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IMF warns of risks to global turnaround despite impressive financial market resilience

The world's financial markets proved remarkably resilient in 2001, weathering the bursting of the technology stock bubble, the September 11 terrorist attacks, the U.S. recession and global slowdown, record bankruptcies, the largest U.S. corporate bankruptcy ever, and Argentina's default on foreign debt. But, as the inaugural issue of the IMF's new *Global Financial Stability Report* cautions, this resilience "would again be tested if a global economic recovery is subdued."

According to IMF officials, signs that an economic recovery is under way have recently increased. At a press conference on March 14, Gerd Häusler, Counsellor and Director of the IMF's International Capital Markets Department, also said, however, that vulnerabilities in the global financial system merited attention. The report identifies some of these vulnerabilities.

First, household and corporate debt in Germany, Japan, the United Kingdom, and the United States has reached record levels relative to disposable income and profits (see chart, page 83). This means that consumer spending could be subdued and business investment weak in the months ahead. Hung Q. Tran, Deputy Director of the IMF's International Capital Markets Department, told (Please turn to the following page)

Hung Q. Tran (left) and Gerd Häusler brief the press on the new Global Financial Stability Report, citing vulnerabilities that could pose risks to world economic recovery.

Economic Forum

New ideas for reducing poverty

As the international community debates the best ways to reduce poverty, the IMF is stepping up its efforts to better understand the complex links between macroeconomic policies and poverty reduction. In that spirit, the second annual conference on the topic was held March 14 and 15, bringing together academics, policymakers, nongovernmental organizations, and IMF and World Bank staff (see the next issue of the IMF Survey *for a full report). The conference culminated in an Economic Forum with Nicholas Stern, Chief Economist, World Bank; Santiago Levy, Director General, Mexican Institute of Social Security; Nancy Birdsall, Center for Global Development; and Montek Ahluwalia, Director, IMF's Independent Evaluation Office. Anne Krueger, IMF First Deputy Managing Director, moderated.*

Birdsall: Governments need to create "safety rope" programs.

New poverty "tool kit"

Nicholas Stern noted that the World Bank's most innovative work on poverty reduction of late is in designing and assessing pro-poor growth policies. The design work is based on a two-pillar approach: helping countries improve their investment climate to attract foreign investors and investing in people so they are able to participate in the growth process. The emphasis is on helping countries make the right decisions rather than telling them how to allocate resources.

As for assessment, he said, one of the biggest problems is inadequate data. Countries need decent household surveys to evaluate the distributional incidence of public spending and taxation on households. They also need firm-level surveys to (Please turn to page 84)

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Vulnerabilities in global financial system

(Continued from front page) journalists that, with an already high and burdensome level of debt servicing despite low current nominal interest rates, "the ability of households to continue to underpin economic growth is something that everyone should pay close attention to."

Second, equity markets may be overoptimistic in their expectations for corporate profit growth, and if anticipated earnings fail to materialize, stock markets could undergo a correction. Tran said that the average current price-to-earnings ratio of the U.S. S&P 500 is 22, which indicates that investors are expecting an increase of 20–30 percent in corporate profits over the next two quarters or so.

Third, financial institutions have been weakened by corporate defaults and higher loan-loss provisioning during 2001. Häusler expressed concern that a full correction of the corporate overleveraging that took place over the 1990s might not have occurred during the relatively short-lived economic downturn. He explained that defaults would probably peak only later this year, given that the credit cycle lags the business cycle by roughly two quarters.

Fourth, there is uncertainty, in the wake of the Enron and Global Crossing scandals, about the true levels of corporate profitability and indebtedness (see box below). This uncertainty has been exacerbated by the new credit-risk transfer markets, which Häusler described as having "teething problems." It remains to be seen whether credit default swaps and other credit derivative instruments work as smoothly as market participants expect, he said, adding that the securities markets would probably scrutinize all companies for the possibility of any "creative accounting that might have masked lower profitability or higher leverage."

There is uncertainty, in the wake of the Enron and Global Crossing scandals, about the true levels of corporate profitability and indebtedness.

Ensuring global recovery

Looking ahead, Häusler said that financial markets were demanding greater disclosure and that the financial community would be well advised to strengthen disclosure and transparency mechanisms to allow

Collapse of Enron

Enron has come to symbolize the use of aggressive accounting techniques to mask excessive leverage and weak earnings. Some segments of financial markets have been volatile since Enron's collapse—the largest bankruptcy in U.S. history—and the full extent of the losses suffered by investors and financial institutions will not be known until the company's complex operations are unwound.

Enron's failure highlighted uncertainties about credit-risk transfer vehicles and underscored three broader issues:

Inadequate oversight of financial activities of nonfinancial corporations. Enron was the main dealer, market-maker, and liquidity provider in major segments of the over-the-counter energy derivatives markets and was also active in other derivatives markets (at the end of September 2001, its overall derivatives-trading liabilities stood at about $19 billion), yet these activities were essentially unregulated. It was not required to disclose information either about its risk exposures or about market prices or conditions, nor was it required to set aside prudential capital. Because its trading unit's capital was not segregated from the parent company's capital, banks lost confidence in the parent company and withdrew their credit lines, which, in turn, contributed to the collapse of the trading operation. Some observers have since called for revisions to the 2000 Commodity Futures Modernization Act, which exempts energy derivatives from regulatory oversight. Even without these exemptions, however, Enron's activities in credit and other financial derivatives markets would have been essentially unregulated.

Ineffective private market discipline, disclosure, corporate governance, and auditing. Enron's financial difficulties and vulnerabilities, including those associated with its extensive off-balance-sheet transactions, seemed to have gone undetected by analysts, shareholders, and creditors until it was on the brink of bankruptcy. In part, this may have been due to inadequate accounting rules and standards as well as to errors by its auditors, who failed to uncover related-party transactions and did not require Enron to properly consolidate its numerous, complex off-balance-sheet special-purpose vehicles in its financial statements. In October 2001, the correction of this and other errors resulted in a restatement of income by $600 million and a writedown of shareholder equity by $1.2 billion. Questions also arose about the auditor's possible conflict of interest owing to its parent company's extensive consulting business with Enron. Along with allegations that the auditor destroyed documents relevant to a Securities and Exchange Commission inquiry, these revelations led to calls for a close examination of auditing standards and practices.

Misallocation of retirement savings. More than 10,000 of Enron's employees held most of their retirement savings in Enron stock, including Enron's contributions (entirely in company stock that the company prohibited them from selling until age 50). In addition, the Enron shares in the pension fund were frozen for three weeks in October 2001 as the company switched plan administrators, during which time Enron stock fell by 35 percent. As a result of the lack of diversification and inflexibility, a large share of employee savings was wiped out in 2001, as Enron's stock price plummeted from about $90 to less than $1. In early 2002, the U.S. authorities formed a working group to consider potential reforms to the Employee Retirement Income Security Act (ERISA) rules that govern private pension investments, and the U.S. Congress held hearings on how to address the gaps in ERISA that had permitted a high concentration of Enron stock in the company's pension fund.

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market participants to gauge the amount of credit risk, where it was concentrated, and how it was being distributed. This, in turn, would bolster the self-correcting mechanisms of the market economy, the first line of defense against financial instability. Indeed, several corporations have already responded, releasing much more information in their annual reports than in the past.

Similarly, policymakers need to update supervisory and regulatory frameworks and strengthen oversight of nonbank and nonfinancial entities that are increasingly active in financial markets. Acknowledging that there were no "quick fixes," Häusler highlighted the dangers of having different regulatory regimes for different types of firms—or even, in some cases, no regulatory regime. This might encourage firms involved in similar financial activities with similar market and credit risks to engage in "regulatory arbitrage."

