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In this issue

21 Köhler visit to Asia

21 American Economic Association meeting

23 Köhler: exchange rate policy challenges

29 Aninat: China and WTO accession

32 Drazen: political economy of reform

34 Tirole: banking regulation and IMF's mission

and...

22 Recent publications

30 New on the web

31 IMF arrangements

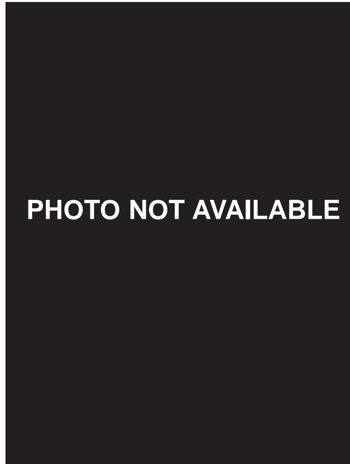
33 Use of IMF credit

35 Selected IMF rates

Visit to Asia

In Kobe remarks, Köhler stresses importance of floating rates among major currencies

IMF Managing Director Horst Köhler visited Asia in mid-January for discussions with officials and representatives of private financial institutions in Singapore, Hong Kong SAR, and Japan, and to attend the meeting of the Asia-Europe Finance Ministers (ASEM) in Kobe, Japan. While in Hong Kong, he also opened a suboffice of the existing IMF resident representative office in Beijing, China.



IMF Managing Director Horst Köhler at the Japan National Press Club before his Kobe speech.

ASEM meeting

In remarks to the third ASEM, held on January 13–14, the Managing Director noted the lessons learned about capital controls and liberalization and discussed developments in the choice of exchange rate regimes.

With reference to the three major currencies—the dollar, the euro, and the yen—he stressed that "realistically, there is no alternative to floating exchange rates," but, he emphasized, "this does not mean that the major industrial countries should practice benign neglect."

With regard to intervention, Köhler observed that "intervention cannot change market trends...[it] must be very selective and, ultimately, also well coordinated."

Looking beyond the three major currencies, Köhler noted that "an important conclusion of our research and reviews of country experience in the IMF is that no single exchange rate regime is appropriate

(Please turn to the following page)

American Economic Association

Conference examines U.S. economic uncertainties, exchange rate choices, and globalization

The annual conference of the American Economic Association (AEA) is one of the largest gatherings of economists in the world. The event, held this year in New Orleans on January 5–7, drew economists from around the globe and offered nearly 150 panel discussions and lectures on an extraordinary array of macro- and microeconomic topics. Here, Prakash Loungani and Sheila Meehan of the IMF's External Relations Department report on several issues that emerged from the conference, including the direction of the U.S. economy, forecasting, choice of exchange rate regimes, and globalization.

U.S. economy: will Atlas shrug?

Is the value of the U.S. stock market justified by economic "fundamentals"? Is the new economy here to stay? Amid a slowing U.S. economy and falling stock prices, the answers are of more than academic interest.

Struggling to understand the stock market. Stanford University's Robert Hall made the case that there is no need to invoke fads, animal spirits, or irrational exuberance to explain what appear to be wild swings in the value of the stock market (relative to GDP). To the contrary, he argued, the stock market's movements are generally consistent with rational behavior by investors.

Delivering the 2001 Richard T. Ely lecture, Hall said that a rational stock market measures the value of the property owned by corporations. But property today is not just physical capital. A far more important part of corporate property is "intangibles"—stocks of business know-how and organizational principles, all of which are becoming increasingly dependent on the use of computers and software.

Valuation of such electronic capital is difficult, Hall observed, because it is a relatively

(Continued on page 25)

Köhler opens IMF office in Hong Kong SAR

(Continued from front page) for all members in all circumstances." Heavily managed or pegged exchange rate regimes can be tested suddenly by markets, the Managing Director said: "My conclusion is that the IMF needs to support its member countries in making choices that best suit their needs, given the shocks they face and their stage of institutional development. For a wide range of countries, a floating exchange rate regime will be the best option."

Köhler also observed that the slowdown in the United States and the stalling recovery in Japan had increased the downside risks for the world economy, but stressed that "in our analysis, it would be an exaggeration to embark on doomsday scenarios now." (For an edited text of Köhler's remarks, please see page 23.)

