 28

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By arrangements				
Argentina[1]	March 10, 2000	March 9, 2003	10,585.50	6,751.19
Bosnia and Herzegovina	May 29, 1998	May 29, 2001	94.42	13.99
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	113.38
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Nigeria	August 4, 2000	August 3, 2001	788.94	788.94
Pakistan	November 29, 2000	September 30, 2001	465.00	315.00
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	56.66
Turkey[1]	December 22, 1999	December 21, 2002	8,676.00	4,742.90
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			**31,772.69**	**15,750.25**
EFF arrangements				
Bulgaria	September 25, 1998	September 24, 2001	627.62	104.62
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
FYR Macedonia	November 29, 2000	November 28, 2003	24.12	22.97
Indonesia	February 4, 2000	December 31, 2002	3,638.00	2,786.85
Jordan	April 15, 1999	April 14, 2002	127.88	91.34
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Ukraine	September 4, 1998	August 15, 2002	1,919.95	1,017.73
Yemen	October 29, 1997	October 28, 2001	72.90	32.90
Total			**8,696.57**	**6,342.51**
PRGF arrangements				
Albania	May 13, 1998	July 31, 2001	45.04	9.41
Benin	July 17, 2000	July 16, 2003	27.00	16.16
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	22.35
Cambodia	October 22, 1999	October 21, 2002	58.50	33.43
Cameroon	December 21, 2000	December 20, 2003	111.42	95.50
Central African Rep.	July 20, 1998	July 19, 2001	49.44	24.96
Chad	January 7, 2000	January 7, 2003	36.40	26.00
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	13.63
FYR Macedonia	November 29, 2000	November 28, 2003	10.34	8.61
Gambia, The	June 29, 1998	June 28, 2001	20.61	6.87
Georgia	January 12, 2001	January 11, 2004	108.00	99.00
Ghana	May 3, 1999	May 2, 2002	191.90	120.85
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Guyana	July 15, 1998	July 14, 2001	53.76	28.88
Honduras	March 26, 1999	March 25, 2002	156.75	64.60
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	28.69
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2002	46.65	33.15
Mauritania	July 21, 1999	July 20, 2002	42.49	24.28
Moldova	December 15, 2000	December 14, 2003	110.88	92.40
Mozambique	June 28, 1999	June 27, 2002	87.20	33.60
Nicaragua	March 18, 1998	March 17, 2002	148.96	33.64
Niger	December 14, 2000	December 21, 2003	59.20	50.74
Rwanda	June 24, 1998	June 23, 2001	71.40	19.04
São Tomé and Príncipe	April 28, 2000	April 28, 2003	6.66	4.76
Senegal	April 20, 1998	April 19, 2001	107.01	28.54
Tajikistan	June 24, 1998	December 24, 2001	100.30	34.02
Tanzania	March 31, 2000	March 30, 2003	135.00	95.00
Uganda	November 10, 1997	March 31, 2001	100.43	8.93
Yemen	October 29, 1997	October 28, 2001	264.75	114.75
Zambia	March 25, 1999	March 28, 2003	254.45	224.45
Total			**3,172.23**	**1,818.51**
Grand total			**43,641.49**	**23,911.27**

[1] Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Treasurer's Department

Extended Fund Facility Arrangements are designed to rectify balance of payments problems that stem from structural problems.

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Opening remarks to conference

Köhler sees standards and codes as a tool for growth and financial stability

Standards and codes are an integral part of the IMF's work on crisis prevention.
—Horst Köhler

Following are edited excerpts of remarks prepared for delivery by IMF Managing Director Horst Köhler at the beginning of the IMF–World Bank Conference on International Standards and Codes, in Washington, DC, March 7–8. The full text of Köhler's remarks is available on the IMF's website (www.imf.org).

We have come a long way in building a consensus on the importance of internationally recognized standards and codes. But it is also clear that there are unresolved issues. Most important is the view of some emerging market and developing countries that the bar has been set too high. This conference is an important opportunity for the IMF, the World Bank, and other standard-setting bodies and forums represented here to hear your concerns and learn how we can help to make standards work for you.

Role of standards and codes

While standards and codes deal with highly technical matters, there is nothing narrow or technical about their purposes. They are an important tool for achieving the main objectives of the IMF—namely, to promote sustained growth, which is essential for reducing poverty in member countries, and greater stability in international financial markets. They are an integral part of the IMF's work on crisis prevention. But they are also crucial for our efforts to help member countries strengthen their financial systems and take advantage of the opportunities of global capital markets.

While it is still early in the game, there is already evidence that meeting standards can pay off. For example, countries that have introduced shareholder and creditor rights in line with international standards have developed deeper financial markets and, as a result, have grown faster than those countries where these rights are not protected by regulation. In countries where minority shareholder rights were protected, stock markets generally declined less during the recent emerging markets crises. In addition, it is fairly clear that countries like Argentina and Chile were better placed to resist contagion during the Asian crisis because they were known to have systems of banking supervision and capital adequacy that met or exceeded the Basel standards.

As a part of our constructive engagement with private financial markets participants, we have explored extensively the role of standards and codes in crisis prevention. It is clear from these discussions that as more information on the observance of standards and codes has become available, private creditors have begun using this information in their country risk assessments.

IMF and standards and codes

Our experience over the past few years has also made it clear that developing, assessing, and implementing standards and codes is an enormous undertaking. The IMF and the Bank, with other standard-setting agencies, can help by providing experts to undertake assessments, making recommendations for reforms, and providing technical assistance for countries implementing the necessary changes. But ultimately, country authorities have the most important role in this initiative. You have the task of implementing standards—to the extent that they are appropriate in your countries.