With respect to emerging markets, Häusler urged institutional investors to continue their "discriminating behavior." He attributed the lack of contagion following Argentina's default to the fact that the crisis developed slowly, over several months, giving investors time to assess the situation as one specific to Argentina. He also encouraged emerging market countries to provide adequate and timely data to financial markets—thereby enabling investors to make well-informed judgments—and not to take any steps that could jeopardize foreign direct investment inflows.

As for Japan, Häusler urged the financial and corporate sectors to undertake a "swift restructuring" to cope with the heavy volume of nonperforming loans. He said that the risk of contagion from the Japanese financial system to the international financial system had decreased over the past three years as its financial institutions reduced their international operations and international banks reduced their exposure to Japanese banks.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
March 11	2.29	2.29	2.69
March 18	2.32	2.32	2.73

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).

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

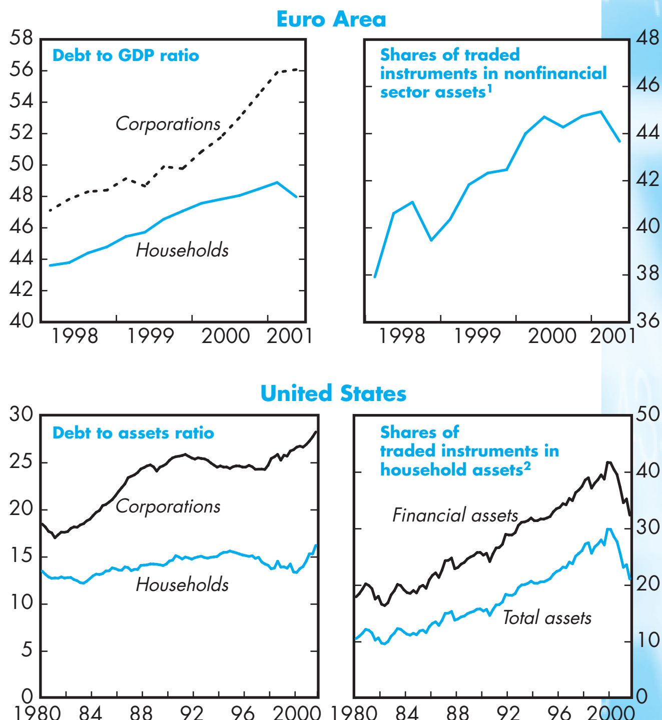
Data: IMF Treasurer's Department

Early warning systems

The quarterly *Global Financial Stability Report*, which replaces both the annual *International Capital Markets* report and the quarterly *Emerging Market Financing*

Household and corporate debt is at record levels

(percent)



[1]Includes general government.
[2]Credit market instruments, corporate equities, and mutual fund shares as a percentage of assets. Includes assets of nonprofit organizations.

Data: IMF, *Global Financial Stability Report*, March 2002

report, aims at providing timelier and more comprehensive coverage of mature and emerging financial markets as part of the IMF's stepped-up surveillance of financial markets. Each issue will include articles on structural or systemic issues relevant to international financial stability. The inaugural issue looks at early warning systems and alternative debt instruments that countries are using to maintain access to global capital markets and diversify risk.

In response to a question about the IMF's early warning systems, Häusler recognized that current models sometimes gave false alarms and needed further development. He said that the IMF did not take a mechanical approach, but used information from the models as just one of many inputs in making a judgment, and that it was working to extend the models to predict not only currency crises but also debt and banking crises. ■

Copies of the *Global Financial Stability Report* are available for $42.00 ($35.00 for academics) each from IMF Publication Services. For ordering details, see page 87.

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Poverty reduction takes center stage

Nicholas Stern

Santiago Levy

Montek Ahluwalia

(Continued from front page) determine the problems that firms face with regard to the investment environment. Service-delivery indicators would also be useful to measure service quality and efficiency, such as how well hospitals function. The goal would be to evaluate economic policy choices ex ante and monitor ex post the impact on poverty and distribution. To achieve this, Stern said, the World Bank, in collaboration with the IMF, has been developing a new "tool kit" for evaluating the distributional and poverty impact of economic policies. This comprises several tools (from simple benefit incidence analysis and poverty maps to more sophisticated models) to be used by economists in the field and is expected to become operational in two to three months. It will help poverty-impact analysis of macroeconomic policies to be conducted by linking the tools used in traditional microeconomic analysis of the distributional incidence of policies with the tools used for macroeconomic simulations.

Mexico's social safety net

Santiago Levy stressed that macroeconomic shocks hit the poor the hardest and, thus, social safety nets are critical. They provide a mechanism for transferring income to the poor—for example, through price controls and food subsidies—and allow investment in human capital. But, he warned, governments need to be careful about the costs of setting up and administering the various social programs so that they do not reduce actual transfers to the poor. An overly narrow range of goods covered by subsidies might also render the programs ineffective. Given these potential problems, he argued that governments should rely more on monetary transfers than on subsidies because they are more efficient and have lower administrative costs.

Mexico, for example, is moving in this direction, he said, with the elimination of general food subsidies. This is being done as part of PROGRESA—the government's integrated program for education, health, and nutrition—which Levy said helps 20 million Mexicans at an annual cost of 1/3 of 1 percent of GDP.

"Safety rope" programs

Nancy Birdsall commended Levy for leading a social safety net program that successfully fights poverty. However, she noted that Mexico's highly targeted PROGRESA program is an exception.

She stressed how politics and ownership matter in the design of socially responsible macroeconomic policies by governments and international financial institutions. In most developing countries, there is a missing political alliance between the poor and nonrich—those who are at risk of becoming poor, typically in the informal sector. "Safety rope" programs, rather than safety net programs, can forge such alliances.

Birdsall said the fact that the IMF was even holding a conference on poverty reduction was an "enormous step forward," but in its work, the IMF and others should pay more attention to the middle quintile income groups. This means looking at how these groups are affected by fiscal and monetary policies, especially during crises. She cautioned that, too often, the crisis response pits the political interests of the nonrich against those of the poor.

Tackling poverty in India

Montek Ahluwalia stressed the need to distinguish between longer-term issues of the impact of development policies on poverty and short-term problems of the impact of crisis management on poverty.

On the longer-term, India's experience validates that strong growth contributes greatly to reducing poverty. At the start of India's reforms there were concerns that growth might be picking up without a reduction in poverty, but recent data confirm that 10 years of around 6 percent growth in GDP have produced a significant reduction in poverty.

He said the concern with poverty reduction is sometimes projected as if achieving growth alone is easy, and what is difficult is poverty-reducing growth. However, experience around the world shows that the failures in poverty reduction are almost always cases where there was a failure to achieve growth. There were no examples of rapid growth where poverty had not come down. This is not to deny that some types of growth would be more poverty reducing than others, and we should certainly try to design policies that ensure that the maximum poverty reduction takes place, but the central focus must be on policies that can stimulate growth.

