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*Krueger speech*

## Making the most of the euro

Almost two months after the successful launch of euro notes and coins in the 12-member euro area, IMF First Deputy Managing Director Anne Krueger says Europe now needs to tackle outstanding economic reforms more forcefully to ensure that monetary union delivers on its promise. Speaking at the Royal Institute of International Affairs in London on February 25, she refrained from commenting on the pros and cons of U.K. entry into the euro area but observed that a "strong and prosperous European economy is essential to a strong and prosperous world economy." Edited excerpts from Krueger's speech follow. The full text can be found on the IMF's website ([www.imf.org](http://www.imf.org)).



Let me begin by acknowledging what a remarkable achievement monetary union has been to date. Europe's progress toward a single currency over the postwar period has been likened to the emotional roller coaster of a television soap opera: every advance accompanied by inflated rhetoric about Europe's glorious future; every setback greeted with exaggerated predictions of conflict and disaster. But with the changover to euro notes and coins, the drama

has successfully reached its "season finale," thanks to determined political leadership and economic convergence. The challenge now is to ensure that this positive political and economic momentum is maintained in the years to come. (Please turn to the following page)

*Run-up to Monterrey conference*

## Elusive quest for development financing

It is through development that the world's poorest countries will be able to eliminate extreme poverty and become fuller participants in the global economy. But so far the resources for financing development have proved woefully inadequate. How can this situation be altered? A distinguished group of about 30 finance ministers, central bank governors, and development ministers from around the world joined leading nongovernmental experts in

Washington, D.C., on February 20 to debate this topic. Cohosted by the Center for Global Development and the Institute for International Economics, the roundtable sessions were intended to inspire new ideas for

consideration at the UN Global Conference on Financing for Development in Monterrey, Mexico, on March 18–22.

In a rousing opening address the night before the roundtables began, Michel Camdessus, former IMF Managing Director and one of UN Secretary-General Kofi Annan's two special envoys to the Monterrey conference, categorically declared that the conference "must be a success." Anything less, he warned, would undermine the growing sense of solidarity spawned by the New Partnership for African Development and the international community's response to the September 11 terrorist attacks (see box, page 68).

But while the roundtable participants agreed that the Monterrey conference will provide a unique opportunity for world leaders to take a comprehensive look at all sources of development finance—domestic as well as external, public as well as private, aid as well as trade, and investment as well as (Please turn to page 67)



Soros calls for \$18 billion trust fund for poor countries.

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*Krueger speech*

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Krueger: "We must hope that the creation of the euro...proves a spur to the area's long-standing structural reform agenda."

## Positive momentum must be maintained

(Continued from front page) Fortunately, macroeconomic policy in the euro area is built upon firm institutional foundations. Despite initial skepticism in some quarters, the European Central Bank (ECB) has clearly established its independence and commitment to price stability. The ECB faced a difficult policy environment last year, with growth slowing and inflation above its target range. It responded appropriately, lowering interest rates modestly to begin with and then responding more resolutely when September 11 unsettled financial markets and dealt a blow to business and consumer confidence.

### Economic turning point

We now appear to be at or near a turning point in global economic activity—always a difficult juncture at which to set monetary policy. For now, the risks to medium-term price stability seem pretty evenly divided. If recovery proves sluggish, additional easing could be required. But the inflationary impact of an unexpectedly rapid recovery or a move away from wage moderation could argue for a touch on the brakes. For the time being, watchfulness is the key.

Macroeconomic policies focused on stability are a prerequisite for strong growth and job creation. But they are not sufficient. The external weakness of the euro seems to reflect the relative equity boom in the United States, portfolio shifts, and a current account position that has not reacted in typical fashion to the depreciation. But it may also reflect, in part, a belief among market participants that productivity growth will remain lower in Europe than in the United States in the years to come. An important challenge for European policymakers will be to try to prove them wrong.

### Unfinished structural reforms

At the Lisbon summit in March 2000, European leaders adopted the goal of creating over the next 10 years an economy with integrated, employment-generating, and smoothly functioning markets. This will be important to boost productivity growth and increase the economy's potential output by reducing structural unemployment. Progress to date has fallen short in a number of areas. We must hope that the creation of the euro—and now its physical manifestation in notes and coins—proves a spur to the area's long-standing structural reform agenda. If policymakers allow the loosening of exchange rate and current account disciplines to enervate the reform process, then all Europe's citizens will be the poorer for it.

Broader and deeper structural reform is required in a number of areas. For example, growth and job creation in Europe are hampered by labor market rigidities, overstretched and expensive social security systems, and subsidies that hinder efficiency and weaken fiscal positions. A study in the IMF's *World Economic Outlook* of October 1997 suggested that more rapid structural reform could deliver a growth premium of about 5½ percentage points over a 10-year period, helping reduce unemployment by 4 percentage points from a slow-reform baseline. To date, alas, this premium appears to have gone unclaimed. Further reforming labor and product markets is unavoidable if the European economy is to achieve the productivity growth rates that it is capable of.

If monetary union is to enjoy high levels of public confidence—and to be attractive to potential entrants—then it will have to be seen to contribute to greater economic stability and higher living standards for Europe's citizens. This means getting macroeconomic policy right and accelerating structural reform. No one should underestimate the magnitude of what has been achieved to date, but neither should anyone underestimate the magnitude of what remains to be done. ■

### IMF sending mission to Argentina

The IMF announced on March 4 that it was sending a mission to Argentina to conduct a comprehensive assessment of the country's current economic situation and to assist the authorities in developing a sustainable program. Anoop Singh, who has been named the IMF's Director for Special Operations, would head the mission, which departed on Tuesday, March 5, for Buenos Aires.

"The purpose of the visit is to make a comprehensive assessment of the progress being made by Argentina in all the main areas of its economic program," stated Thomas Dawson, the IMF's Director of External Relations. "This will be the first time under the current Argentine government that an IMF team will look in an integrated way across all areas of the economy.

"We anticipate that the mission will return to Washington to share its assessment with management and the IMF Executive Board prior to continuing discussions over an IMF-supported program," Dawson added.

On January 16, to help Argentina cope with a deepening recession and the depreciation of its currency, the Executive Board agreed to extend by one year the due date of a repayment of \$933 million under the Supplemental Reserve Facility as part of a stand-by credit. Such extensions are allowed if repayment would cause undue hardship to a borrower and if the borrower is taking actions to strengthen its balance of payments. On September 7, 2001, the IMF increased Argentina's stand-by credit to \$21.57 billion.

## Developing countries need private capital

(Continued from front page) debt relief—there was a wide range of opinion on where the finance should come from. Perhaps the liveliest debate centered on the relative importance of increasing the quantity versus the quality of overseas development assistance (ODA) and the role of private capital.

Financier-philanthropist George Soros launched the debate by outlining his vision of a new mechanism that, he argued, would better deliver and coordinate assistance, while allowing the burden to be shared more equitably. Rich countries would effectively donate \$18 billion to a trust fund set up for poor countries needing assistance. This onetime donation would come out of developed country allocations of a \$27 billion special issue of SDRs authorized by the IMF in 1997. As Soros envisages the scheme, the IMF would designate an impartial jury of technical experts on the ground in poor countries—independent of the IMF and its member governments—to provide quality control by selecting and vetting acceptable projects as candidates for assistance. Donors would still have the final say on how funds are used, however, choosing from among projects on the final list. A trial run of this mechanism could focus on projects in three critical areas: health, education, and strengthening of legal systems.