This conference follows the recent review in the Boards of the IMF and the Bank of the experience under our pilot programs with standards and codes. This review demonstrated that there is nearly universal support for the use of standards and codes in our institutions. In particular, our Executive Boards reached four important conclusions:

• Standards assessments have been useful in helping country authorities identify sources of vulnerability and priorities for institutional development.

• When published, these assessments also enable private market participants to make better investment decisions.

• The IMF and the World Bank are uniquely positioned to provide balanced assessments—ones that highlight progress that countries have made in implementing standards as well as the areas where further reform is needed.

• Assessments need to take account of country differences and conditions. However, it is important to use consistent definitions across countries—a key aspect of international standards.

At the same time, our review of the standards initiative highlighted concerns. In particular, there was concern that our existing standards may reflect a one-size-fits-all approach. This concern has many dimensions:

• a feeling that developing countries have not had a sufficient voice in the design of standards;

• a concern that these standards are not easily applied to countries at an early stage of institutional development, especially low-income countries; and

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• a conviction that the administrative burdens imposed on countries by this work, as well as the bottlenecks and constraints that countries face in implementing standards, are not fully appreciated.

Addressing concerns

I see this conference as a mechanism for understanding these concerns more fully and trying to find ways to address them. I recognize that our members will not fully own this process unless they feel that standards are relevant to them. Some of our member countries have indicated that their creditors appear to be making use of standards assessments in evaluating creditworthiness, but others have questioned whether they will really see benefits from this type of differentiation. The IMF's data dissemination standards make a clear distinction between what is expected from countries with access to international capital markets and what is appropriate for countries that have not yet reached that stage. I hope this conference will help us find ways to make all standards more relevant to all our members while maintaining their benefits as standards. We need to be careful to avoid permanently creating two or more classes of member countries and risking that some may never gain access to global financial markets. But we also need to find ways to chart a clearer strategy for moving from an early stage of institutional development to full market access.

I am also very conscious of the burdens imposed by this work. This conference should help us understand better the constraints countries face as they try to implement standards. We will want to explore the degree to which the constraints are financial and how much they may also reflect a lack of qualified experts. We need to consider in practical terms how technical assistance can help. As you know, there is a limit to the resources available in the IMF for this purpose, and we are exploring ways of mobilizing assistance from other institutions and bilateral donors. In the period ahead, we will need to work out how the IMF and the Bank can assist you in identifying which standards, and elements of standards, are a priority in your countries. ■

The joint IMF–World Bank Conference on Standards and Codes drew senior authorities from finance ministries, central banks, and international agencies.

A report on the IMF–World Bank Conference on International Standards and Codes will be published in the April 2 issue of the *IMF Survey*.

Mussa to relinquish position as IMF Director of Research

Michael Mussa will be stepping down from his position as the IMF's Economic Counsellor and Director of the Research Department at the end of his current term, IMF Managing Director Horst Köhler announced.

Mussa will relinquish his post on June 29. But, at the request of Köhler, he will remain on staff until the end of September as Special Advisor to the Managing Director.

In announcing Mussa's resignation in a news brief dated March 7, Köhler said, "Michael Mussa has made an enormous contribution to the IMF and its work over the past decade, giving great service to our membership. He has provided wise counsel to the Executive Board, management, and staff, leading the Research Department during one of the most eventful periods in the IMF's history. I know he will be greatly missed by his many friends and colleagues here.

"During his tenure, Mike has significantly increased the contribution that the Research Department makes to the operational work of the IMF and has upgraded the *World Economic Outlook,* the *International Capital Markets* report, and the regular briefings to the Board on world economic and market developments," Köhler said.

Responding, Mussa said, "It has been an honor and a pleasure to work for the past decade as a member of the staff of the IMF. Despite recent criticism of the institution, the IMF is undoubtedly a highly efficient international organization that effectively serves the needs and interests of its 183 member countries. I cherish the opportunity to have contributed to that service, and I wish my colleagues on the IMF staff, in management, and on the Executive Board well in their continuing endeavors."

Michael Mussa

Mussa took up his post in August 1991, following a distinguished career in academia and public service. He was a William H. Abbott Professor of International Business at the University of Chicago, a member of the U.S. Council of Economic Advisers under U.S. President Ronald Reagan, and a Research Associate at the National Bureau of Economic Research.

Köhler announced that the IMF would be undertaking an intensive search over the coming months to identify suitable candidates to succeed Mussa.

The text of News Brief No. 01/25 is available on the IMF's website (www.imf.org).

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Kosovo

Economic, political, and social uncertainties pose challenges to fiscal sustainability

Kosovo, a province of Serbia in the Federal Republic of Yugoslavia, is rebuilding from the conflict of March–June 1999 under the provisional authority of the United Nations (UN) Mission in Kosovo (UNMIK). In a recent IMF publication, *Kosovo: Macroeconomic Issues and Fiscal Sustainability*, Robert Corker (of the IMF's European I Department), Dawn Rehm (Fiscal Affairs Department), and Kristina Kostial (formerly in the European I Department and now in the African Department) review aspects of this rebuilding. The authors argue that establishing a sound tax base, as well as properly controlled and targeted public spending, is crucial to the sustainability of economic recovery.

Economic and political developments

The conflict set back an economy already in serious decline. Kosovo had not yet started the transition to a market economy; per capita GDP was low even for southeastern Europe; banks were essentially insolvent; and infrastructure was neglected. During hostilities, housing, utilities, and industry suffered extensive damage, and population flight disrupted commerce and created a severe shortage of experienced workers.