On the shorter term, he stressed the need to avoid hurting the poor in periods of crisis management, seconding Levy's thoughts on social safety nets. However, it is not easy to design policies that can do this effectively within a 12 to 18 month time horizon, especially since it is not a simple matter of increasing allocations for existing poverty programs. Often, it is those who are linked to the modern economy that are worst hit at times of stabilization but they may not be beneficiaries of existing anti-poverty programs. In fact, poverty reduction programs are often designed precisely for those not linked to the market economy. Nor is it easy to design new programs for groups that become vulnerable. Hence, the importance of establishing social safety nets that can be intensified countercyclically. ■

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Detection, early action are keys to nipping banking crises in the bud

For emerging market economies, in particular, banking crises can impose huge costs in terms of both the direct fiscal expense of recapitalizing banks and the real output losses. Early detection is the key to keeping financial sector weaknesses from mushrooming into full-blown crises. On March 11–12, the IMF Institute organized a seminar on assessing banking fragility for 30 country officials, as well as IMF and World Bank staff. Drawing heavily on recent experiences in emerging markets and industrial countries, the speakers and other participants shared ideas and suggestions on how countries could identify problems early and move decisively to head off or quickly resolve banking crises.

Sounding the alarm

Seminar coordinator Morris Goldstein, a Senior Fellow with the Institute for International Economics, opened by telling participants that "we hope to 'improve your sense of smell' so you know what to look for and what embarrassing questions to ask." Even so, he noted, assessing banking fragility is no easy task. During the Asian crisis, some early warning indicators—such as interest rate spreads on sovereign borrowing and ratings by major credit rating agencies—had provided no advance warning.

But in the wake of that crisis, much work has gone into developing more robust indicators that would sound timely alarm bells for policymakers. In his view, the "prime suspects" among the qualitative indicators that officials should be mindful of would include

- high volatility in the macroeconomic environment, which is especially pronounced in emerging markets;
- surges in capital inflows that are linked to lending booms and subsequent asset price bubbles and collapses;
- large currency mismatches in bank and corporate sector debt;
- financial liberalization without adequate strengthening of supervisory and prudential regulation capability;
- high levels of government involvement or state ownership of financial institutions or significant "connected" lending (that is, lending based on personal relationships rather than likely profitability);
- poor internal controls, especially on the size of the risk exposure;
- weaknesses in accounting, disclosure, and legal frameworks;
- distorted incentives in official safety nets;
- exchange rate regimes that limit the official sector's lender-of-last-resort capability; and
- small banking sectors that do not allow sufficient diversification.

All of these indicators should be considered together, he said, because none of them, in and of itself, is sufficient to predict a crisis.

But in the case of early warning indicators, just how early is early enough to permit effective preventive action? According to Goldstein, one of the toughest issues in using early warning indicators is determining when banking crises actually end. Since banking crises typically last about 3–5 years and usually peak after 1 year, he indicated that ringing the alarm bell up to 12 months after the start of a crisis could still be helpful.

How confident should officials be about early warning indicators? Goldstein argued that recent empirical research has shown that a relatively small set of quantitative indicators could add significantly to the ability to anticipate banking crises, although banking crises have proved harder to forecast than currency crises.

Good-bye, deposit insurance?

As for explicit or implicit official safety nets—such as deposit insurance or financial support from the government or the central bank—George Benston of Emory University and Charles Calomiris of Columbia University argued that these create moral hazard by giving banks an incentive to take excessive risks and maintain lower levels of capital in the knowledge that they will not bear the cost when things go awry. In turn, depositors and other creditors, because they do not fear losing their funds, fail to monitor banks as carefully as they should. While bank supervision exists to counter moral hazard, in many countries it has tended to be lax, with regulatory agencies all too willing to exercise forbearance in the hope that weak or insolvent banks will recover without intervention.

What needs to be done to create the right incentives for shareholders, managers, depositors, and supervisors? Benston maintained that a higher capital requirement would give institutions offering insured deposits strong incentives not to take excessive risks and ensure sufficient resources to absorb losses that might be incurred. This higher capital requirement would take two forms: a higher capital-to-asset ratio equivalent to the ratio banks would hold in the absence of government-provided insurance; and

Morris Goldstein

George Benston

Charles Calomiris

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Thomas Cargill

Ruth de Krivoy

Stefan Ingves

issuance of subordinated debt whose main advantage is that subordinated debt holders, unlike small depositors, would be expected to be sophisticated enough—and have enough at risk—to exercise careful oversight of banks.

What can governments do to mitigate moral hazard? Benston called for structured early intervention and resolution—a system that maps out what actions regulatory authorities would take vis-à-vis banks, based on the adequacy of their capitalization. These actions would range from minimum supervision when banks are well capitalized to merger or liquidation when banks are severely undercapitalized.

In the same vein, Calomiris argued that the problem with the current system is that there is no market discipline. Before the advent of deposit insurance, he said, the U.S. banking system allowed banks to reduce their exposure when they were hit with a negative shock—with very few generalized crises or panics. That market discipline disappeared, he argued, with the introduction of deposit insurance. Protected by the government, banks now take large risks, with adverse fiscal consequences when crises do occur.

Calomiris cautioned, however, that a return to market discipline would imply credit crunches during downturns, as banks would lose financing and cut back on risky loans during a recession. But the current trend toward regulatory forbearance during a downturn is not stabilizing, he said. It merely postpones and enlarges the inevitable adjustment. So what is needed to restore credible market discipline? Repealing deposit insurance would be difficult, but he, like Benston, favored the idea of subordinated debt.

The pros and cons of official safety nets provoked perhaps the most lively debate, among both the presenters and the active audience participants. The "academics" generally took a tough market discipline line, in contrast to the "practitioners," who felt that markets often operated imperfectly and that retail depositors would not be good monitors of weak banks.

Japan, Venezuela, and East Asia

Turning to country cases, Thomas Cargill of the University of Nevada (Reno) weighed whether Japan was headed for another lost decade. Describing the historical evolution of Japan's financial system, he indicated that half-hearted attempts at reforming the Japanese financial system have not worked because they have failed to tackle the root cause of the problems—namely, the government's large role in financial intermediation. Despite numerous attempts at reform, the regulatory authorities continue to react to financial sector problems through "understatement, denial, forbearance, and forgiveness." Meaningful reform, he said, will require dealing with the Postal Savings System, which accounts for 35 percent of household deposits, and the Fiscal Investment and Loan Program, whose budget is equivalent to 11 percent of GDP. Both are key channels for transferring funds to designated sectors of the economy.

As for Japan's immediate problems, Cargill noted that the two main challenges facing the authorities are to reverse the decline in prices—steps taken by the Bank of Japan in December 2001 to expand the monetary base are in the right direction—and to deal aggressively with nonperforming loans, which would accelerate bankruptcies and raise unemployment but lay the foundation for sustainable economic growth through a more efficient allocation of credit.

It's not all about economics, either, according to Ruth de Krivoy, former Governor of the Central Bank of Venezuela. "Banking regulation and supervision are at the heart of the power play," she said, noting that how things are done or not done has a lot to do with politics. She observed that the 1994 banking crisis in Venezuela had all the classic ingredients: imprudent risk taking, cozy relationships between banks and the government, inefficient financial intermediation, maturity mismatches (for example, 14-year projects financed with eight-day funds), off-balance-sheet operations, weak accounting standards, a poor regulatory and supervisory framework, macroeconomic fragility, and economic and political shocks. In the end, she estimates, the crisis cost Venezuela the equivalent of 11 percent of GDP.

Were the problems foreseen? The World Bank and the IMF had warned of potential problems, including a rising number of nonperforming loans. But the authorities had hoped the banks would grow out of the problems, and in the years leading up to the crisis, weak banks did grow aggressively, only to go under later. Bad loans at the time of the crisis were much larger than initial estimates. One of the chief lessons to be drawn from the Venezuelan crisis, de Krivoy added, is that, in good times, policymakers should make contingency plans, since crises are inevitable.