One hang-up, however, is that the onetime SDR allocation has the approval of 72 percent of the IMF membership, but is still shy of the 85 percent approval that would give the allocation effect. For this reason, Soros

called on U.S. President George Bush to ask Congress to approve the special SDR issue, warning that Monterrey otherwise could end up a “nonevent or an outright flop.”

Nobel Laureate Joseph Stiglitz lauded Soros’s proposal as a “concrete measure that could be a real achievement.” Calling for a system that “doesn’t depend on the vagaries of national parliaments,” he agreed that Soros had devised one way to provide new liquidity to undo the downward bias in global demand caused by poor countries having to set aside increasing amounts of reserves in the face of global instability. But this global liquidity should be available in a much more general way, he declared, and should not necessarily be dependent on the IMF. He outlined two alternatives to do this. One would devote revenues from the “efficient management” of global natural resources—for example, from the oceans and seabed—to funding global public goods. The second would shift some of what he referred to as the disproportionately large burden of risk faced by developing countries borrowing on international markets. The international community, perhaps through the multilateral institutions, would assume more of this risk. Like Soros,



Stiglitz: Anyone who says there’s no evidence that aid can be spent effectively hasn’t looked at the record.

### IMF’s Köhler names Anoop Singh Director for Special Operations

IMF Managing Director Horst Köhler announced on February 25 the appointment of Anoop Singh as Director for Special Operations, a newly created position in the IMF.

“This initiative will enhance the ability of the IMF to respond to critical situations affecting its member countries. The IMF’s considerable experience in managing such situations is at present diffused across departments. A key function of the new Director will be to bring together this experience so that it is directly supportive of area departments’ work in critical situations,” Köhler stated.

Singh will immediately assume leadership of the IMF staff team that is working with the Argentine authorities, in close coordination with the Western Hemisphere Department, as well as other departments of the IMF. “I am confident,” the Managing Director said, “that this decision will strengthen the IMF’s ongoing effort to help Argentina in formulating a comprehensive program to overcome its severe economic and social crisis.”

In the months ahead, Singh is expected to make recommendations about enhancing the IMF’s capacity in managing critical country situations, based on consultations with the IMF’s area departments and the Policy Development and Review Department.

Singh, an Indian national, will transfer from his current position of Deputy Director of the Asia and Pacific Department to the Office of the Managing Director and report to First Deputy Managing Director Anne Krueger. He has held a range of senior positions within the IMF, including in the Policy Development and Review Department and the European Department. Singh has headed IMF missions to Australia, China, India, Indonesia, Japan, and Thailand.

In the early 1980s, Singh served as Special Advisor to the Governor of the Reserve Bank of India. In the late 1980s, on secondment from the IMF, he was Senior Advisor to the World Bank’s vice president for the Asia region.

*The full text of the News Brief is available on the IMF’s website: [www.imf.org](http://www.imf.org).*



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O'Neill: "We cannot even get close with charity."

Stiglitz cautioned that the new proposals should not undermine the commitment to debt relief and more ODA—and he challenged those questioning whether aid has been well spent to look at the record.

### What role for private capital?

But U.S. Secretary of the Treasury Paul O'Neill, backed by Alan Larsen, U.S. Secretary of State for Economic and Business Affairs, argued that the focus should be on using existing aid more effectively and policy reforms to attract private capital to poor countries, rather than on raising ODA contributions.

O'Neill called for a review of current aid flows rather than an emphasis on "magic numbers"—the setting of numerical targets for countries' aid contributions. This was basically a restatement of the U.S. administration's insistence during the Monterrey planning sessions in January that language for the preparatory document omit mention of the UN's three-decade-old target of raising ODA to 0.7 percent of developed countries' gross national income. While summing up the administration's position as taking an interest in specifying the "kinds of things that would be eligible for grants," O'Neill declared that the charitable spirit that does exist in the United

States "will not be real until we can do a better job of getting better value for money spent." For example, he said, the numbers of children who can read, write, and compute—rather than the numbers attending school—are more important for measuring gains in education quality, given that student-teacher ratios may be as high as 150 to 1.

This vision of development assistance immediately met with some strong objections from a number of participants, led by Soros, who denounced the current U.S. aid contribution—at  $\frac{1}{10}$  of 1 percent of gross output—as "unconscionable." Similarly, Gun-Britt Andersson, Sweden's State Secretary for Development Cooperation, remarked that the developed countries "just don't deliver," despite promising for the last 30 years to share their wealth.

Asked by David Beckmann, President of Bread for the World, to describe those policies that would help Africa reduce poverty, O'Neill responded "we cannot even get close with charity." Noting that private capital flows to China last year—on the level of \$45 billion—matched total aid flows globally, he stressed the need for private capital to play a far greater role in development assistance. While conceding that it



Camdessus: "Monterrey must be a success."

### Camdessus urges major powers to resist siren calls

In his keynote address, Camdessus noted that the millennium had begun with tremendous challenges and horror, but also with elements of hope—such as the pledges in New York to eradicate poverty and the planting of the seeds of a global partnership in Genoa. He urged the international community to give full support to the Monterrey conference—in the name of partnership, peace, good governance, and development financing.

**Partnership.** "The name of the game is partnership" between industrial and developing countries, Camdessus said, urging heads of government to get to work on a broad collaborative agenda that would put the needs of the poor on the front burner of world attention. In this context, he took the media to task for devoting undue attention to the "lamentable attitude" of police in Genoa, which kept the public in the dark about a policy statement in which African leaders called for a new, more pragmatic partnership with industrial countries. This extraordinary statement, Camdessus said, constitutes a new way of doing business, reflecting a readiness to embrace prudent fiscal and monetary policies and appropriate exchange rate policies.

**Peace.** With the successful conclusion of military operations in Afghanistan—post September 11—phase two in the campaign against terrorism for "America and its allies" calls for a coordinated effort to address "violence at its very roots all around the world" in the form of mass poverty and hopelessness. The new phase "will require global solidarity

in the broadest possible coalition for development," he maintained. Monterrey provides an ideal venue for discussing the "extraordinary opportunities for constructive change, and we should not miss that opportunity."

**Governance.** Throughout Africa, Camdessus said, there is a strong political will to conduct the business of government and politics in a new—more participatory, transparent, and honest—way. The underlying cause of this shift is the desire of African leaders and their peoples to take "primary responsibility for the future" into their own hands. Industrial countries have ample reason to celebrate this attitudinal shift; they also have a major responsibility to help ensure a successful transition to good governance by providing substantial technical assistance in institutional capacity building, with judicial reform as the key priority.

**Financing.** The most important outcome at Monterrey, Camdessus said, must be a renewed commitment by industrial countries to make good on their pledge to provide \$50 billion a year in overseas development assistance (ODA). Reaching this numerical target would significantly enhance future development prospects by promoting a greater sense of mutual accountability between donors and recipients; broaden the membership of "good performers" in the developing world; and, over time, help establish a system of regional surveillance among developing countries. Alluding to Odysseus, who successfully resisted the songs of the sirens by tying himself to the mast of his boat, Camdessus exhorted the industrial countries to resist siren calls for reducing foreign assistance and remain bound to their ODA pledges.

wasn't easy for a poor country "to get into that kind of position," he nonetheless felt that capital would flow to countries that enforced the rule of law and contracts and that did not tolerate corruption.