Postconflict, the provisional authority is empowered by a UN Security Council resolution to pass regulations that override Yugoslav law; there is no recognized indigenous government, and Kosovo's political status is in limbo.

Recovery, say the authors, is well under way, spurred by a donor-financed reconstruction boom. But just how much has the economy rallied? Preliminary IMF estimates place the per capita GDP level for 2000 in the $650–$850 range—below the level in other regional postconflict countries (in Albania, per capita GDP is about $1,000; in Bosnia and Herzegovina, it is about $1,100). Income levels exceed GDP, but only because of sizable humanitarian aid and private remittances.

The economic recovery program has several important dimensions other than merely repairing the infrastructure. Foremost, it is essential that basic institutions and regulations be put in place to foster private sector development. The adoption of the deutsche mark and regulations to reestablish a payments system and properly regulated banks were important early steps in this regard. But the public sector also has a vital role to play as provider of essential services, such as health care, education, policing, and a welfare net. Accordingly, the authors stress, a priority for Kosovo is to develop tax and expenditure policies to ensure that public services are comprehensive, efficiently provided, and financed mainly from locally generated resources. However, as long as Kosovo's political status remains unresolved, medium-term planning exercises are fraught with uncertainty. In particular, the degree of Kosovo's future economic and political autonomy will have an important bearing on the structure of the tax system and the extent to which public expenditures remain devolved from the rest of the Federal Republic of Yugoslavia. "Recent political change in the Federal Republic of Yugoslavia," the authors say, "opens up possibilities for moving forward on the issue of Kosovo's status, but there are as yet no firm clues as to direction."

Fiscal structure and the 2000 budget

Given Kosovo's unique circumstances, its fiscal policy is rather rudimentary. The tax system relies mostly on tax collection at the border, and almost all revenues stem from imports; the domestic economy, in contrast, escapes virtually untaxed. On the spending side, the structure of expenditure is not comprehensive, and a large share is financed by donor grants. The initial budgets for the last few months of 1999 and for 2000 focused on essentials, such as reestablishing the provision of basic goods and services, setting up a minimal welfare net, and rehabilitating utilities. It covered only recurrent spending; reconstruction spending was drawn up separately and financed in full by donors.

According to the authors, execution of the recurrent budget has worked remarkably well so far, helped by the establishment (with technical assistance from IMF staff) of the Central Fiscal Agency, which exercises firm control over all aspects of the budget. The large foreign-financed reconstruction program has temporarily raised total government expenditure to a high level, but if capital spending is excluded, expenditure levels in Kosovo are not high by international stan-

Donors meeting on Kosovo

Representatives of international bilateral and multilateral donors met February 25–26 in Kosovo's capital, Pristina, to examine and reevaluate the level of their financial support for Kosovo's reconstruction budget. Donors were generally pleased with the progress made toward establishing a sustainable budget and pledged funds to bridge the gap between expenditures and locally generated revenues in 2001. Donor grants will finance about one-third of recurrent budget spending in 2001, compared with one-half in 2000.

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dards. On-budget recurrent spending amounts to about 14 percent of GDP, against an average of 20–23 percent in the low- and middle-income countries with which Kosovo might reasonably be compared. Most of the difference can be accounted for by the exclusion from the Kosovo budget of defense and debt service. But welfare and social security spending is also low by international standards, primarily because the government makes no payments for public pensions and because social spending has, at least until recently, been augmented by sizable off-budget humanitarian assistance. The wage bill, too, is low, mainly because employment levels are lean and because some functions (for example, military, police, judges) are not fully developed. Spending on health care and education, where employment levels are relatively high, is broadly in line with that in other economies of comparable size.

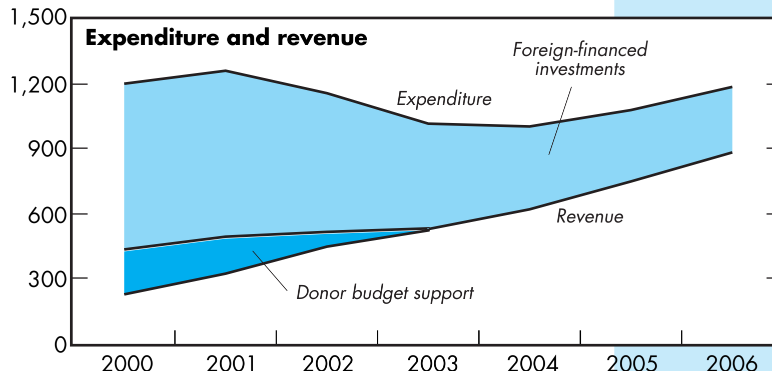
Path toward sustainability

Kosovo needs to make budget decisions now with a clear view to achieving a sustainable fiscal position. According to the authors, the objective should be to avoid the need for sharp expenditure adjustments in the future, when external financing sources are likely to dry up. Although donor support for reconstruction could continue for several years, donors have stressed that support for recurrent expenditure will decline substantially in the next few years (see box, page 92). In the short term, this will constrain spending options as increases in tax revenue replace declining donor grants. In the longer term, the authors suggest, a fully sustainable fiscal position would require all expenditures—including large off-budget items, such as investment, defense, and debt service—to be financed mainly from local revenues.