Turning to the Asian crisis, Stefan Ingves, Director of the IMF's Monetary and Exchange Affairs Department, suggested three major lessons. First, regulatory and supervisory agencies should be given autonomy, clearly defined by law. Markets must be allowed to work efficiently, he said, as "competition requires occasional exits" to keep the system sound and healthy. Blanket government guarantees may be necessary to buy time when dealing with massive systemic problems, but success hinges on rapid decisions to close deeply insolvent institutions, as well as the introduction of credible macroeconomic stabilization

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and bank restructuring plans. Second, banks should focus on effective risk management, which involves good corporate governance practices. This means putting in place a supportive legal and regulatory framework, with effective insolvency laws and strong institutions, before a crisis. Third, policymakers should closely gauge market vulnerabilities, as well as vulnerabilities in the real economy. Remember the bigger picture and remain vigilant, he said. "Banking is a derivative of the real sector and asymmetrically absorbs losses but not gains. Hence, robust macroeconomic management is essential."

Small can be big

In the final session, John Heimann and Patricia Armendariz of the Bank for International Settlements' Financial Stability Institute counseled participants that a small, "low-tech" investment in crisis prevention can often provide large payoffs. Acknowledging the budgetary constraints and the scarcity of sophisticated expertise that often constrain developing country efforts, they urged supervisors to use a small set of probing questions and simple indicators to identify problems. The quality of bank supervision also matters. A country without on-site inspections or consolidated supervision really has "no supervision," they said, underscoring the need for supervisory independence and appropriate legal powers and protections for supervisors.

Turning to banking data, Heimann and Armendariz suggested that no bank could safely see its balance sheet grow by more than 15 percent a year and that questions to bank managers about internal risk management, provisioning policies, and how overdue loans would be treated (especially when rescheduled) provide useful clues about the credibility of bank data. Identifying the bank's owners and any connections they may have to political groups and/or large business conglomerates is also vital.

Patricia Armendariz and John Heimann.

A final pragmatic tip from Heimann and Armendariz: include at least three people on bank inspections. It is almost impossible, they said, to bribe three persons for the same job! ■

Sabina Bhatia and Peter Stella
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Interview with Edward Prescott

Japan's prolonged slowdown parallels sharp decline in productivity growth

Whither Japan? That question may not be fully answered until there is a clearer understanding of what prompted the country's extended slowdown. In a recent IMF Institute seminar, Edward Prescott, professor of economics at the University of Minnesota, presented research undertaken with Fumio Hayashi of the University of Tokyo. They find that the decline in Japan's economic growth rate is explained almost entirely by a decline in the rate of productivity growth. Jahangir Aziz, a Deputy Division Chief in the IMF's Asia and Pacific Department, spoke with Professor Prescott about these findings and his thoughts on the U.S. economy.

Prescott: "If Japan's productivity were to suddenly increase to the U.S. level, the Japanese people would be better off by 40 percent of consumption."

AZIZ: Most analysts see the collapse of the asset price bubble, difficulties in the banking system, and poor policies as central to the reasons why Japan experienced an economic slowdown in the 1990s. But you don't agree; why is that?

PRESCOTT: Fumio Hayashi and I found that if productivity growth is treated as exogenous, the Japanese economy behaved just as neoclassical growth theory predicts. This is why I say the sharp decline in Japan's productivity growth in the 1990s accounts for its economic slowdown. The preferences of the Japanese people for work and leisure and their participation in the workforce are the same as in France or the United States; their saving behavior is the same, too.

So why has total factor productivity growth declined? Why did productivity growth, after increasing quite rapidly between 1984 and 1991, drop to almost zero subsequently? I would argue that it is not a matter of stabilization policy or the lack thereof. I think it's got to be related to a multitude of factors. One problem may be with the financial system—with savings being directed in a way that subsidizes inefficient producers. I suspect that the Japanese government does not want its banks to fail; their failure would be very embarrassing to the Japanese government. This is why inefficient producers are being subsidized and protected from competition. This may not be the case, but this area bears careful investigation.

AZIZ: Why did Japan's productivity decline during the 1990s? It isn't a period one typically associates with productivity slowdowns.

PRESCOTT: First, it's not exactly a productivity decline. There was a decline in the rate at which productivity grew. Rather than growing at 2 percent a year, the productivity growth rate fell to slightly above zero—about 3/10 of 1 percent. Why in Japan and not in North America or Western Europe? The question is a very good one, and that's where we should focus our research attention.

One difference could be that Japan experienced a major financial crisis, while the United States had only a very minor one. Western Europe, except for a couple of Scandinavian countries, avoided a financial crisis. Another difference could be greater competition in both North America and Europe. An industry in France competes with the same industry in Spain, Italy, the United Kingdom, or Germany. An industry in California competes with the same industry in Canada, Mexico, or New York. You don't see that competition so much within Japan. The Japanese industries that do face global competition are highly efficient. The Japanese automobile industry is the most efficient automobile industry in the world.

AZIZ: Your paper contrasts Japan and France, both of which have per capita incomes that are 30 percent less than in the United States today.

PRESCOTT: Today the French work 30 percent less than do Americans. In the 1970s, the French worked 10 percent more than U.S. workers did. They have more holidays and more weeks of vacation, and a lower percentage of their working-age population that work. There's a nice connection here between policy and why this happened.

The intratemporal tax wedge in France is large. In France, if someone works more and produces 1.0 additional unit of output, that person gets to keep less than 0.4 unit of that additional output he or she produced. The rest is taxed away. In the United States, the person would keep 0.6 unit of the additional output. Taking into consideration consumption taxes and social security taxes as well as income taxes, the French marginal tax rate is 60 percent. In the United

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States it is only 40 percent. This is why the French work 30 percent less than Americans.

If France adopted the U.S. tax system, France would collect as much revenue as it currently does and would realize a welfare benefit equivalent to consuming 20 percent more now and in all future periods. More precisely, the increase in welfare that would result from this change in the tax system would be as great as a tax-free gift that started at $5,000 a year and grew at 2 percent a year. I want to emphasize that this is a real gift—that is, one corrected for inflation. This welfare gain is a big number.

Even more striking, if Japan's productivity were to suddenly increase to the U.S. level, the Japanese people would be better off by 40 percent of consumption. In other words, the welfare gap with the United States is twice as big for Japan as it is for France. A danger is that Japan will adopt a tax system like France in the hope of financing benefits that it promised to its citizens. If it does this, the Japanese economy will become 30 percent more depressed and revenue collections will not increase.

AZIZ: Given your finding that a decline in productivity growth is the main cause for the slowdown in Japan, what do you recommend?

PRESCOTT: I would look to the United States, which had very low productivity growth in the 1970s but then, in the late 1970s and the early 1980s, undertook significant reforms that led to a recovery in productivity growth. What were these reforms? There was quite a range: from deregulation in various sectors—banking, airlines, telecommunications—to the way pollution was controlled. Government policies were subject to cost-benefit analyses, and such analyses sometimes resulted in not adopting policies that had bad consequences for productivity and few benefits.

It is important to note that the reforms featured market rather than command mechanisms. There are all kinds of moral hazard problems associated with command mechanisms. For example, in the case of pollution controls, command mechanisms do not give parties the incentive to honestly report the costs of reducing pollution. Sulfur dioxide was a dramatic example. The cost of reducing pollution from sulfur dioxide under market mechanisms turned out to be a small fraction of what it would have been under a command-type system. I don't have a detailed knowledge of Japan's regulatory environment, but I suspect that it is command-based rather than market-based. A command-based regulatory system is often used to protect industry insiders with vested interests in producing inefficiently.