Similarly, Larsen recommended further efforts to put in place policies that strengthen developing countries' financial markets and encourage more diversified trade and investment flows—particularly foreign direct investment. Describing development assistance as nonetheless "terribly important" in helping poor countries tap into these larger private capital flows, he mentioned that the United States has been directing a bigger portion of its aid money to trade and to building investment capacity, as well as to agriculture, education, and health. Larsen also said that the United States had presented a proposal that would increase funding to the World Bank's International Development Association (IDA) by 18 percent—provided certain performance benchmarks can be met and the Bank distributes up to half of its IDA assistance as grants rather than loans.

Roberto Zahler, former governor of the Central Bank of Chile, and Francisco Gil-Diaz, Mexico's Secretary of Treasury, also spoke out strongly in favor of a bigger role for private capital, given the limits to ODA flows. Zahler, in particular, urged solutions that would mobilize finance domestically. Observing that high economic growth rates are usually linked with

high saving rates, Zahler called for more clear-cut information on the determinants of domestic saving and further analysis to distinguish structural reforms that work from those that do not. Here, he saw the IMF and other multilateral financial institutions making a contribution. For his part, Gil-Diaz called for an improvement in the transparency of nongovernmental organizations (NGOs) and the information available on them—particularly to identify those that provide microcredit effectively.

But Ugandan Finance Minister Gerald Ssendaula pointed out that his own country has been unable to attract large amounts of private capital in spite of having done all that is "humanly possible" to open and reform the economy. For developing countries to duplicate China's experience with private capital, he said, they must first put in place basic infrastructure.

Pressed by C. Fred Bergsten, Institute for International Economics Director, about his expectations of the "bottom line" results to come out of Monterrey, O'Neill responded that the conference should resolve to increase incomes and measure progress on a five-year basis. He advised the conference participants to find ways to somehow combine the efforts of the private sector and NGOs to "lead to the private flow of investment capital so that it begins to create a perpetual motion machine of economic development." ■



Gil-Diaz: We have to work on improving transparency among NGOs—particularly to identify those that provide microcredit effectively.

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### Public Information Notices

- 2/12: IMF Executive Board Informally Discusses Preliminary Considerations and Next Steps in the Twelfth General Review of Quotas, February 19
- 2/13: IMF Concludes Article IV Consultation with Namibia, February 22
- 2/14: IMF Concludes 2001 Article IV Consultation with the Republic of the Marshall Islands, February 22
- 2/15: IMF Concludes 2001 Article IV Consultation with Chad, February 25
- 2/16: IMF Concludes 2001 Article IV Consultation with the Republic of Congo, February 25
- 2/17: IMF Concludes 2001 Article IV Consultation with São Tomé and Príncipe, February 28
- 2/18: IMF Concludes 2001 Article IV Consultation with Spain, February 28

### Press Releases

- 02/11: Ghana to Receive \$3.7 Billion in Debt Service Relief: The IMF and World Bank Support Debt Relief for Ghana Under the Enhanced HIPC Initiative, February 27
- 02/12: IMF Approves Two-Year, \$299 Million Stand-By Credit for Bulgaria, February 27

### News Briefs

- 2/14: IMF Approves \$10 Million Tranche Under PRGF Loan to the Azerbaijan Republic, February 20
- 2/15: IMF Completes Fourth Review Under the PRGF Arrangement for Ghana and Approves \$65 Million Disbursement, February 22
- 2/16: IMF Managing Director Names Anoop Singh Director for Special Operations, February 25 (see page 67)
- 2/17: IMF Completes First Review of Lao PDR's PRGF Program and Approves \$5.6 Million Credit, February 25
- 2/18: IMF Sending Mission to Argentina, March 4 (see page 66)

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- "Making the Most of the Euro," address by Anne Krueger, IMF First Deputy Managing Director, at the Royal Institute of International Affairs, London, February 25 (see page 65)

### Transcripts

- Press Briefing by Thomas C. Dawson, Director, IMF External Relations Department, February 28

### Concluding Statement for Article IV Consultations

- Angola, February 19 (preliminary)

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Asia Business Conference speech

## Asian countries must tackle unfinished reforms

Asia was not immune to the effects of the recent global economic slowdown, but there are some indications that the region's emerging market economies are beginning to recover. In a speech to the Eleventh Asia Business Conference at the Harvard Business School on February 2, Wanda S. Tseng, Deputy Director of the IMF's Asia and Pacific Department, said that these countries now need to move forcefully on the unfinished structural reform agenda—particularly in the banking and corporate sectors—to ensure sustained growth and resilience against external shocks. She focused on the progress Asian countries have made to date in financial sector and corporate restructuring. But what more needs to be done to cement the progress already made? Following is an edited version of her remarks.

Asia's recovery from the financial crises of 1997–98 was interrupted last year by serious external shocks, notably the collapse of the technology bubble and the terrorist attacks in the United States on September 11. However, the effects of these shocks appear to be receding, and signs of a recovery are beginning to

emerge. The key uncertainty in the outlook for much of Asia is the strength of export demand, especially the pace of the global recovery in corporate investment in information technology. Judging by recent indicators, the sharp export decline may have bottomed out. Exports are now rising again in some countries. Nonetheless, countries in Asia cannot rely on external demand alone. They need to implement policies that would position their economies for a faster takeoff and sustained growth.

In response to the slowdown, macroeconomic policies across the region have generally been eased. Most countries have lowered official interest rates since September 11, continuing the trend established before this date, and the weakening of most regional currencies (apart from those with fixed pegs) has also contributed to an easing of monetary conditions. On the fiscal policy front, the scope for adjustment varies considerably. Following widespread easing of fiscal policy earlier last year, some economies, including Hong Kong SAR, Malaysia, and Singapore, have announced supplementary budgets. But high public debt, or deficit in some cases—particularly in Indonesia, the Philippines, and India—greatly constrains the scope for further fiscal support.

### Recovery strategy in Asia

But perhaps even more important for the Asian crisis countries is the need to tackle the unfinished structural reform agenda. If we look back for a moment at the Asian financial crisis, one lesson we can draw is that sound macroeconomic fundamentals must be accompanied by sound structural fundamentals to ensure sustained rapid growth and resilience against external shocks. While Asian countries, for the most part, had pursued prudent macroeconomic policies, the core of the problem was the absence of a strong institutional framework to impose market discipline. It became apparent that the institutions that provide checks and balances in a market economy—a sound and well-supervised banking system, a corporate governance structure, and a legal and judicial system—were weak or lacking in Asia. In many countries, the institutional weaknesses allowed severe balance sheet problems to develop and fester, triggering a breakdown of the corporate and banking sectors.

Over the past four years, the recovery strategy in the region has focused on rebuilding the banking system and deleveraging the corporate sector. Let me briefly review the progress that has been made in the crisis countries.

**Banking sector.** There has been significant consolidation in the banking system. The number of banks has declined in all countries surveyed, most dramatically in Indonesia, where the total has fallen from 240 in 1997 to 146 in 2001. Bank ownership structures have also changed markedly. In all countries, foreign bank ownership has increased; in some, foreign banks have entered for the first time. But this change has not been as significant as originally expected. Instead, it is the state that has expanded its market share, quite significantly. And, while some of this expansion has been rolled back over the past few years, the decline has been slow and small. In Thailand, for example, the government still owns about one-third of bank assets, almost unchanged from 1998, while in Indonesia the government controls nearly three-fourths of bank assets.

Banks have also been repairing their balance sheets. Average capital adequacy ratios—measured by governments and tending to be overstated—now exceed 10 percent, and headline nonperforming loan ratios have been falling. In Thailand, for example, reported nonperforming loans have fallen from a high of nearly 50 percent during the crisis to 13 percent at



Tseng: "Corporate sector restructuring has been slow and incomplete, with the debt overhang still high."