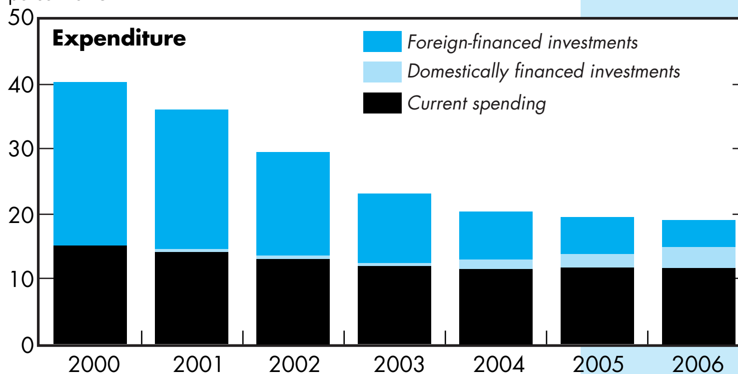
The priorities are thus to diversify the tax system and contain expenditure growth through a careful review of spending needs. On tax policy, IMF technical assistance staff have outlined a sequenced plan to improve existing instruments and introduce new ones. The main steps include an immediate strength-

Kosovo: medium-term scenario

million deutsche mark[1]



percent of GDP



[1]DM 1 million is approximately $462,900 at current rates.
Data: IMF staff estimates

ening of existing tax collections by raising and refining excise duty rates, reducing exemptions from import and sales taxes, and continuing to improve border administration; introducing a value-added tax (VAT) and wage tax in 2001; and, beyond 2001, taxing profits.

The key issues for expenditure policy include maintaining a lean public sector; avoiding industrial subsidies; avoiding commitments on public pensions that cannot be honored in the future; and ensuring adequate provision for the rising maintenance cost of public investment under the foreign-financed reconstruction program. At the same time, Kosovo will need to continue building an efficient intergovernmental structure.

The 2001 budget focuses on raising revenue and containing overall expenditure growth. Assuming that tax administration improves and that planned taxes, like the VAT, are introduced, revenue will increase by 40 percent to DM 338 million ($156 million). Meanwhile, expenditures are budgeted to rise by about DM 70 million ($32 million) in 2001 to DM 500 million ($231 million), even assuming that wages are

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
March 5	4.27	4.27	4.95
March 12	4.20	4.20	4.87

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

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frozen and that employment is reduced to the level originally budgeted for in 2000. Donors have been asked to contribute about DM 160 million ($74 million), or about one-third of recurrent expenditures, rather than the one-half provided in 2000.

The 2001 budget involves considerable uncertainties and risks. For instance, the projections assume that the VAT will be introduced by mid-2001 (which is projected to raise DM 30 million ($14 million) on domestic value-added in 2001) and that the strong performance of border collections will continue. If these projections fail to materialize, spending may have to be constrained if additional donor financing is not forthcoming. Thus, the authors stress, it is particularly important to enforce the intended wage freeze, to reduce employment in some budget sectors, and to contain subsidies to the utilities—a particular drain on scarce budget resources to date.

Beyond 2001: longer-term scenarios

An examination of fiscal sustainability requires looking beyond the near term. As the authors note, this exercise is highly uncertain in the case of Kosovo. Nevertheless, starting from the assumption that Kosovo remains an autonomous economic entity, they construct a medium-term scenario that assumes real GDP growth of 10 percent a year, inflation of 2 percent a year, full implementation of the IMF staff's tax policy proposals, and the cessation of donor support for the recurrent budget in 2003. It is assumed, however, that more than half of capital spending would continue to be financed by foreign donors.

The assumed strong recovery in GDP and the broadening of tax instruments are projected to permit tax growth to average about 25 percent a year in 2001–06, bringing the revenue-to-GDP ratio close to 15 percent. Even so, the authors stress, the elimination of donor support for the recurrent budget by 2003 would impose tight limits on spending. After 2003, continuing revenue growth would not be offset by declining donor support, implying scope for more rapid expenditure growth. But, the authors caution, the extra room for spending could easily be eaten up by the need to incorporate potentially big ticket items (defense, debt service, and pensions) into the budget (see chart, page 93).

Kosovo's expenditure constraints would be more severe if the economy were to grow less strongly in the medium term. For example, if real GDP growth were limited to 5 percent a year, there would be no room for an increase in current expenditures in 2001–03 if donors kept to their intention of removing budget support by 2003. The constraints on expenditure would also be tighter if there were delays in introducing new taxes, like the VAT and the wage tax, given that it takes time for revenue from new taxes to build up.

At the same time, some of the spending constraints could potentially be alleviated. First, tax revenues could turn out to be more buoyant in the future and there might also be scope to broaden tax instruments and raise marginal rates. Second, Kosovo will likely have alternative financing sources in the medium term, including domestic borrowing. Finally, donors may be more generous than the scenario assumes.

Conclusions

The UN provisional authorities, the authors note, have made a good start in budget implementation and have taken an important step toward budget sustainability for 2001. However, the small tax base and the expectation of diminishing donor support for recurrent spending imply a very tight constraint on expenditure—especially with pressures to expand the budget's scope.

Policies to foster economic growth are essential to ensure that constraints on spending are not unbearable. Because growth will hinge on private sector development, an enabling environment is crucial—solutions to property rights problems, establishment and enforcement of modern commercial codes and regulations, and a deeper banking system. Maintenance of law and order and lessening of ethnic tensions are also essential ingredients. Other important priorities include avoiding delays in diversifying the tax system and exercising caution against introducing spending programs that carry long-term commitments. ■

Copies of *Kosovo: Macroeconomic Issues and Fiscal Sustainability*, by Robert Corker, Dawn Rehm, and Kristina Kostial, are available for $18.00 each from IMF Publication Services. See page 98 for ordering information. The text is also available on the IMF's website (www.imf.org/external/pubs/ft/kosovo/index.htm).