Foreign competition is also important. Japan is beginning to permit some competition from foreign financial institutions. There are a number of U.S. financial institutions with offices in Tokyo, for example. More of this is the way to proceed, I think, but basically the Japanese people have to figure out what to do. They know what reforms are acceptable and at what pace. Outsiders cannot tell them what to do; that never works. I've been going to Japan over the past five years, and over this time, I've noticed a shift in the thinking. The Japanese are much more sympathetic to the view that reforms are needed to restore productivity growth and that productivity growth must be restored.

AZIZ: During these past five years, have you seen studies like yours and others have a greater influence on Japan's public policy?

PRESCOTT: Well, you just give a little bit of moral support to the people who are thinking about these problems, and that's important. Some of the IMF's work has helped influence this policy debate, too, but then again, the IMF can't go in there and reform Japan either. But Japan will reform; I'm sure of that. The only question is when.

AZIZ: Your work on the United States found that productivity shocks explain most of the cyclical fluctuations the economy has experienced. Does this finding have any bearing on the nature of public policy?

PRESCOTT: These productivity shocks between 1954 and about 1980 accounted for about 70 percent of the cyclical fluctuations, which is a big number. An implication of this finding is that the economy responds in the best possible way to technology shocks, so stabilization policy can at best have no effect and at worse a negative effect on the economic welfare of people. Consistently, productivity comes up as the most important determinant of differences in living standards.

Tax factors are also very important, as evidenced by how little the French now work on a per capita basis. In the 1970s, their marginal tax rate was lower and as a result, they worked 10 percent more than Americans did at that time. In the 1980s, the United States saw a large increase in its labor supply. It appeared to be related to changes in the tax system that lowered marginal tax rates and broadened the tax base. With regard to tax policy reform, you should just think of what tax system best balances efficiency and distributional considerations. You should not be using tax policy to stabilize the economy. That's the key point.

I don't think you should be using monetary policy to stabilize the economy either. It doesn't work. People have been searching desperately for a mechanism by which monetary policy can have significant and predictable real effects. The prime candidate for a mechanism is rigidity in wage and price setting. There is a

The Japanese are much more sympathetic to the view that reforms are needed to restore productivity growth and that productivity growth must be restored.
—Edward Prescott

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fascinating paper by V. V. Chari, Patrick Kehoe, and Ellen McGratten that studies the consequences of staggered price setting behavior for monetary policy. The hope was that a staggered nature of price setting would give rise to persistent effects of monetary policy. They carefully work everything out and ask if it fits together and is coherent in a consistent way. They find the real consequences of monetary policy are very short term. It's not much of a mechanism for stabilizing the economy even if you wanted to do it.

I hope Japan changes its policy—and I'm using that word in a very general sense as "the rules of the game." Policy is a game, and with a better policy game, productivity growth will again be rapid and the Japanese economy will again boom.

Aziz: What do you think about the U.S. policy response to its current, or now perhaps just concluded, recession?

Prescott: First, it was quite clear to me that lowering the interest rate would not make the economy boom. Second, I think the economy is in pretty good shape. It's neither prosperous nor depressed right now. It's very close to trend. It had been above trend. Why? The Y2K problem led to the purchase of a lot of computers and software in 1998 and 1999 and fewer purchases in 2000 and 2001. There was also a telecommunications boom that led to a huge investment in fiber-optic systems in the late 1990s.

In my way of determining recessions and expansions, I detrend the time series using a 2 percent annual trend. This is the average rate at which per capita output grew throughout the twentieth century in the United States. I see this trend growth as being due to the accumulation of knowledge useful in production. If you detrend in this way, you find the economy peaked right at the beginning of 2000 and then the recession started. This is one year earlier than the National Bureau of Economic Research's estimate, which ignores population growth and assumes a zero trend. I would say we're roughly back to normal, or right on trend. I was very pleased to see the recent productivity report. It was good to see the number come in so big; a few more big productivity growth numbers and the economy will be booming. If, however, productivity growth falls well below trend, as has happened in Japan, then I would get worried. Until then, I remain optimistic.

There have been very modest cuts in tax rates, and they will boost the economy some. But, when I did some rough calculations, their consequences are small. ■

Available on the web (www.imf.org)

News Briefs

02/19: IMF Completes Review Under Sierra Leone's PRGF Arrangement and Approves $12 Million Disbursement, March 12

02/20: Press Statement by the IMF Mission to Argentina, March 15 (see page 92)

02/21: News Brief: IMF Executive Board Completes Reviews of Poverty Reduction Efforts in Poor Countries, March 15

Public Information Notices

02/18: IMF Concludes 2001 Article IV Consultation with Spain, February 28

02/19: IMF Concludes 2001 Article IV Consultation with Niger, March 1

02/20: IMF Concludes 2001 Article IV Consultation with Cambodia, March 1

02/21: IMF Concludes 2001 Article IV Consultation with Greece, March 1

02/22: IMF Concludes 2001 Article IV Consultation with the United Kingdom, March 7

02/23: IMF Concludes 2001 Article IV Consultation with Norway, March 7

02/24: IMF Concludes 2001 Article IV Consultation with the Azerbaijan Republic, March 8

02/25: IMF Concludes 2001 Article IV Consultation with the Former Yugoslav Republic of Macedonia, March 8

02/26: IMF Board Discusses Modalities of Conditionality, March 8

02/27: IMF Concludes 2001 Article IV Consultation with Belgium, March 13

02/28: IMF Concludes 2002 Article IV Consultation with Canada, March 12

02/30: IMF Executive Board Reviews the PRGF, March 15

02/31: IMF Executive Board Reviews the Poverty Reduction Strategy Paper (PRSP) Approach, March 15

Speeches

"Inflation Targeting," remarks by IMF Managing Director Horst Köhler, seminar on the Statistical Implications of Inflation Targeting, IMF, February 28

Transcripts

Transcript of a Press Briefing by Thomas C. Dawson, Director, External Relations Department, IMF, March 13

Transcript of a Press Conference on the *Global Financial Stability Report*, IMF, March 14 (see page 81)

Concluding Statement for Article IV Consultations

Luxembourg, March 13

Other

IMF's Financial Resources and Liquidity Position, March 15

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FDI in Africa: Why do select countries do better?

Why have some African countries attracted large amounts of foreign direct investment? In a recent IMF study, Foreign Direct Investment in Africa—Some Case Studies, *Anupam Basu of the African Department and Krishna Srinivasan of the International Capital Markets Department find that, while natural resources, locational advantages, and targeted policies can lure investors, political and macroeconomic stability and structural reforms have been consistently important factors in attracting FDI to the region.*

While the stock of foreign direct investment in Africa increased significantly between 1980 and 2000, from slightly more than $32.7 billion to just under $150 billion, Africa's share of new global FDI inflows in 2000 was a meager 0.7 percent. In other words, the volume of FDI has increased strongly since the mid-1980s, but Africa has been unable to keep pace with other regions in attracting its share of new direct investment.

Within Africa, FDI is heavily concentrated in a small group of countries, most notably those richly endowed with oil and mineral resources; nearly three-quarters of total direct investment from overseas goes to this group, which includes Angola, Nigeria, and South Africa. To determine why certain African countries are able to attract fairly large amounts of FDI, Basu and Srinivasan eschewed a regionwide study and confined their analysis to selected case studies covering countries (other than South Africa and the major oil exporters) for which reliable information on capital flows and policies is available. In particular, their study focuses on seven countries with reasonable amounts of FDI diversified across various sectors: Botswana, Namibia, Lesotho, Swaziland, Mauritius, Mozambique, and Uganda.