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present, although this decline largely reflects the transfer of assets to asset management companies.

There are clear signs of progress in financial sector restructuring, but a number of indicators suggest that further efforts are necessary to cement the progress already made. To begin with, bank profitability remains weak. There has been some recovery in profits before provisions, but they remain low by any standard. In Thailand and Korea, for example, profits before provisions as a percent of total assets turned positive in 2001, but only marginally so. Also, banks are not yet performing their intermediary function, as lending remains subdued. This may reflect, in part, the lack of good credit or investment opportunities, but it may also reflect a limited capacity on the part of the banks to lend, given their still-difficult financial positions. Unsurprisingly, given these difficulties, bank share prices remain relatively low. Investors remain concerned about low profits, unrecognized loan losses, inadequate collateral, and a potential deterioration in loan performance, because borrowers remain vulnerable.

Given these problems, what are the reform priorities for banks going forward?

- First, they need to make further progress in operational restructuring. This means, for example, rationalizing branch networks, reducing staffing, and revamping loan approval and analysis procedures.

- Second, banks' capital bases need to be augmented further in some countries to allow them to deal more easily with the remaining nonperforming loans and to improve profitability.

- Third, prudential regulations must be enforced. Regulators must avoid succumbing to the pressures of regulatory forbearance that hide the true magnitude of the problem.

- Fourth, banks should be returned to the private sector. Reprivatizing the banks is an excellent way to achieve the first two objectives—operational restructuring and recapitalization—without burdening public finances. Sound and privately led banks are also indispensable for a truly market-driven approach to working out the remaining impaired assets.

- Fifth, further progress in corporate restructuring needs to be made. In some countries, such as the Philippines, this is necessary because many of the bad loans are still in the banks, rather than in asset management companies. In other countries, where loans have been transferred, it is still important because banks, in the end, can be only as healthy as their clients.

**Corporate sector.** A number of indicators suggest that corporate sector restructuring has been slow and incomplete, with the debt overhang still high. The

stock of impaired assets—that is, nonperforming loans plus loans transferred to asset management companies—remains sizable (see chart, top panel). In Thailand, for example, the ratio held steady at nearly 40 percent of loans in 2001. In Indonesia, the ratio is over 50 percent. Corporate leverage also remains high (see chart, bottom panel). In Korea, where the average debt-equity ratio has been halved since 1997, the ratio nonetheless remains at about 200 percent. Corporate debt today is much the same as it was in 1997. Indeed, in Malaysia and Indonesia, corporate debt as a percent of GDP actually rose in 2001, and, in Indonesia, is even higher than precrisis levels.

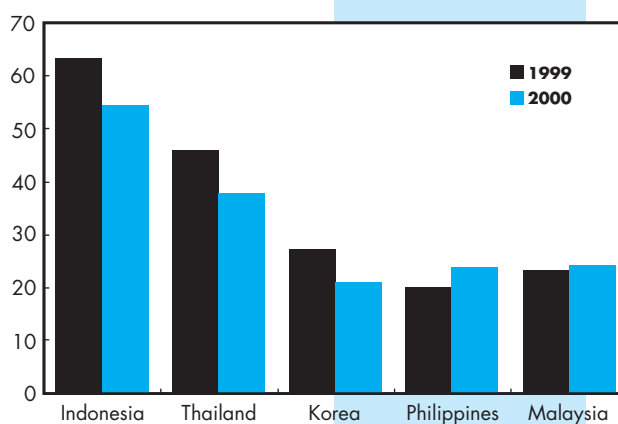
So what can and should be done? Clearly, legal frameworks need improving to speed resolution and strengthen the rights of creditors. In Korea, the authorities are planning another major reform, which should include a provision to authorize court approval of majority-approved restructuring plans even when there are some dissenting creditors—often the shareholders of these enterprises.

In Thailand, bankruptcy criteria need to be clarified, so that debtors can be declared insolvent based on straightforward cash-flow tests of their ability to meet debt-service obligations, rather than on subjective assessments of their net worth.

In most countries, judicial systems need streamlining. Court processes and foreclosure procedures need expediting, so that countries can clear away the existing judicial backlogs, which in some cases amount to

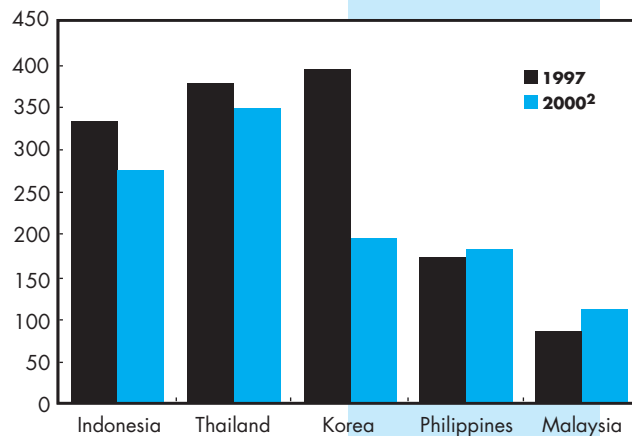
### Impaired assets still sizable<sup>1</sup>

(percent of total loans)



### Corporate debt-equity ratios still high

(percent)



<sup>1</sup> Impaired assets include nonperforming loans plus loans transferred to asset management companies.

<sup>2</sup> Data for Thailand and Korea are for 2001. Data: National authorities and IMF estimates



Despite the current slowdown, protectionist pressures are being held at bay in Asia and elsewhere.

—Wanda Tseng

several years. Bank supervisory frameworks also need to be reinforced. Regulators need to insist that banks remedy their deficiencies in assessing asset quality, and they should press creditors to acknowledge the true health of debtors. As long as firms' problems are denied, they will certainly not be remedied. Finally, corporate governance, shareholder rights, and disclosure requirements need to be strengthened. Such reforms will allow markets to exercise greater discipline on the region's firms to ensure that they are not taking on excessive risk and are acting in the best financial interest of all owners and creditors.

**Other reforms.** In addition to the financial and corporate sector reforms, there are additional areas for reforms that require attention. The first is *trade liberalization*. It is heartening that, despite the current slowdown, protectionist pressures are being held at bay in Asia and elsewhere. Encouragingly, there is a political will to move forward on trade liberalization—as evidenced by the Doha agreement—which will have a major impact on long-term growth. Second, Asia's emerging market economies can also go further in the direction of *facilitating foreign direct investment inflows*. A particular priority would be to remove restrictions that limit or

prohibit foreign ownership in selected sectors. The third area is *export diversification*. The current slowdown highlights the risks of overspecialization in information technology products as primary exports and undue reliance on the United States as the main export market. Finally, *social safety nets need to be strengthened*. Looking back, as Asian countries generally enjoyed high growth rates and low unemployment for most of the period after World War II, an effective social safety net was neglected. Adequate social protection is not only necessary to maintain fairness and human dignity, but it also allows needed structural reforms to proceed without causing social hardships that can lead to social disturbances and instability.