Member's use of IMF credit

(million SDRs)

	During February 2001	January–February 2001	January–February 2000
General Resources Account	1,089.30	3,335.78	261.42
Stand-By	1,089.30	3,335.78	1.42
SRF	867.60	2,349.57	0.00
EFF	0.00	0.00	260.00
CFF	0.00	0.00	0.00
PRGF	29.58	72.44	50.01
Total	1,118.88	3,408.22	311.43

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

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IMFSURVEY

Signs of global economic slowdown cast shadow over international markets

Investors' low expectations of the global economy contributed to lower yield curves, widening credit spreads, and further declines in already weak equity markets during the fourth quarter of 2000, according to the March 2001 *Quarterly Review: International Banking and Financial Market Developments* released by the Bank for International Settlements (BIS). Market attention was focused on the United States, where economic data reinforced concerns that a slowdown would continue during the first half of 2001.

Market movements also revealed how much the U.S. outlook had led to a reevaluation of growth prospects in other regions. An appreciation of the euro implied investor optimism about the European economy, but a downward shift in the euro swaps curve showed that Europe is not immune to the impact of a U.S. slowdown. The yen depreciated and the Tokyo stock market declined—signs that investors perceived a return to weaker growth in Japan (see chart).

International banking market

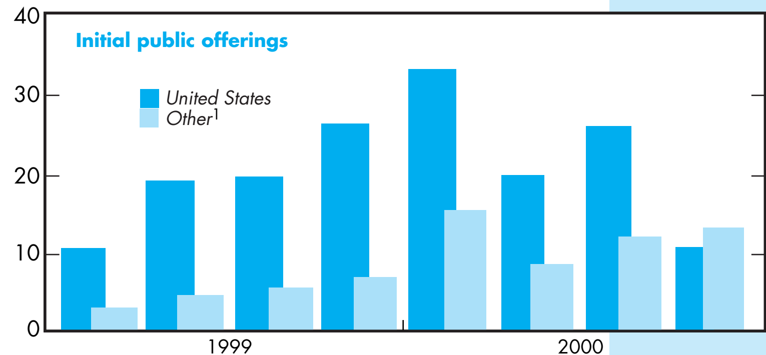
Emerging market countries deposited a record $54 billion in BIS-monitored banks in the third quarter. Members of the Organization of the Petroleum Exporting Countries (OPEC) accounted for one-third of that figure. Among developing countries outside OPEC, the largest deposits came from Taiwan Province of China and China. Unlike in the 1970s, however, these deposit flows were not recycled back into developing countries. In fact, cross-border claims on developing countries have remained broadly unchanged since the last quarter of 1999, with further repayments from Asia offsetting modest amounts of credit extended to Argentina, Brazil, and Turkey and a few other emerging market countries. During the first three quarters of 2000, cross-border claims on Turkey rose by substantially more than on any other developing country, and more recent data suggest that these claims continued to increase in the fourth quarter, despite concern about the stability of Turkey's financial system. Claims on Russia dropped most sharply among emerging market countries, down over $3 billion, owing to debt restructuring rather than a cutback in credit.

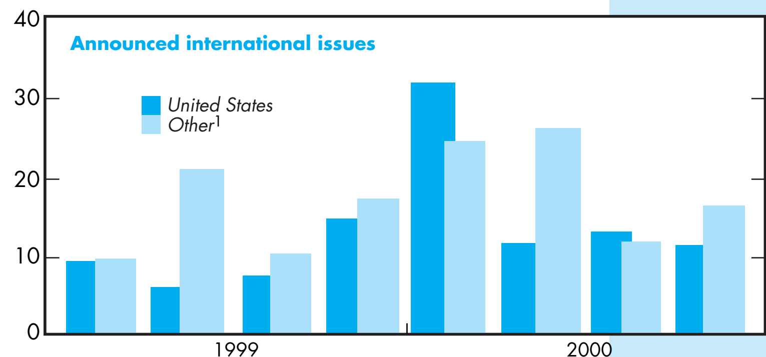
International debt securities market

Borrowing conditions deteriorated in the fourth quarter of 2000. Although aggregate net issuance actually rose 21 percent from the previous quarter, to $328 billion, the increase was concentrated in the money market, where the widening of credit spreads was less pronounced. Issuance of long-term fixed-rate instruments declined sharply as wide credit spreads squeezed out lower-rated borrowers. Also, net issuance by emerging market borrowers declined to $34 billion—17 percent less than in 1999—with the bulk of those funds raised in the first quarter. Investors carefully distinguished among countries according to their perceived credit quality.

Equity issues for selected countries

calender quarters, billion U.S. dollars





[1]Germany, Japan, and the United Kingdom.

Data: Bloomberg; Capital DATA; BIS

Derivatives market activity

The dollar value of exchange-traded derivatives activity rose by 6 percent in the fourth quarter, led by equity contracts, which were up by 22 percent to $11.4 trillion. Worries over a U.S. economic slowdown and unfavorable prospects for technology firms apparently moved investors to hedge their positions; derivatives trading on technology stock indices was especially active, the report observes. Expectations of U.S. monetary easing led to lively trading in U.S. money market contracts, counterbalancing declines in Europe and Asia.