What drives investment?

Basu and Srinivasan set up a simple framework for analyzing FDI by categorizing these seven countries into four groups, based on the considerations likely to be most important in driving investment: a country's natural resources; "specific" locational advantages; policies that actively target inbound foreign investment; and recent economic and structural reforms. While acknowledging that some combination of these four considerations may be at play in any direct investment decision, the authors point to strong evidence that, in most countries, one or a limited subset of these considerations can be identified as predominant.

Natural resources. Botswana and Namibia are among the African countries with abundant natural resources. FDI targeting the oil and minerals sectors of a number of economies—including those of Botswana and Namibia—has been highly profitable, although accompanied by significant risk. But since FDI has been diversified across sectors rather than concentrated solely in natural resources in Botswana and Namibia, the authors observe that sound economic policies within stable, democratic political systems have played a major part in attracting sizable FDI flows. Membership of these countries in the Southern African Customs Union and other regional organizations also seems to have positively influenced FDI inflows, since investors can gain easier access to markets in South Africa and other countries in the subregion.

Africa's abundant natural resources have attracted investment in sectors such as mining.

Locational advantages. Lesotho and Swaziland offered investors specific advantages linked to their proximity to South Africa. By setting up manufacturing subsidiaries in these countries in the late 1980s and early 1990s, investors seeking access to South Africa's large market were able to circumvent the apartheid era's economic sanctions against the country. These countries also offered a good base for companies seeking to take advantage of reduced tariff barriers within the southern African region's Preferential Trade Area and in trade with European Union countries under the Lomé Convention. As with Botswana and Namibia, political stability and sound economic policies increased their attractiveness to foreign investors. Low-cost and productive workforces and, to a smaller extent, generous tax incentives also likely influenced investor decisions.

Tailored policies. Mauritius is a striking example of a country that has tailored policies specifically to attract foreign investment—such as sustained policies of liberalization, economic diversification, and export-oriented development. Because of its small size and lack of natural resources, Mauritius realized early on it would have to put in place policies and measures targeting foreign investors—such as export processing zones and tax incentives—to try to compete with other developing economies that provide an appealing export base. But here, again, the authors find that political stability and sound economic policies have been of overarching importance in attracting investors. Other features of the Mauritian investment environment considered critical in attracting foreign investors are bilingual and low-cost labor as well as good infrastructure.

Economic and structural reforms. Mozambique and Uganda stand out as countries that had earlier been shunned by investors but have recently aroused significant investor interest after they successfully imple-

A critical mass of mutually reinforcing measures must be in place before countries can claim a larger share of FDI flows.

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Even countries lacking natural resources or locational advantages can draw investors . . . by following sound economic policies within an open political environment.

mented far-reaching and sustained macroeconomic and structural reforms. Both of these resource-rich countries have emerged from periods of political instability, civil strife, and poor economic policies to embrace market-oriented reforms that give increasing priority to creating a flourishing private sector. Foreign investors have responded positively to reforms that have reduced the state's role in the economy, shifted government spending priorities to improve the quality and availability of physical and human capital, and removed impediments to foreign investment.

What's the secret?

Above all, the authors find that countries that have successfully attracted large amounts of FDI tend to share certain traits: they promote political and macroeconomic stability on a sustained basis and they put in place essential structural reforms. Strong, pro-democracy political leadership that has embraced policies to overcome social and political strife and a firm commitment to economic reform are key factors linked with sizable FDI inflows.

Prospective investors also tend to favor those countries that pursue sound fiscal and monetary policies, supported by an appropriate exchange rate policy, and promote an operating environment that minimizes obstacles to private sector development. The authors also find that special incentives targeted to foreign investors by themselves do not appear to have significantly helped countries attract well-diversified investment.

What can African countries that have lagged these seven "success stories" do to catch up? The authors conclude that a critical mass of mutually reinforcing measures must be in place before countries can claim a larger share of FDI flows. Eliminating regulatory and other obstacles to private-sector development and implementing supporting structural reforms are essential to attracting these capital flows. In addition, since political stability is a vital determinant of where investors will choose to set up their operations overseas, progress toward conflict resolution is essential. And, as the country case analysis reveals, even countries lacking natural resources or locational advantages can draw investors to their shores by following sound economic policies within an open political environment. ■

Copies of the forthcoming Working Paper, *Foreign Direct Investment in Africa—Some Case Studies*, by Anupam Basu and Krishna Srinivasan, will be available for $10.00 each from IMF Publications Services. See page 87 for ordering information.

IMF mission outlines Argentine work on comprehensive economic program

On March 15, at the conclusion of an IMF mission's discussions with the Argentine authorities, Anoop Singh, Director for Special Operations and head of the mission to Argentina, stated that "The mission was encouraged by the government's determination to implement a comprehensive economic program, in close cooperation with the international financial institutions.

"Such a program aims at stabilizing Argentina's financial situation and establishing the foundations for resuming growth. The discussions centered on putting fully in place a realistic macroeconomic framework, consistent fiscal and monetary policies, fundamental structural and institutional reforms to restore confidence in the banking system, and steps to establish an orderly and fair business environment.

"On the macroeconomic framework, the program aims at containing inflation and restoring confidence as key conditions for minimizing further output decline and resuming growth. Monetary policy would play a key role through containing pressures on the peso within the framework of a freely floating exchange rate system. The central bank has already initiated auctions of central bank bills and is working with commercial banks to develop savings instruments with positive real rates of interest.

"A primary concern of the mission was to address the issue of fiscal sustainability while protecting the poorest members of society. As a first step, the government intends to secure a significant improvement in the primary balance of the consolidated public sector in 2002, through the combined efforts of the central government and the provinces. Approval of the 2002 budget by Congress, as well as the recent agreement between the government and provincial governors, are important steps in this direction. In the coming weeks, the government will develop the additional measures that will be needed to achieve the objectives in this area, including the finalization of a core social safety net to protect the poor.

"Anticipated structural and institutional reforms include measures to rebuild confidence in the bank and corporate sectors, thereby helping to create the conditions for the dismantling of the freeze on bank deposits. Steps have already been announced to inject public capital into banks and restore their adequate capitalization, and begin liberalizing exchange controls. The government and the central bank are working on additional measures to restore depositor and investor confidence. This includes creating an internationally recognized insolvency regime. The government also intends to move quickly to establish close contacts with its external creditors aimed at normalizing relations and restoring trade finance."

The mission team will continue its work at IMF headquarters, and staff will remain in close contact with the Argentine authorities as they elaborate the details of their comprehensive strategy.

The full text of IMF News Brief 02/20 is also available on the IMF's website (www.imf.org).

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Dornbusch on global economy, Argentina, Russia, and much more . . .

Over the years, Rudi Dornbusch, Ford Professor of Economics and International Management at the Massachusetts Institute of Technology, has been a frequent visitor at the IMF. After a March 8 seminar at the IMF Institute on exchange rate issues, Dornbusch sat down with Prakash Loungani for a wide-ranging, and characteristically lively, discussion of, well, just about everything.

LOUNGANI: Alan Greenspan seems to have declared the recession all but over. Do you agree?

DORNBUSCH: One disagrees with Greenspan at one's peril. He has a deep understanding of the U.S. economy. Certainly, the evidence of recovery is clear. The inventory restocking that has accompanied the past 10 recoveries is taking place. Consumer spending has remained strong. And with the tax cuts for businesses that the U.S. Congress just passed, it may be that investment will also join the orchestra in time. The United States has had a growth recession, and it is back on track now with solid productivity growth.