The Kobe meeting was chaired by Kiichi Miyazawa, the Japanese Finance Minister. It was attended by finance ministers from 10 Asian countries, the 15 members of the European Union, and the European Commission. In his concluding statement, Miyazawa welcomed the improvement in growth prospects in Europe and Asia over the past two years, but warned that downside risks to the world economy had increased. Ministers remained committed to taking steps to make their economies more robust and to reducing their vulnerability to external shocks, he said. The ministers also discussed volatility in oil prices, sharing the view that a stable energy market was vital to long-term economic growth.

Discussions in Singapore

Köhler opened his visit to Asia in Singapore on January 10, where he met with Singapore Prime Minister Goh Chok Tong, Senior Minister Lee Kuan Yew, and Deputy Prime Minister Lee Hsien Loong. Köhler also met with senior representatives of financial institutions from Japan, Korea, China and Hong Kong SAR, Malaysia, Thailand, and Singapore. They discussed economic progress in Asia and the role of the private sector in preventing financial crises. Following this meeting, IMF Director of External Affairs Thomas Dawson said, "Discussions centered around the region's economic prospects, the pace of financial restructuring, and the continued need for closer cooperation between the IMF and the financial sector. Against the backdrop of private capital markets playing the major role in promoting investment and growth around the world, participants noted the importance of the IMF and the private sector working closely together in crisis prevention and resolution."

Hong Kong SAR office

Speaking at the January 11 opening of the IMF's Hong Kong SAR suboffice, Köhler said that its establishment reflected Hong Kong's unique qualities and strategic position in global financial markets. "The office should play an important role in promoting and maintaining a dialogue with the international financial community," he observed, adding, "and, in the process, help the IMF and the private capital markets contribute to the stability of the international financial system" (IMF News Brief, No. 01/05, January 11; the text of Köhler's remarks is also available on the IMF website: www.imf.org). Deputy Governor Liu Tinghuan of the People's Bank of China led a delegation from Beijing for the opening.

In Hong Kong, Köhler also met with senior officials, including Chief Executive Tung Chee Hwa; Financial Secretary Donald Tsang; Chief Executive of the Hong Kong Monetary Authority Joseph Yam; and Secretary for Financial Services Stephen Ip. ■

Recent publications

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01/10: Brazil: Selected Issues and Statistical Appendix
01/11: Pakistan: Selected Issues and Statistical Appendix
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01/13: Zimbabwe: Recent Economic Developments, Selected Issues, and Statistical Appendix
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Managing Director in Asia

Köhler addresses challenges of globalization for "central issue" of exchange rate policy

Following are edited excerpts of remarks made by Horst Köhler, IMF Managing Director, at the Asia-Europe Meeting of finance ministers in Kobe on January 13. The full text is available on the IMF's website (www.imf.org).

The strong world economic expansion of the past two years is losing momentum, due in large part to the effects of last summer's run-up in oil prices and developments in the advanced industrial countries. In particular, the slowdown in the United States and the stalling recovery in Japan have increased the downside risks in the global economy. But it would be an exaggeration to embark on doomsday scenarios now. The recent reduction in key U.S. interest rates was a timely measure to help ensure a soft landing in the United States and strengthen global growth prospects. If necessary, the United States has further room to maneuver on both monetary and fiscal policy. In Europe, the fundamentals have improved and tax reforms are taking effect at the right time. But both Europe and Japan can and should do more to promote sustained growth and thereby strengthen investor confidence in the global economy. The key lies in deepening and accelerating structural reforms—with special attention to corporate and financial sector restructuring in Japan and to labor market and pension reform in Europe. Moreover, the broader international community would and should boost investor confidence, not least in the Asia region, by embarking on a new round of WTO negotiations designed to enhance free trade.

Exchange rate policy

Since the breakdown of the Bretton Woods system of fixed parities in the early 1970s, there has been widespread interest in exploring the scope for achieving greater stability in the exchange rates of the three major currencies. Since the introduction of the euro, there has also been renewed attention to proposals for the possible adoption of exchange rate target zones. We must recognize that the global environment is even less hospitable to such a system today than it was 25 years ago. Realistically, there is no alternative to floating exchange rates among the three major currencies.