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Implementation of standards

A feature article in the BIS review reports on the broad strategy framed by the Task Force on Implementation of Standards, established in 2000 by the Financial Stability Forum in the wake of recent financial crises. (The Task Force's report is available on the Internet at www. fsforum.org/reports/.) Key elements to build stronger financial systems include fostering country ownership, setting appropriate priorities, regularly assessing current practices, providing market and official incentives, and mobilizing human and financial resources. The report cites two IMF–World Bank joint initiatives: the Financial Sector Assessment Program (FSAP), which involves a range of national agencies and standard-setting bodies in assessing financial sector vulnerabilities and identifying development priorities, and Reports on the Observance of Standards and Codes (ROSCs), which provide a vehicle for public information on implementation.

The implementation of standards in itself, the review concludes, is not sufficient to ensure financial stability, nor are standards an end in themselves or a "magic cure-all." They should be viewed, rather, as a means for promoting sound financial systems. In particular, the report notes, by helping to improve the functioning of the financial sector, standards can help minimize the buildup of risks and vulnerabilities in the financial system that can lead to crises with heavy costs in output and employment. ■

BIS Quarterly Review: International Banking and Financial Market Developments, and related information, is available at the Bank for International Settlements website (www.bis.org).

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00/26: Tanzania: $26 Million Under PRGF and $17 Million in Additional HIPC Assistance, March 14

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IMF Managing Director Horst Köhler, "Standards and Codes—A Tool for Growth and Financial Stability," IMF-World Bank Conference on International Standards and Codes, Washington, DC, March 7 (see page 90)

Transcripts

Press Conference, IMF African Department Director G.G. Gondwe and World Bank Vice-President (African Region) Callisto Madvo on Köhler/Wolfensohn Africa trip, March 7

Press Briefing, Thomas Dawson, IMF External Relations Department Director, March 12

Press Briefing, IMF Managing Director Horst Köhler and First Deputy Managing Director Stanley Fischer on establishing International Capital Markets Department, March 2 (see page 85)

Letters of Intent and Memorandums of Economic and Financial Policies*

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IMF SURVEY

Mann argues U.S. trade deficits, though large, continue to be sustainable in near term

Is the U.S. trade deficit sustainable? On this issue, when Catherine Mann speaks, people listen. Mann, a Senior Fellow at the Institute for International Economics (IIE), is the author of an authoritative 1999 book on the issue (see her article in *Finance & Development,* March 2000, for a summary).

In her book, Mann predicted that U.S. trade and current account deficits, though a matter of long-term concern, were sustainable in the near term, certainly "for two or three more years." At a March 1 talk organized by the IIE, Mann updated her analysis and said she saw no reason to change her earlier prediction that the deficits, though large, would be sustainable through 2001–02. (Mann considers the deficit to be "sustainable" in the sense that it is unlikely to generate any economic forces *of its own* that would bring about a significant reduction.)

Mann did caution that global investors could decide that U.S. assets account for so large a share of their portfolios that they scale back their holdings of these assets. Under such a scenario, asset prices would have to adjust to reflect this change of sentiment in global markets; most likely, the exchange value of the dollar would decline. However, she assigned a low probability to such a scenario unfolding this year.

What drives the deficits?

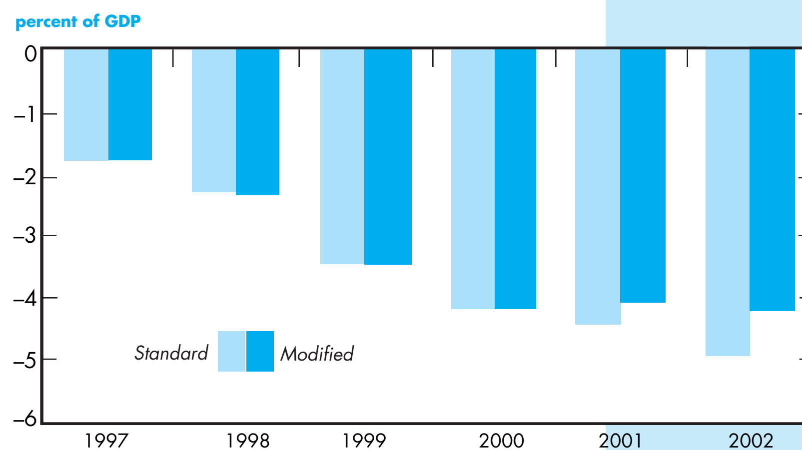
According to Mann, the U.S. trade and current account deficits are principally the outcomes of the stronger economic performance of the United States relative to that of its trading partners. There are two aspects to the stronger performance. First, U.S. real GDP growth over the past few years has been stronger than in its partner countries. Second, investments in U.S. assets continue to provide high returns (adjusted for risk) to global investors.

Rapid real GDP growth in the United States fuels an increase in import demand that far outstrips the growth of exports (which depends on the real GDP growth of its trading partners). As a result, the United States cannot pay for its desired imports through its exports, thereby generating large trade and current account deficits. Mann refers to this as the "real side" or the "U.S. perspective" on the deficits.

But the same transactions can be viewed from what Mann calls the "financial side" or the "global perspective." The United States pays for its current account deficits by borrowing from the rest of the world. This borrowing is reflected in an accumulation of U.S. assets in the hands of global investors. The fact that the United States continues to provide high risk-adjusted returns to these investors is critical to the country's continued ability to fund large current account deficits.

The issue of the sustainability of current account deficits can therefore be viewed from either the real side or the financial side. At the end of the day, these are "two sides of the same coin" and cannot diverge. But the pressures for adjustment in the deficit could come from either side.