### Concluding remarks

While the global economy remains subdued and the outlook uncertain, there are reasons for cautious optimism. The countries that will emerge ahead will be those that position themselves to benefit from the recovery. This requires supportive macroeconomic policies, perseverance with corporate and financial sector reforms, openness to trade and investment, and stronger social safety nets. ■

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Working Paper snapshot

## Lending booms and real estate bubbles: Why Asian crisis countries reacted differently

*Most east Asian countries experienced asset price bubbles in the 1990s, but they responded in different ways to the eventual “bubble burst.” Some suffered severe financial crises; others weathered the storm with much less damage. What do these varying experiences reveal? In a recent IMF study, Lending Booms, Real Estate Bubbles, and the Asian Crisis, authors Charles Collyns and Abdelhak Senhadji maintain that a strong bank regulatory system can make the difference.*

Over the past few decades, the liberalization of financial systems and globalization of capital markets have improved how financial services are provided and resources are allocated, and have opened up a new pool of financial resources for developing countries. But this has gone hand in hand with increased financial instability in some cases, with swings in asset prices amplifying economic instability and sometimes culminating in banking and exchange market crises. Developed and developing countries alike have borne the costs, but emerging market countries have taken the heaviest hit.

How do these financial cycles begin? Typically, a wave of overoptimism underpinned by favorable developments in the real side of the economy contributes to an underestimation of risk, overextension of credit, excessive asset price inflation, overinvestment by businesses, and a boom in consumer spending. But once expectations realign with fundamentals, imbalances can adjust abruptly, with sentiment swinging from too optimistic to too pessimistic, triggering costly disruptions to both the financial system and the real economy.

Moreover, recent research shows that these cycles can be amplified by the procyclical character of bank credit. The property market plays a key role here because rising real estate prices tend to boost banks’ willingness and ability to lend. With financial markets more globally integrated, large capital inflows can intensify these credit cycles. When a surge in capital flows combines with lax regulation of the financial sector, the resulting credit cycle can end in severe financial crisis.

The Asian crisis of the late 1990s followed this general pattern, observe Collyns and Senhadji, who note that key features of the buildup to the crisis included heady optimism in the mid-1990s that the “east Asian miracle” would be capable of delivering continued rapid economic growth over an extended period; capital account and financial market liberalization that contributed to heavy capital inflows, intermediated largely through the banking system; and high rates of investment and rapid rises in asset prices, espe-

cially in the property sector, as poorly regulated banking systems expanded domestic credit at a fast pace. Once the bubble burst, economic growth fell off, asset markets reversed, and both financial and corporate balance sheets began to deteriorate. Eventually, investor sentiment declined sharply, unleashing a cascading series of banking and exchange crises across the region.

What were the differences in experience across the Asian crisis countries? Thailand and, to a lesser extent, Malaysia suffered pronounced property price cycles, while Korea’s property cycle was much more subdued. Other economies—such as Singapore and Hong Kong SAR—experienced fairly dramatic booms and slumps in property prices, yet were able to weather the crisis without major exchange and banking crises. So property price cycles were neither necessary nor sufficient causes of a subsequent exchange and banking crisis.

Following their examination of the links among lending booms, asset price cycles, and financial crises across east Asia, Collyns and Senhadji conclude that the countries’ varying experiences underline the critical importance of strong bank regulation. Certain steps reduce the risk of asset price bubbles and contain the disruptive impact when bubbles burst: strengthening credit assessment, reducing moral hazard, applying a comprehensive approach to bank regulation, and encouraging other nonbank sources of financing for the real estate sector. The Asian experience also shows that sound macroeconomic and related policies help avert bubbles and limit their disruptive impact.

One difficulty, the authors warn, is to judge correctly whether a hike in asset prices is caused by overly optimistic expectations or policy distortions, on the one hand, or genuine structural shifts in demand or gains in long-term productivity, on the other. Reflecting on the potentially huge costs from judgment mistakes, however, they conclude it would be better to err on the side of caution. ■

Copies of Working Paper 2/20 are available for \$10.00 each from IMF Publication Services. See page 72 for ordering information.

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**The countries’ varying experiences underline the critical importance of strong bank regulation.**

—Charles Collyns  
and  
Abdelhak Senhadji

March 11, 2002

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## Boosting growth through home ownership

*M*aking affordable home mortgage loans available to a large cross-section of a country's population can enhance growth and improve living standards, argue S. Nuri Erbaş, Senior Economist in the IMF's Middle Eastern Department, and Frank E. Nothaft, Chief Economist at Freddie Mac—the second largest mortgage investor in the United States. In a recent IMF Working Paper, they look at the state of housing and mortgage

*markets in a handful of Middle Eastern and North African countries—Algeria, Egypt, Jordan, Morocco, and Tunisia—where home mortgage finance facilities are virtually nonexistent for low- and middle-income groups and where demand for affordable housing is high and will remain high, reflecting pent-up demand and*

*medium- to long-term demographics. The authors emphasize that more widely available mortgage financing is a fundamental part of financial sector development and a crucial vehicle for increasing the depth and breadth of the financial sector.*

**IMF SURVEY:** Affordable mortgages always sound like a good thing, but you suggest that they can have a wide economic impact. How can they enhance a country's growth and improve living standards?

ERBAŞ: We undertook this study because Pierre Dhonte, Deputy Director of the IMF's Middle Eastern Department, made some very basic and challenging observations about the connections between demography, poverty, and the state of housing in the Middle Eastern countries. Living standards—which are fundamentally dependent on where people live—are not particularly good in the countries we're looking at, in large part because of a lack of good housing (see table).

There is a lot of pent-up demand in these countries, and the governments have not been able to meet this demand, at least not with the existing government institutions. For all intents and purposes, these five countries have no mortgage market for low- and middle-income families. Developing mortgage markets, as a part of financial sector development, will presumably stimulate growth, at least through the construc-

tion sector, because availability of mortgage financing can make it possible for more people to buy homes. NOTHAFT: Much employment is based on businesses, and many small businesses are sole proprietorships, in both developed and developing countries. Credit is generally a little bit more available for large corporations and well-to-do individuals. Financial sector reform means trying to provide better access to credit for other individuals and small businesses. A more developed mortgage market can also provide access to credit for moderate-income families, many of whom own small businesses or sole proprietorships, and it might be the way to assist them in buying credit to develop their small businesses, too.

ERBAŞ: When our paper was reviewed by our peers, they often asked about crowding out. They wondered if general savings channeled into housing would be siphoned away from something else. This is not the case in developing countries, where people often get negative rates of return on their savings. If you can give them a positive rate of return, it will bring savings out of the woodwork and put them to productive use. This is how growth is produced.

**IMF SURVEY:** How can a family struggling to meet its most basic needs save enough to buy a house?

ERBAŞ: Low-income families save, too. The question is, where do their savings go? For example, your wife could be wearing the savings—gold bracelets—on her wrist. Or a person living in a shack might have a wide-screen color television. It's evidently fashionable to have cell phones, however poor you are. How can such savings be channeled into better living standards, into the housing market? How can such savings be given greater incentives and, to some extent, be subsidized for low-income groups?

NOTHAFT: Everyone lives in some form of a house. The issue is the quality of the house. Having access to credit enables people to improve their homes or acquire homes with more amenities, like sewerage. If a family vacates one house, it becomes available to another family. So, in both cases, the overall quality of the country's housing infrastructure is improved. As Nuri mentioned, there are shortages of affordable housing in these countries. Providing the financing and credit to families is one way to address this problem.

**IMF SURVEY:** What have you learned from housing markets in the United States, Mexico, and Turkey, and how have you applied your findings to the countries in your study?



Erbaş (left) and Nothaft: The construction sector is likely to boom with a program like this. It is an enormous employer, especially of lower-income individuals.

NOTHAFT: Affordable housing has long been a component of public policy in the United States. The rationale is that promoting home ownership leads to a variety of positive externalities. For example, homeowners generally maintain the housing stock better than renters do. Research on social issues that relate to home ownership shows that neighborhoods with a high rate of home ownership also tend to have more active community involvement.