However, this does not mean that the major industrial countries should practice benign neglect. The undervaluation of the euro (and corresponding overvaluation of the U.S. dollar) may have boosted European exports, but it has also posed problems—not least for emerging market countries of Asia and Latin America. The good news is that a reversal has been getting under way, thanks mainly to better economic performance in Europe and slowing growth in the United States. It was right for the European Central Bank to make clear that a heavily undervalued euro was unacceptable. Its interventions have demonstrated the ECB's institutional maturity. Markets have taken note of this. But we also know that intervention cannot change market trends. Thus, intervention must be selective and, ultimately, well coordinated. Although it would be unwise to enter into formal commitments about particular exchange rate levels or ranges, the IMF's largest member countries do have a responsibility to make the most of possibilities for effective policy coordination to reduce exchange rate volatility and risk of misalignments.

In the wake of the Asian crisis, many emerging market countries have adopted systems of managed floating. And a number of countries still maintain fixed exchange rates. Experience has shown that heavily managed or pegged exchange rate regimes can be tested suddenly by exchange markets and that it can be costly either to defend them or to exit under disorderly circumstances. On balance, we have a responsibility to advise our members that while such regimes can succeed, the requirements for a country to maintain a pegged or heavily managed exchange rate are daunting—especially when the country is strongly engaged with international capital markets. There is essentially no room for error. Countries opting for such a system must pursue, unwaveringly, sound macroeconomic policies and be fully aware of the associated costs, including that extraordinarily high interest rates might be required at times of severe financial market pressure. Moreover, their domestic financial institutions and businesses must be well prepared to live with such policy adjustments.

On balance, a floating rate system is more forgiving of policy errors and therefore a somewhat safer solution for most countries. I do not mean a system in which the authorities are indifferent to the behavior of the exchange rate; indeed, it may at times be appropriate to adjust monetary policy in response to external developments. But with a floating rate, there is no need to risk unsustainable drains on its foreign exchange reserves to defend an exchange rate target. Moreover, a country can pursue a more independent monetary policy while receiving important signals from the exchange markets about the soundness of its policy framework. To be sure, floating is no panacea. It requires an alternative anchor for monetary policy and inflation expectations, such as inflation targeting. And countries can still face difficult choices, especially if they are faced with large swings in international capital flows. Still, the absence of

The IMF's largest member countries do have a responsibility to make the most of possibilities for effective policy coordination to reduce exchange rate volatility.
—Horst Köhler

an exchange rate target provides an important, extra degree of freedom for domestic policy management and dealing with external shocks.

Controls and capital account liberalization

We should not be surprised that the recent financial crises in emerging markets have led to renewed examination of the merits of capital controls. The earlier experience in Chile, for instance, confirmed that judicious use of controls on short-term inflows can help to avoid an excessive buildup of short-term debt. In Malaysia, which adopted controls on capital outflows in the context of the Asian financial crisis, the evidence is not clear. In some other countries, the effect of capital controls has been clearly negative. In particular, when controls are used as a substitute for necessary adjustment or institutional development, they reduce a country's growth potential, create incentives for corruption and evasion, and impede access to foreign capital without addressing the underlying economic vulnerabilities. For this reason, even controls on short-term inflows should be used in support of sound policies, and in conjunction with an exit strategy and timetable for their removal. Given the mixed experience to date, I see a need for further research and analysis to assess the costs and benefits of capital controls in particular circumstances. Still, there should be no confusion: in my view, integration into the global economy is challenging, but, over the long run, it clearly provides better prospects for growth and prosperity.

PHOTO NOT AVAILABLE

Japanese Finance Minister Kiichi Miyazawa (second from right, first row) greets his counterparts from Asia and Europe at a photo session of the ASEM finance ministers' meeting in Kobe.

In particular, the benefits of carefully prepared integration into the global financial system outweigh the risks. But we should also draw a lesson from the recent crises in emerging markets that, in some cases, there was clearly overly rapid capital account liberalization. Coping safely with volatile international capital flows requires sound domestic financial systems, adequate supervision and prudential regulation, and good risk-management capacities in banks and businesses, reinforced by greater transparency and market discipline. It is important to put these preconditions in place, insofar as possible, before the capital account is fully opened. Thus, in some cases, the transition may need to be gradual. The IMF staff will be reviewing the experience in a number of country cases to begin distilling more detailed, practical suggestions on sequencing.