LOUNGANI: What's the economic outlook elsewhere?

DORNBUSCH: The recovery of the U.S. engine helps the rest of the globe, but other than that, I don't see that the risk factors have changed. Japan remains a huge risk factor. Balance sheets in Japan, private and government, are basically unviable. Growth doesn't collapse immediately because the country has captive finance, but in time it will. Europe is rich, complacent, and stable. It will keep dragging its feet on structural reform because, at heart, it does not really want to do it. It is happy the way it is. Certainly, you are not going to see any movement on reform in an election year. In the Middle East the question is whether reforms can be managed in Saudi Arabia without political turmoil. It's difficult to generalize about the emerging markets, but it seems that hyperinflation has been licked almost everywhere and whatever could be privatized easily has been sold off. Now come the hard reforms, and there is starting to be reform fatigue.

Argentina and spillovers

LOUNGANI: What are your views on Argentina?

DORNBUSCH: I'm not sure my views can be printed in a family magazine like the *IMF Survey*. But everybody knows that I think Argentina is, and has been, badly governed. Carlos Menem, after a few good years, started backpedaling on reforms to help himself get re-elected. And Fernando De la Rua accelerated that process of going backward.

For Argentina to get out of this crisis, reconstruction rather than quick-fix financial support has to be the answer. Tax evasion and corruption—and the government's acceptance of this—must be suppressed in the most radical fashion. The cumbersome tax code must be simplified to a flat tax, hopefully leading to better enforcement. The economy needs a quick productivity boost by massive privatization of ports and customs and deregulation of the wholesale and distribution sectors. Argentina must move quickly to a new temporary convertibility plan—say, two pesos to the dollar, just because it is the next simple number after one-to-one. The world should provide financial support, but only upon its acceptance of radical reform and foreign hands-on control and supervision of fiscal spending, money printing, and tax administration. Further IMF money without this change of the rules of the game would be a dramatic error. The IMF is placed in a difficult position when people are in the streets, but I hope you will not be forced again into supporting an incomplete or implausible program.

Dornbusch on Argentina: "Tax evasion and corruption . . . must be suppressed in the most radical fashion."

LOUNGANI: Is it realistic to turn a country's economic management over to foreign control?

DORNBUSCH: It'll be more like Paul Volcker heading the oversight committee for the restructuring of Arthur Andersen. Argentina needs a debt workout, and the people who carry it out have to be impartial and independent. It's not respectful of national sovereignty to treat countries like corporations, but how else do you deal with repeated economic mismanagement of a country by its politicians? Turning things over to the military is no longer acceptable, thank God.

LOUNGANI: Some say Argentina's crisis has discredited neoliberal economics or the "Washington Consensus."

DORNBUSCH: Nonsense. Neoliberal economics or the Washington Consensus—a terrible term, by the way—is simply a list of policies that have worked better than the alternatives, such as central planning, import substitu-

In November 2001, the IMF's Second Annual Research Conference specially honored Rudi Dornbusch. Kenneth Rogoff, Director of the IMF's Research Department, presented the Mundell-Fleming lecture on *Dornbusch's Overshooting Model After 25 Years*. The text is available on the IMF's website (www.imf.org) and as IMF Working Paper 02/39 (copies, $10.00 each, are available from Publications Services. See page 87 for ordering information).

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How is a poor country going to lift itself except by taking advantage of world markets in some of its export sectors and accumulating skills in the process?
—Rudi Dornbusch

tion, nationalization, and the like. There is no promise of quick growth or industrial country standards of living in a few years. In fact, you may have to stick to the policies for a while to get any growth dividend at all. Think about all the deregulation and restructuring the United States went through in the 1970s and 1980s to get a few years of a growth bonanza with the New Economy. Argentina has a history of promising too much, too soon—"plata dulce" [sweet money].

And Russia?

LOUNGANI: Why have Russia's fortunes improved after the 1998 crisis?

DORNBUSCH: Russia's reversal owes much to the change in the political landscape. Under Putin, the power of the oligarchs and their conspiracy to steal the remaining pieces of Russia have been checked. Now tax collection from organizations such as Gazprom is considered normal, when a few years back it was inconceivable. Where oligarchs are still at work in Russia, they have learned that a fair distance from politics and a focus on normal business are in their interest. That shifts the focus to entrepreneurship and making money in Western ways. The high oil prices came just in time to help Putin put in place his financial responsibility policy and his reform strategies.

LOUNGANI: Would the Soviet Union's transition have been handled better if it had been more gradual, particularly with respect to privatization?

DORNBUSCH: You cannot slow-motion the phase-out of the KGB. Same thing for privatization. Where gradualism, circumspection, a plan, and rules might have led is open to question. You may well say, "OK, but did you have to give it all to the oligarchs?" Here it's true that the Russian reformers—Yegor Gaidar and Anatoly Chubais above all—privatized without much care for niceties. They got rid of public sector assets at literally any price and with just about any process. This was controversial, and it created an oligarchy with great wealth and political power.

Yet, in the end, it worked. The massive privatization and restructuring of state enterprises is paying off. The initial phase, because of poor existing productivity, is always traumatic; it's not surprising that, after 90 years of bad economics, it takes some action to get the joints flexed. But now—with reduced debts, less overstaffing, and a gain in flexibility—the process is starting to bear fruit. Now you can begin to think about attracting foreign capital. Would that have been possible if Russia had been advised by someone who would still be drawing up perfect privatization schemes in his head?

Choosing an exchange rate regime

LOUNGANI: Given all the recent currency crises, do economists really have any coherent advice to offer countries on how to choose an exchange rate regime?

DORNBUSCH: Things are a bit chaotic on that front, but there is some advice economists can offer. For Eastern Europe, we're basically right to advocate that they become part of the euro area. They should do it right away to eliminate some of the noisemakers and the potential for instability because of concerns about the currency. And, for countries with a long history of monetary instability, I still stick with the recommendation of a currency board. But there should be no promises of quick growth and no slacking off on reforms. Can we really say that leaving the dollar has been a great strategy for Argentina? It has put people in the streets and devastated the country's banks. Would it really have been more painful to stick to the dollar and do the hard reforms—the deregulation and the fiscal reforms—that were needed?

Some large and financially stable countries can manage flexible exchange rates—Canada, Brazil with an Arminio Fraga, for example. Floating can be combined with a bit of careful inflation targeting. But if countries become obsessed with inflation targeting, they run the risk of ending up with an overvalued real exchange rate and killing the economy. This was Chile's problem, and it led to the 1999 recession. As long as inflation is headed downward, we shouldn't worry too much about how long it takes to go from 10 percent to some lower rate. We should worry more about avoiding real exchange rate appreciation by having a sort of "Taylor Rule" that limits the impact of inflation targeting on the real exchange rate.

On the globalization debate

LOUNGANI: What do you make of the antiglobalization movement?

Members' use of IMF credit
(million SDRs)

	During February 2002	January–February 2002	January–February 2001
General Resources Account	7,358.40	7,759.22	3,335.78
Stand-By	7,358.40	7,483.98	3,335.78
SRF	0.00	0.00	2,349.57
EFF	0.00	275.24	0.00
CFF	0.00	0.00	0.00
PRGF	45.32	50.72	72.44
Total	7,403.72	7,809.94	3,408.22

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 because of rounding.
Data: IMF Treasurer's Department

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Dornbusch: Most of it is a theater of the absurd. How is a country going to lift itself out of poverty except by taking advantage of world markets in some of its export sectors and accumulating skills in the process? You can't bootstrap a closed economy from the Stone Age to prosperity—North Korea would have been the miracle economy if that were possible.