ERBAŞ : Mexico and Turkey were chosen as middle-income comparators. In general, we can say that Mexico has more developed financial markets, and mortgage markets, than Turkey. Turkey is experiencing many of the same problems as the countries in our study, whereas Mexico appears to be more advanced in the development of financial arrangements, at both the institutional and the grassroots level.

**IMF SURVEY:** Are there characteristics about the region, such as Islamic banking restrictions, that set it apart in terms of mortgage financing?

ERBAŞ : Generally, no. Islamic banking exists in some of those countries, but, in principle, it is not a deterrent to developing mortgage financing. Mortgage financing through Islamic banking can be accomplished through profit-sharing arrangements. But this is a secondary issue. The primary issue is the existing banking standards in these countries, which, if reformed and given the right legal and economic incentives, can address mortgage requirements in the standard way.

NOTHAFT: It's worth noting that mortgage financing arrangements in line with Islamic banking principles are already available in the U.S. market.

**IMF SURVEY:** Don't even higher-income groups have difficulty obtaining mortgage financing? Wouldn't the development of mortgage finance programs simply end up benefiting them rather than lower- and middle-income groups?

ERBAŞ : In these countries, high-income groups can readily buy housing. For example, in Cairo, you can buy a \$1 million apartment in two weeks, but you can't find a \$50,000 apartment. The idea is to extend this facility, make it affordable to lower- and middle-income groups. It may be true that upper-middle-income and middle-income groups will come into this scheme much earlier than lower-middle-income and lower-income groups, but there's nothing wrong with that. There will be transfers. If better housing is built for middle-class people, they move out of less good housing, and people who live in shacks can move up. Furthermore, the construction It is an enormous employer, especially of lower-income individuals.

NOTHAFT: Generally, higher-income people don't have as many problems accessing home ownership or credit. If you look at the U.S. experience, home ownership was about 40 percent 60 years ago, and today it's 68 percent. Over that time, the federal government was committed to promoting home ownership and affordable mortgage credit. Who were the homeowners 60 years ago? They were disproportionately middle- and higher-income people. By providing affordable credit, the United States

**Potential demand for housing exceeds supply**

	1990–95	2000–05	1995–2025
	(thousands of housing units per year)		
Algeria	109	118	117
Egypt	241	228	229
Jordan	43	38	44
Morocco	98	87	91
Tunisia	30	28	29
Total	521	499	510

Note: Numbers do not include pent-up demand.  
Data: Authors' estimates

has disproportionately helped middle-income families, but higher-income people have benefited, too. But it's not exclusively benefiting higher-income individuals. The availability of home ownership to a much larger part of the population is a lesson to be learned from developments of the last 60 years in the United States. So the U.S. experience is proof that improving mortgage financing helps not only the middle- and upper-income groups but lower-income groups, too.

**IMF SURVEY:** Do the governments in this region already have housing policies in place to help lower-income groups? How is your proposal different?

ERBAŞ : They do, but with some exceptions—Jordan, maybe as a result of recent reforms, and, to some extent, Tunisia—the housing finance schemes have been a failure. They created specialized public institutions that produced low-quality, high-cost housing that essentially ended up being sold on the market to higher-income groups. The schemes did not serve their purpose. In fact, most of those institutions and specialized government-owned banks are insolvent—a relic of the old public enterprise days. In most of the countries, even the construction materials sector is a public monopoly, which means construction costs are higher. Also, the presence of monopolies precludes importation of such products as cement and steel. You might end up waiting months or years to get these materials.

The existing setup in these countries has not addressed housing shortages created by expanding



population and pent-up demand. A lot of people end up living at home even after marriage—extended families grow, so you add another floor, and so on. There’s a lot of potential out there. Reform of mortgage financing is essential to meet this potential.



An Egyptian family in Cairo, home to about 15 million people. A growing population and a shortage of affordable housing have created pent-up demand here and throughout the region.

NOTHAFT: There are a couple of different approaches governments can take. They can subsidize the construction of housing directly, but that’s a relatively inefficient way of promoting the creation of affordable housing. Subsidies generally end up being costly, and there are issues with monopolies and overall control of the

production process. The alternative way to go—or it could be a complement—is to promote reforms in the financial sector generally and in the mortgage market specifically. That helps target credit toward the families who can use the credit to improve their current homes or acquire better-quality housing. This allows the free housing market to work to create additional affordable housing, which addresses some of the shortages in these countries. It’s really about providing incentives to make the housing market work more effectively by reforming the financing part of the market.

**IMF SURVEY: How would mortgages be financed?**

ERBAŞ: Whether you are building a dam or financing a home, the money ultimately comes from domestic or foreign savings. Foreign savings represent foreign borrowing. And domestic savings are not necessarily what people are saving at home, but what is being saved through better budgetary practices. Instead of providing blanket subsidies, you rationalize those subsidies and make them incentive based, so that people will save.

If the market opens up, and there is movement in this market, then companies will come in and start building, creating financing opportunities for lower- and middle-income people. This has been the experience in many countries. By the same token, why can’t a foreign creditor or a foreign financial institution operate in these countries? At present, foreign banks operate in these countries, but they are in the government bond business. The financial sector is far deeper than trading government bonds, especially when it comes to turning a hard-earned profit. Actual banking requires lending to businesses, lending to housing, lending to construction. This is what financial sector development is, and this is what we mean by financial

sector liberalization. There are a number of important prerequisites for these countries before this can happen. One, countries have to pursue legal reforms. Often, property rights, entitlement, eviction, and loan recovery are on questionable legal grounds. Second, banking and finance laws have to be liberalized.

NOTHAFT: That’s absolutely right. Property rights have to be clear and enforceable. If they aren’t clear, mortgage contracts can’t be enforced. If you can’t enforce lawyers’ contracts, then if people default, you can’t move them from their homes.

In terms of where the financing is coming from, it’s the capital markets, global or domestic. In some sense, it may not matter. Ultimately, financial sector reform would promote savings and more use of the banking system by families. If families have savings accounts at financial institutions, that provides the financing that banks can use to make additional loans, whether for mortgage credit, commercial credit, or what have you.

**IMF SURVEY: Won’t the availability of affordable mortgages in this region, with its high population growth rate and existing housing shortages, only exacerbate the supply-demand gap? What are the implications for the construction sector?**

ERBAŞ: There is a very high population growth rate in these countries, and the populations are also very young. We cannot overemphasize the magnitude of demand. But this is precisely what such development would aim to address. Developing mortgage financing means developing the housing sector, making housing available to a larger number of people. There’s no short solution; this is not a short-run program but rather a medium- to long-term agenda.

**IMF SURVEY: How long would it take before such programs would begin to show results in terms of faster growth and improved living standards?**

NOTHAFT: I agree that it’s a long-term agenda. You may start seeing some benefits in the first year or two, but really it’s a much longer-term process. Look at the U.S. experience. It took a long time to raise the home ownership rate from 40 percent to 68 percent. It takes a while for people to become comfortable with the reforms that have been put in place, to believe that these are permanent reforms and that they’re not somehow going to lose their homes or their savings by participating in the program. I suspect there would be some latent concerns about how committed the government ultimately would be. When we did the simulations in our paper of the benefits to overall economic growth and housing construction, we looked at a 10-year horizon because it takes time for the effects to work their way through the economies.

**IMF SURVEY:** When you talked about the prerequisites that need to be in place—the reforms—are they under way, or are you optimistic that they can happen pretty quickly?