Regional cooperation

Regional cooperation and integration can play a very significant role in helping countries become successfully integrated into the global trade and financial systems. Regional cooperation in Asia has recently gained new momentum as a way to cope with the challenges of globalization. I find this quite natural and positive. Through the Chiang Mai initiative [March 25, 2000], the ASEAN+3 countries [the members of the Association of Southeast Asian Nations, plus China, Japan, and Korea] have proposed strengthening regional financial cooperation through an expanded network of swap facilities. I welcome this initiative and encourage the ASEAN+3 countries to make it operative. I understand it as a complement to the IMF's financial assistance for members in the region that undertake adjustment efforts, and look forward to defining the modalities for our cooperation on this important matter.

European Economic and Monetary Union

The European Union represents a far-reaching process of regional integration. At the outset, it was guided by strong political considerations—especially by the desire to promote peace and stability in a region devastated by the Second World War.

There can be no doubt that this process has helped to create wealth and stability in Europe. But the turbulence in the European Exchange Rate Mechanism in 1992 and 1993—which led the United Kingdom to leave the system and made it necessary to widen the exchange rate band of this system of fixed but adjustable exchange rates—served as a powerful reminder that progressive monetary integration needs to build on strong convergence of national economic policies and performance. I still believe that monetary union in Europe must be underpinned, in the long run, by some form of political union—where the members are prepared to act together on a wider range of policies. The process of integration in Europe obviously has not yet ended, and its final outcome is still to be determined. In this context, the recent European summit in Nice was another step forward. But it also highlighted the need to clarify further the nature of European integration.

I am not here to suggest that the European experience is a model that Asia can and should copy. Regional developments in Asia should be driven by its own political dynamics and unique historical background. But trading patterns and geography do make it reasonable to think of the creation of an internal market in Asia as a possible future stage in regional cooperation. And why should this not be a basis for greater monetary integration if that is what the people of Asia desire? ■

Photo credits: Toshifumi Kitamura for AFP, page 21; Eriko Suita for Reuters, page 24; Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 25–29, 33, and 36.

AEA takes hard look at forecasting's reliability

(Continued from front page) new development, and investors have no easy way of forming beliefs—say, by using a long history of performance of similar companies. This is a problem not just in valuing Yahoo, a new company, but also in valuing established retail businesses like Wal-Mart. Now, he said, even companies at the "mundane end of a mundane business" have a much higher stock of intangibles than of physical capital.

The difficulties of forming beliefs about future earnings, combined with the phenomenal growth in earnings for companies such as eBay, lead to a situation where stock market valuations are high but volatile.

New economy, old risks? A panel on "Charting Our Course in the New Economy," perhaps unavoidably, had one eye on the recent past and one eye on the possible implications of a hard landing. Robert Gordon of Northwestern University served as the panel's hard-nosed skeptic, dismissing talk of a new economy as the unhappy product of circular arguments and prodigious hype. The Phillips Curve is alive and well, he said, and the "good things in the 1980s" played a key role in holding down inflation in the 1990s.

The remainder of the panel, however, were true believers. According to Martin Baily of the U.S. Council of Economic Advisers, the economy's sharply improved performance was linked to developments in information technology, and recent data give indications that accelerated labor productivity is now a fact in the services as well as in the manufacturing sector.

William Nordhaus of Yale University, underscoring the importance of information technology, cited the unprecedented speed with which computer products have evolved and pointed to an eye-opening 50 percent annual increase in the speed of electronic communication. The cost of obtaining knowledge has tumbled and the rate of diffusion has jumped, he said, but there is no evidence yet that the speed with which new knowledge is developed has been affected.

Paul Krugman of the Massachusetts Institute of Technology (MIT), a self-professed "big skeptic" early on, rued having ignored the groundswell of support among business for a "new economy" explanation. He said he had a very hard time buying a supply-side explanation that favorable shocks alone fueled the strong performance of the U.S. economy in the late 1990s. But what, he wondered, should he make of the current pessimism? Is America 2001 really Japan 1990? He doubted it, noting that much of the recent pessimism is emanating from financial rather than business circles.

The United States might not be Japan, but Gordon, alone among the panelists, was downright worried that a vicious cycle may supplant the current virtuous one. The U.S. economy, he said, is in trouble for old economy reasons—among them, rising energy prices ("you ain't seen anything yet"), the dollar hanging by a thread, and increases in medical insurance premiums.

Gazing into the crystal ball

Recession or a soft landing? That is one question facing the U.S. economy and its policymakers. A number of panels looked at forecasting tools and what esteemed economists have to say about times like these.