U.S. current account deficit



Data: Catherine Mann, IIE

Real-side estimates

Mann presented updated estimates of the U.S. current account deficit based on a standard econometric analysis of import and export equations. She also presented an alternative set of estimates for 2001–02, which are based on a modification of the standard analysis to take account of the more rapid technological change of the last few years (the "New Economy" phenomenon) and trends in the liberalization of trade in services.

Mann's estimates (see chart) are that the U.S. current account deficit in 2002 would be just over 5 percent of GDP under the standard analysis, and 4¼ percent of GDP under the modified analysis.

Though the deficits would continue to be large, Mann felt that—viewed from the real side—they were sustainable for a number of reasons. First, high productivity growth in the United States provides reassurance that the United States will "make good on the expectations" of strong economic performance. Second, the payments associated with the borrowing needed to finance the deficit are still small relative to the size of the U.S. economy; Mann described them as

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"being a small credit card payment to make each month on a very large income." Third, the nature of the financing of the U.S. deficit buys it some time before the inevitable pressures to adjust. The United States borrows almost exclusively in domestic currency; more than 90 percent of its external debt to banks is in dollars. In addition, most of the private capital flowing into the United States consists of foreign direct investment and portfolio investment, rather than bank lending. All told, the United States can afford to carry a larger external deficit than a country whose obligations consist primarily of contractually fixed, short-term bank loans denominated in foreign currencies.

Catherine Mann

Financial side worries?

Mann injected a note of caution, however, by suggesting that the same deficit, viewed from the financial side, does raise some doubt about its sustainability. The flip side of a continued U.S. trade deficit is the growing share of U.S. assets in the portfolios of global investors. These investors could reach a point where—for reasons of diversification—they are no longer willing to absorb U.S. assets. These concerns would be heightened if investors chose to replace the shrinking supply of U.S. government debt instruments in their portfolios not with other *U.S.* assets but with the assets of other *governments*. If a scaling back of demand for U.S. assets does take place on the financial side of the coin, it would have to be reflected also on the real side. The most likely adjustment would be a decline in the value of the dollar, which would lower the current account deficit by making U.S. imports more expensive and U.S. exports more competitive. While suggesting that this was a scenario to keep in mind, Mann did not think it likely that it would unfold in 2001. ■

Prakash Loungani
IMF External Relations Department

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IMFSURVEY

Sizable changes in relative goods prices during transition partly explain Albania's low inflation

Although Albania's inflation performance has been similar to that of other transition economies, it has been distinguished by generally lower rates. After an initial spike in 1992, inflation declined substantially and was almost nonexistent between mid-1999 and the end of 2000. In an IMF Working Paper, Philipp C. Rother, who was an Economist in the IMF's European I Department when the paper was written and is now a Senior Economist at the European Central Bank, investigates some of the forces driving Albania's inflation performance and draws some implications for the design of monetary policy.

Inflation during transition

After Albania embarked on reforms to transform its centrally planned economy into a market-driven one, inflation initially jumped to more than 200 percent in 1992, largely because the prices of a number of goods in the consumption basket were freed. Subsequently, Rother says, "inflation declined steadily and rapidly in an environment of strong economic growth and macroeconomic stability" and, by 1995, had dropped to less than 8 percent. In 1996, however, inflation surged again as the general elections and the rise of pyramid schemes (see *IMF Survey*, November 8, 1999, page 366) led to both political and social turmoil. The pyramid schemes collapsed in 1997, Rother notes, and the authorities managed to regain control over economic conditions in the second half of that year by implementing strong stabilization policies, including monetary tightening. Inflation declined to about 20 percent in 1998 and prices were essentially stable by 1999.

These low rates, Rother says, can be explained partly by the structure of Albania's real sector, which is dominated by agriculture. After the collapse of centralized economic planning, agricultural assets were privatized quickly, providing most rural families with their own production base. As a result of privatization and price liberalization, agricultural output improved, helping contain the effect of a monetary overhang (an excess accumulation of savings). Also, Rother notes, labor costs became flexible because most farmers were self-employed. In contrast, Albania's industrial sector was smaller and external trade relations were limited, features that spared the country from having to reallocate and support a large number of workers.

While inflation behavior in Albania can be explained partly by structural factors and monetary and fiscal policies, Rother says, it can also be explained partly by the sizable changes made in the relative prices of individual goods during the country's transition. He notes that menu costs—the costs to firms of changing their prices—motivate firms to make price adjustments in response to shocks in an asymmetric fashion, with more upward than downward changes, which in turn drives up inflation in the short run.

Role of shocks

Rother describes two possible scenarios that would lead to asymmetric relative price adjustments: one in which underlying shocks to the economy are symmetric (that is, they drive the costs of some goods up and others down by an equal amount), and the other where the shocks themselves are asymmetric, driving some costs up without an offsetting reaction in other goods.

When shocks are symmetric, they trigger inflation only in an environment of positive trend inflation. In this scenario, Rother explains, relative price adjustments in response to the symmetric shocks are generally positively skewed; that is, there are more large positive changes than large negative ones. This is because suppliers who want to lower their relative prices tend to maintain the nominal prices, while price increases must also account for the inflation rate and are thus larger than they would be without trend inflation.

When the shocks are asymmetric, in contrast, relative price adjustments will affect inflation regardless of whether prices in general are increasing. In particular, Rother says, asymmetric relative cost increases will tend to spur inflation because large increases in a few prices are not offset by small declines in many prices, as a small adjustment is too costly in view of the menu costs. A typical example of a one-off asymmetric shock is an oil price increase that leads to a higher price level because non-oil prices are not lowered. The reverse holds for asymmetric reductions in costs.