ERBAŞ: Egypt is in the process of adopting reforms. Even Algeria, where the housing sector has been particularly stagnant, is moving toward reform. In Jordan, there are some efforts at privatization. So there has been some movement, but these countries should probably give priority to the financial sector reform and liberalization programs that the IMF looks at. Mortgage financing is a very deep and fundamental reform of the financial sector, and it has a cascading aspect. The construction sector is not only putting on a roof, it's also financing and insuring it, building infrastructure, and insuring and financing the buyers. These numbers add up—in the United States, to about 12 percent of GDP. That's about \$1.2 trillion.

**IMF SURVEY:** What are the broader policy implications of this program for the countries in this region?

ERBAŞ: I see this as a part of medium- to long-term basic reform in these countries. Mortgage market reform is one aspect of financial sector liberalization. There are a lot of blanket subsidies, and budget reform needs to create incentives. You can't give preferential interest rates to certain public enterprises. These distort the financial market. In financial sector development, development of mortgage financing is probably a long-

term reform. It would be a good idea to highlight it in IMF programs. A mortgage financing market will attract foreign capital, but this may have a downside in the balance of payments—construction sectors in these countries have a large import component. If the housing sector is going to grow, you have to watch your balance of payments. If you allow the construction materials sector to develop and eliminate monopolies, the balance of payments will take care of itself. NOTHAFT: There's a variety of empirical evidence, primarily for developed countries, to support the concept that financial liberalization promotes economic growth in the longer term. It pertains to developing countries, too. Mortgage market reform would be particularly useful for these developing countries because it really provides access to credit for all families, not only to address shortages of affordable housing but also to extend financial reform to the small businesses that are the crux of most of the employment in these countries. So much of the employment is with small businesses and sole proprietorships that cannot get access to business credit. ■

Copies of Working Paper 2/17, *The Role of Affordable Mortgages in Improving Living Standards and Stimulating Growth: A Survey of Selected MENA Countries*, by S. Nuri Erbaş and Frank E. Nothaft, are available for \$10.00 each from IMF Publications Services. See page 72 for ordering information. IMF's website ([www.imf.org](http://www.imf.org)).

*Interview with Corbacho and Schwartz*

## Pro-poor policies in Mexico aim to reduce income disparities and improve efficiency

Some of the largest and most persistent income disparities in the world can be found in Latin America, and, within this region, Mexico's income inequality is among the highest. Over the past decade, and particularly since the financial crisis of 1994–95, the Mexican government has initiated a range of pro-poor policies to address this problem. The policies are designed to improve equity through expenditure programs directed to the poor and to make public spending more efficient. In an interview with the IMF Survey, Ana Corbacho and Gerd Schwartz of the IMF's Fiscal Affairs Department discuss their recent Working Paper, Mexico: Experiences with Pro-Poor Expenditure Policies.

**IMF SURVEY:** Why did you undertake this study?

SCHWARTZ: This study started a year after the Mexican crisis of 1994–95, when it was important to understand, first, how badly the crisis would affect

income distribution and poverty and, second, what expenditure policy measures could be taken to address these issues. An initial version of the paper was included in the 1997 Selected Issues Paper for Mexico's Article IV consultation, but we felt we needed more time to assess the full distributional consequences of the crisis. Ana joined the IMF last year—having just completed her dissertation related to income distribution, with Mexico as one of the case studies—and additional data are now available, so we thought we would revisit these important issues with a longer time perspective.

**IMF SURVEY:** What is at the root of Mexico's unequal income distribution?

CORBACHO: Like other Latin American economies, Mexico has a very unequal income distribution that can largely be attributed to inequality in factor endowments—such as land, natural resources, and physical



capital—and in human capital formation—that is, differences in access to education and health care. Income inequality in Mexico has a marked urban-rural and regional dimension: average incomes in



Corbacho (left), and Schwartz: Lagging rural development and a strong urban expenditure bias are frequently seen as being at the root of Mexican poverty and inequality.

urban areas and in the richest states are much higher than those of the rural areas and poorest states. Lagging rural development and a strong urban expenditure bias are frequently seen as being at the root of Mexican poverty

and inequality. In addition, a fairly unstable macroeconomic environment during much of the past three decades may have worsened income distribution.

**IMF SURVEY: What happened to Mexican income disparities in the 1980s, and what was the effect of the December 1994 crisis?**

SCHWARTZ: Until the 1980s, Mexico's income distribution was evening out. However, in the 1980s, there was a relatively strong increase in income disparities, at a time when Mexico and other Latin American countries were going through a debt crisis and had major macroeconomic problems. The increase in inequality largely

reflected an increase in the income gap between the very rich and the rest of the population. During the early 1990s, there was neither a further increase nor a significant reduction in Mexico's income disparities, similar to what has been observed for much of the region.

The December 1994 crisis seems to have reduced income disparities in the short term but increased poverty. Real wages dropped in 1995, dramatically in many sectors. In the agricultural sector, for example, the decline in incomes was steep, which probably led to a significant increase in the incidence of poverty in rural areas. The crisis also had a big impact on the unemployment rate, with manufacturing and construction sector workers in urban areas probably the hardest hit.

**IMF SURVEY: What happened to government expenditures during the crisis, and after?**

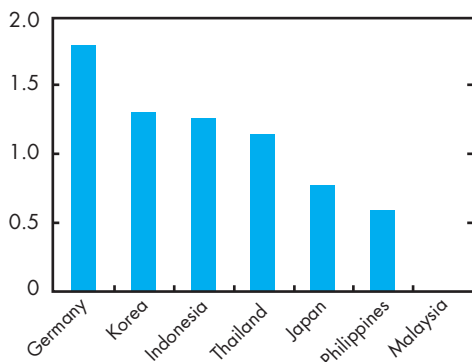
CORBACHO: During 1990–2000, social expenditures increased sharply, particularly in the first half of the 1990s, and then leveled off in the second half. In this paper, we looked at spending on health, education, social security, and some special poverty programs. Total social expenditure amounted to about 9.5 percent of GDP in 2000, compared with 6.1 percent of GDP in 1990, which implies an increase of 83 percent in real terms over the decade. While this probably helped to mitigate the effects of the crisis on the poor, overall government expenditure patterns did little to improve income distribution.

SCHWARTZ: To some extent, this was because of the impact of additional crisis-related expenditures. For example, government programs geared toward providing short-term support to the banking system directly benefited those population groups with outstanding consumer and mortgage credits, who tend to be middle- and upper-income groups. Other government programs that restructured loans or provided support for specific interest groups, such as highway concessionaires, also benefited better-off income groups. In addition to these direct transfers, public finances had to absorb the cost of operations to restructure the banking system. In parallel, however, over the past several years, the Mexican government has worked hard to direct social expenditures to lower-income groups. Although aggregate indicators of social well-being have already begun to improve—some quite significantly—access to basic health care, education, and social security needs to be improved further, particularly for the rural poor.

**Correction:** In the article on Asian crisis countries in the February 25 issue of the *IMF Survey*, the chart on page 57 (bottom panel) was mislabeled. The corrected version follows.

**Asian crisis countries more flexible but not like some industrial countries**

(ratio of exchange rate volatility to reserves volatility in postcrisis period)



Data: Authors' calculations

ture programs and to improve expenditure targeting. In the education sector, there has been a massive effort to reallocate resources from tertiary to basic education, and quality standards and controls have been strengthened. Also, the central government has passed operational responsibilities to the states, enhancing the efficiency of the education system.