Loungani: But people seem to be fighting over the evidence on the effects of globalization. There is the David Dollar-Dani Rodrik debate, for instance.

Dornbusch: David Dollar is a very serious researcher. It is, in part, thanks to his prodding that the World Bank has had to confess that "globalization is good for the poor, growth is good for the poor, foreign direct investment is good for the poor." It just

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	16,936.80	7,180.49
Brazil[1]	September 14, 2001	December 13, 2002	12,144.40	8,468.82
Bulgaria	February 27, 2002	February 26, 2004	240.00	208.00
Croatia	March 19, 2001	May 18, 2002	200.00	200.00
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Latvia	April 20, 2001	December 19, 2002	33.00	33.00
Lithuania	August 30, 2001	March 29, 2003	86.52	86.52
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Romania	October 31, 2001	April 29, 2003	300.00	248.00
Serbia/Montenegro	June 11, 2001	March 31, 2002	200.00	50.00
Sri Lanka	April 20, 2001	June 19, 2002	200.00	96.65
Turkey[1]	December 22, 1999	December 21, 2002	5,784.00	0.00
Turkey[1]	February 4, 2002	December 31, 2004	12,821.20	5,494.80
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			**49,507.50**	**22,614.64**
EFF arrangements				
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2003	3,638.00	2,201.96
Jordan	April 15, 1999	April 14, 2002	127.88	60.89
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Ukraine	September 4, 1998	September 3, 2002	1,919.95	726.95
Total			**7,971.93**	**5,275.90**
PRGF arrangements				
Armenia	May 23, 2001	May 22, 2004	69.00	59.00
Azerbaijan	July 6, 2001	July 5, 2004	80.45	64.35
Benin	July 17, 2000	July 16, 2003	27.00	12.12
Bolivia	September 18, 1998	June 7, 2002	100.96	37.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	11.17
Cambodia	October 22, 1999	February 28, 2003	58.50	16.72
Cameroon	December 21, 2000	December 20, 2003	111.42	63.66
Chad	January 7, 2000	January 6, 2003	47.60	18.40
Djibouti	October 18, 1999	October 17, 2002	19.08	10.00
Ethiopia	March 22, 2001	March 21, 2004	86.90	52.14
Georgia	January 12, 2001	January 11, 2004	108.00	81.00
Ghana	May 3, 1999	November 30, 2002	228.80	105.17
Guinea	May 2, 2001	May 1, 2004	64.26	51.41
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Honduras	March 26, 1999	December 31, 2002	156.75	48.45
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	61.68
Lao People's Dem. Rep.	April 25, 2001	April 24, 2004	31.70	22.64
Lesotho	March 9, 2001	March 8, 2004	24.50	17.50
Madagascar	March 1, 2001	February 29, 2004	79.43	56.74
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2003	51.32	19.65
Mauritania	July 21, 1999	July 20, 2002	42.49	12.14
Moldova	December 21, 2000	December 20, 2003	110.88	92.40
Mongolia	September 28, 2001	September 27, 2004	28.49	24.42
Mozambique	June 28, 1999	June 27, 2002	87.20	25.20
Nicaragua	March 18, 1998	March 17, 2002	148.96	33.64
Niger	December 22, 2000	December 21, 2003	59.20	33.82
Pakistan	December 6, 2001	December 5, 2004	1,033.70	947.54
Rwanda	June 24, 1998	April 30, 2002	71.40	9.52
São Tomé & Príncipe	April 28, 2000	April 27, 2003	6.66	4.76
Senegal	April 20, 1998	April 19, 2002	107.01	19.54
Sierra Leone	September 26, 2001	September 25, 2004	130.84	84.00
Tanzania	April 4, 2000	April 3, 2003	135.00	55.00
Vietnam	April 13, 2001	April 12, 2004	290.00	207.20
Zambia	March 25, 1999	March 28, 2003	254.45	149.63
Total			**4,213.78**	**2,711.90**
Grand total			**61,693.21**	**30,602.44**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals because of 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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missed one extra credo, which is also true: "The IMF is good for the poor." But I think Dollar would agree that one cannot rely solely on regression evidence from a tired old data set. You have to use your common sense as well. You have to ask, for instance, why China—which doesn't decide anything based on orders from the West or on regression evidence—has concluded that markets do miracles and that the World Trade Organization and foreign corporations are, on net, good for China.

LOUNGANI: Some of the antiglobalization protests have targeted large corporations.

DORNBUSCH: But these multinational corporations are generally far more responsible employers than domestic corporations in developing countries. The multinationals often offer good jobs in export sectors, pay more, and provide skills. There are cases of blatant exploitation, but this is not the rule. Multinationals have too much to lose in terms of reputation. And how else are poor developing country producers, who cannot even afford the airfare to New York, going to develop a brand name that is present in every shopping mall in the United States? Hooking up with the distribution channels and brand name of a multinational is a wonderful opportunity.

LOUNGANI: But Nike, for example, has admitted that in one factory village children hand-stitched footballs.

DORNBUSCH: In the United States until 20 years ago it was perfectly normal for 14-year-olds to work in the fields. Canadian school and university calendars are organized around the harvest so the kids can come back and work. So who is to say that developing countries should be guaranteed today the standard of living that we did not have 20 years ago? That's just nutty! I think environmental issues are more important. I'd like to see some of the rage against multinationals' alleged ravaging of poor countries shifted to U.S. suburbanites' ravaging of the environment.

And at the IMF . . .

LOUNGANI: You know Anne Krueger, the IMF's new First Deputy Managing Director, well.

DORNBUSCH: I know, love, and cherish her. She has strong views about how economies should be run. She is an expert on trade policies and, more broadly, on resource use. This is essential for dealing with emerging markets and developing countries: the poorer you are, the more efficient your use of resources has to be. This is obvious to the poor but not always to the people who advise them.

Anne's combat experience as the World Bank's chief economist in the 1980s will stand her in good stead. Back then she forced a somewhat reluctant organization to say that economies need to be opened to trade, governments need to be downsized, and inefficient public enterprises need to be privatized. That was shocking advice at that time, and she would have failed had Reagan and Thatcher not been advocating similar policies for the advanced economies.

And Anne is not a pushover. That is important at an institution like the IMF where the Executive Board basically always comes to the table with some kind of compromise in mind for every situation. You need someone to occasionally say "No!" to a bad compromise. And "No!" comes very easily to Anne.

Dornbusch: "Do we really want to have some court system . . . deciding whether a country is bankrupt and how to restructure its debt?"

LOUNGANI: What do you think of her proposal for a sovereign debt restructuring mechanism?

DORNBUSCH: I would have thought she would share my worry that we could end up taking the job away from capital markets and giving it to some really bad institutions. Market solutions are messy, but do we really want to have some court system, say, in New York, deciding whether a country is bankrupt and how to restructure its debt? It is dangerous to apply Chapter 11 to countries. Legal rules are fine for deciding, say, that a plumber's lifetime earnings are not enough to pay off his debt and hence he is bankrupt. But do we want to end up in a situation where we say that Argentina—where no one pays any taxes—is bankrupt and the bill should be paid by you and me and the rest of the international community? I say, "No, thank you; that's an offer I can refuse."

LOUNGANI: Anything we haven't touched on?

DORNBUSCH: No, you've squeezed it all out of me. ■

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