In transition countries, substantial shocks are likely to occur because the shift from a centrally planned to a market-driven economy causes a total rearrangement of economic relationships and requires a new structure of relative prices. Sometimes, the necessary changes are symmetric, but asymmetric shocks are also likely to happen continuously. They may happen, in particular, for the following reasons:

• The relative prices for capital-intensive services such as housing may increase slowly from the

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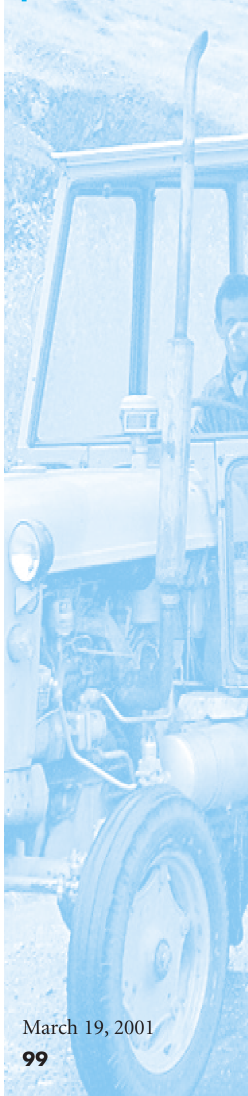

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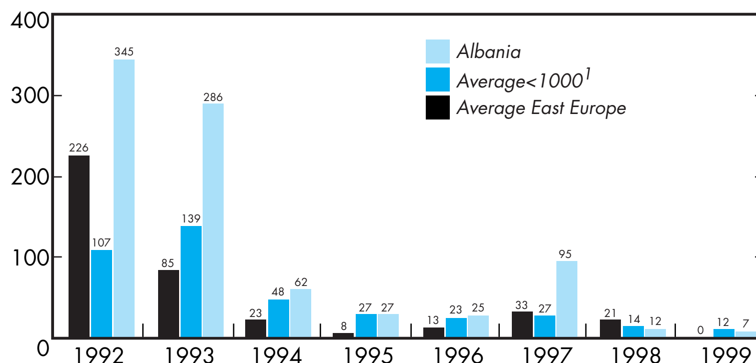
depressed levels that prevailed under central planning, triggering a sequence of price hikes.

- The relative wages of highly skilled workers may be slow to converge to their equilibrium level, causing corresponding gradual adjustments in the relative prices of skill-intensive goods and services.
- Measured prices may be insufficiently adjusted for quality improvements, so that observed relative price changes exceed actual changes.
- The relative prices of nontradable goods and services may rise if productivity gains in that sector fall behind those in the traded goods sector (the Balassa-Samuelson effect).

Inflation in Albania and transition economies

annual average in percent



[1]Transition economies with annual inflation below 1,000 percent during transition: Czech Republic, Estonia, Hungary, Kyrgyz Republic, Latvia, Lithuania, Mongolia, Poland, Romania, Slovak Republic, and Slovenia.

Data: IMF, Working Paper No. 00/207

In the first case above, Rother notes, it may be optimal for relative prices of capital-intensive services to adjust slowly during transition because countries embarking on market reforms have a large capital stock (for example, in the form of housing) relative to their per capita income and no associated debt. Thus, he explains, it might be desirable for the prices of services to be set initially to recover only current costs while allowing the capital stock to depreciate to a level in line with income. As incomes rise, prices gradually rise to cover depreciation and the cost of capital.

In the case of wages, relative adjustments between skilled and unskilled workers may induce a similar gradual shift in relative prices. Under central planning, skilled workers earned only slightly more than unskilled workers, and the opening of the economy caused real wages to converge to market-determined levels. Despite a shortage of empirical evidence for Albania, Rother concludes on the basis of evidence from other transition countries that the wages of skilled workers rose rather than that those of unskilled workers declined. He also concluded that wage changes were driven by newly established enterprises. Thus, he says, "the slow emergence of new private enterprises in Albania suggests that the adjustment of the wage structure has evolved only gradually over time, inducing a sequence of wage shocks to the economy."

Looking at the evidence of individual price changes during Albania's transition to a market economy, Rother notes substantive relative price adjustments. Between 1994 and 1999, cumulative inflation of the Albanian unweighted consumer price index basket (containing 221 items grouped into 8 categories) amounted to 123 percent, with price changes of individual items varying from declines of 12 percent (for satellite dishes) to increases of more than 900 percent (for grapes). In addition, he found that the price adjustments were indeed positively skewed so that, in line with the theory, they may have contributed to overall inflation. The inflationary impact of asymmetric relative price adjustments was supported by an econometric analysis, where the skewness of relative price changes was found to affect the inflation rate positively.

Implications for monetary policy

Rother concludes that the continued need for relative price adjustments has put upward pressure on inflation. The effect of such adjustments on inflation is large enough to be economically meaningful and is likely to persist, he says. In his view, policymakers must decide the extent to which monetary policy should accommodate the inflationary impact of asymmetric price increases. This will involve weighing the trade-off between the risks of inducing inflationary expectations in the economy and the costs of disinflation when inflation is already low.

For Albania, Rother says, the optimal rate of inflation is probably higher than the level—generally around 2 percent—that developed countries usually aim for. He suggests that an inflation target of about 3 percent should be sufficient to allow for the necessary price changes without exceeding the threshold (about 5 percent) above which inflation is likely to harm the economy. ■

Copies of Working Paper No. 00/207, *Inflation in Albania,* by Philipp C. Rother, are available for $10 each from IMF Publication Services. See page 98 for ordering information.

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