In the health sector, basic health care has been improved and access has been broadened, including for remote communities. In social security, a reform implemented in July 1997 was important from an efficiency perspective but should not be expected to improve distribution significantly because large parts of the working population, including the working poor, do not participate in the system. Finally, the government has significantly increased resources for many social assistance and anti-poverty programs that target specific poorer population groups. Many of these programs have already shown good results.

**IMF SURVEY: Which pro-poor policies have worked particularly well?**

**CORBACHO:** PROGRESA—the government’s integrated program for education, health, and nutrition—is an example of a program that has been working particularly well. PROGRESA links the size of income transfers to families to their compliance with a schedule of preventive health checkups and vaccinations and to continued primary and secondary school enrollment for children up to age 16 in their households. This is expected to provide strong educational and health incentives. When it started in 1996, the program operated in one state but has since expanded; by 2000, it covered 2.6 million families, or about 40 percent of all rural families. The most recent results indicate that in the rural areas of Mexico where PROGRESA is currently operating, infants are more robust and have better nutrition, and children are more likely to enroll in school. Adult PROGRESA beneficiaries have also shown signs of improved health, and visits to health clinics and early prenatal care have increased.

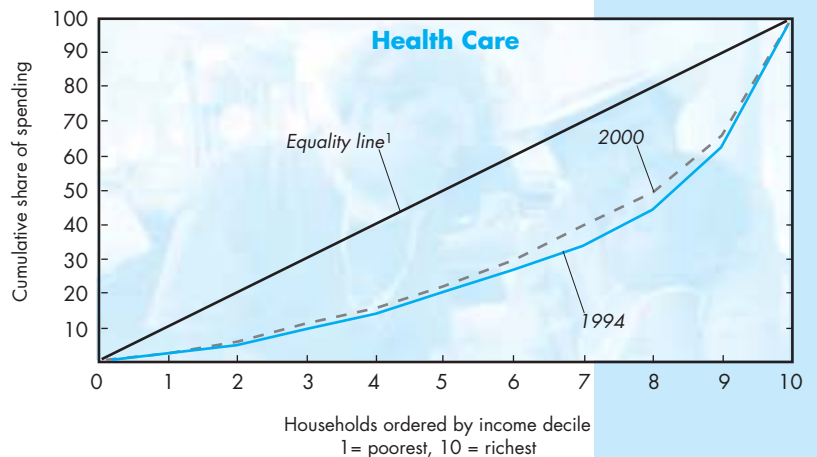
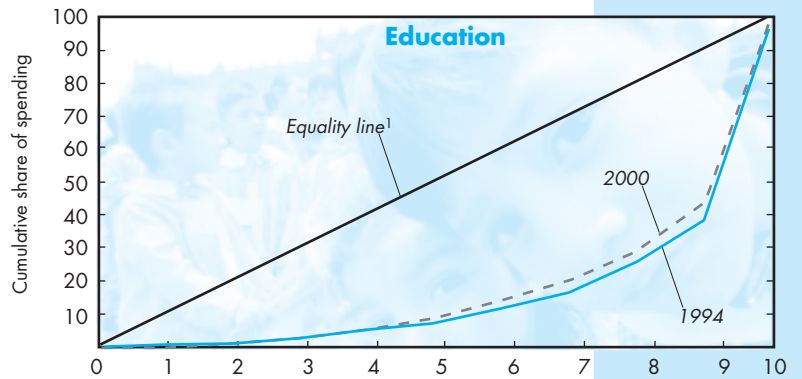
**IMF SURVEY: Could other Latin American countries duplicate programs like PROGRESA? How about other regions of the world?**

**SCHWARTZ:** Because PROGRESA is still a new program, whose total effects will be felt only after the current young beneficiaries enter the labor force, it seems too early to predict how it might work in other regions. Some other Latin American countries, including Argentina, Brazil, Colombia,

Honduras, and Nicaragua, are implementing similar incentive-based welfare programs. It would be interesting to compare these various PROGRESA-type programs across countries, to see how their performance has differed and could be further improved.

**Richer households spend disproportionately more on education and health care**

**... but inequality has declined slightly since 1994**



<sup>1</sup> If the distribution were perfectly equal—as represented by the equality line—households in the first income decile (poorest 10 percent of total households) would account for 10 percent of the spending, those in the second income decile would account for 20 percent of total spending, and so on. The actual distribution lies below the equality line, indicating inequality in the distribution of the household spending, which is more pronounced for education than for health care.

Data: Ana Corbacho and Gerd Schwartz, *Mexico: Experiences with Pro-Poor Expenditure Policies* (Washington: International Monetary Fund, 2002)

**IMF SURVEY: What other policies could help improve the equity and efficiency of social expenditure?**

**SCHWARTZ:** Despite the government’s efforts to improve distributional equity, income inequality in Mexico was not reduced in the 1990s, making it more of a challenge to improve the efficiency of social expenditures. Other policies that would further improve the equity and efficiency of social expenditure include introducing user fees for higher educa-





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tion, reducing the pro-urban expenditure bias in health care, and increasing the coverage of the social security system.

**CORBACHO:** Specifically, we suggest that, in the education sector, the government introduce user fees in higher education and also identify

and strengthen the support for those inputs in primary education that are effective in increasing enrollment and attainment—for example, books and school materials. These suggestions are designed to reduce education inequality and therefore income inequality. In the health sector, it would also be important to extend health care coverage to the entire population. For the social security system, improvements in equity and efficiency would critically depend on increasing the number of insured workers. But at the same time, increased participation in the system would mean increased labor costs in companies where workers currently do not participate and, therefore, may adversely affect the demand for labor.

**IMF SURVEY:** How does your work fit into the top Millennium Development Goal of halving poverty by 2015?

**SCHWARTZ:** We don't make projections in the paper, but we can see that the government is on the right track. Much of what will happen in the next 13 years will depend on how these programs are implemented and what lessons are learned to improve them. Of course, a stable macroeconomic environment is a precondition for achieving any goal of poverty reduction.

**IMF SURVEY:** How can boosting pro-poor spending be reconciled with the need for sound fiscal policies? Does it necessarily entail higher taxes?

**SCHWARTZ:** A main challenge in all expenditure policy reforms is to make more efficient use of existing resources. This may mean cutting programs that don't work and expanding those that do work, always within the limits of the overall expenditure envelope—that is, while maintaining fiscal sustainability. We have seen what happens to



Celebrating the Day of the Children in Mexico City. In the education sector, Mexico has made a massive effort to reallocate resources from tertiary to basic education.

income distribution if this imperative of macroeconomic stability is not maintained. That was the experience of the 1980s, when income distribution clearly got worse. The scope for these efficiency-enhancing reforms is usually large—most

countries could do a lot more with existing resources. At the same time, there is usually scope for cautiously exploring user fees for those government expenditures that largely benefit better-off population groups, which could help free up government financial resources. There is no contradiction between boosting pro-poor spending and maintaining fiscal sustainability, and the governments of many Latin American countries, including Mexico, are showing how it can be done. ■

Copies of Working Paper 2/12, *Mexico: Experiences with Pro-Poor Expenditure Policies*, by Ana Corbacho and Gerd Schwartz, are available for \$10.00 each from IMF Publication Services. See page 72 for ordering information.

**Selected IMF rates**

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 25	2.27	2.27	2.67
March 4	2.27	2.27	2.67

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?2002](http://www.imf.org/cgi-shl/bur.pl?2002)).

General information on IMF finances, including rates, may be accessed at [www.imf.org/external/fin.htm](http://www.imf.org/external/fin.htm).

Data: IMF Treasurer's Department