Forecasting the economy and the stock market. While academic debate continues on the broader questions about the economy, corporations and policymakers face the immediate task of forecasting the extent of the apparent economic slowdown and judging whether declines in the stock market presage a more calamitous fall. The reliability of forecasts of GDP growth and corporate earnings was the subject of a panel chaired by Clive Granger of the University of California, San Diego. Prakash Loungani of the IMF suggested that, if past experience is any guide, forecasters are good at recognizing that slowdowns are in progress but underestimate their severity. The record of forecasting recessions, in fact, is one of virtually unblemished failure.

Why are recessions not predicted? One reason may be that forecasters prefer to cluster around a common prediction rather than issue an "outlier" forecast. Granger presented evidence that forecasters tend to conform to the mean ("consensus") forecasts; in particular, an individual's growth forecasts are strongly influenced by the consensus forecast of the previous month. This "imitation" behavior can sometimes lead the consensus toward convergence at a forecast value far from the target (actual) value.

Dan Bernhardt of the University of Illinois and Edward Kutsoati of Tufts University noted that forecasts of corporate earnings are less subject to clustering. Participants at the session suggested earnings forecasts, and forecasts of financial variables more generally, translate into decisions on whether to buy or sell particular stocks. Hence, the reputation and the compensation of forecasters are more directly related to the outcome of their recommendations. In the case of economic growth forecasts, where the link is more tenuous between forecasts and decisions based on those forecasts, there is less incentive to differentiate their product, and forecasters may instead attempt to free ride off the opinions of others, thus producing the clustering Granger described.

Oil prices and the economic outlook. Gyrations in oil prices over the past two years have complicated the task of assessing the economic outlook. At a session organized by the International Association of Energy Economists, Loungani and Mine Yucel of the U.S. Federal Reserve Bank of Dallas noted the impact of oil on the macroeconomy—unemployment, in particular—has dampened in recent years. In other words,

Robert Hall

Martin Baily

Paul Krugman

Prakash Loungani

Rudiger Dornbusch

Robert Mundell

"oil shocks" do not appear to cause the economic disruptions they once did. Participants at the session, including the IMF's Allan Brunner, speculated on whether this was due to structural changes in the energy markets and in the economy's dependence on oil, changes in the way the U.S. Federal Reserve responds to oil shocks, or differences in the characteristics of oil shocks. Loungani suggested that recent oil shocks did not have the same impact on the macroeconomy as earlier ones, because they were not associated with the potential threat of major disruptions to oil supplies.

Is it all in Mundell? Would U.S. policymakers responding to a slowing economy and falling stock prices benefit from rereading their Robert Mundell? Participants at a luncheon honoring the 1999 Nobel Prize winner seemed to think so. MIT's Rudiger Dornbusch said that Mundell solved the "policy mix problem" by showing that fiscal policy should shore up the supply side of the economy and boost growth, while monetary policy took on containing inflation. This solution was very much against the conventional wisdom when Mundell proposed it. The IMF's Economic Counsellor, Michael Mussa, referring to Mundell as an "intellectual agent provocateur," noted that U.S. policymakers at the moment are grappling with the policy mix problem Mundell tackled many decades ago.

Exchange rate regimes: anything goes?

Over the past three decades, countries have experimented with a wide variety of exchange rate regimes. What have we learned about the choice of exchange rate regimes from this rich experience?

Avoid the middle? Delivering the Distinguished Lecture on Economics in Government, IMF First Deputy Managing Director Stanley Fischer noted that countries have started to avoid soft pegs (regimes intermediate between fixed and floating) in favor of either hard pegs or floating regimes. The middle has hollowed out, he said, not because of prodding from the IMF or the U.S. Treasury, as some have suggested, but because soft pegs have proved unsustainable. Each of the major international capital market–related crises since 1994 has in some way involved a fixed or pegged exchange rate regime.

Which corner should countries go to? The decision, Fischer emphasized, has to be made on a case-by-case basis. Hard pegs, he noted, make more sense for countries with a long history of monetary instability or those closely integrated with another economy or a group of other economies. Hard pegs can also be used to disinflate from high levels of inflation, but it is critical to have a strategy in place to exit from the peg during the process of disinflation.

For countries moving toward greater exchange rate flexibility, the inflation targeting framework has much

AEA panel addresses reform issues facing Bretton Woods institutions

Stanley Fischer

More than a year after publication of the "Meltzer Report" (the findings of the U.S. Congress–authorized Financial Institutions Advisory Commission), Allan Meltzer of Carnegie Mellon University asked coauthors of the report, prominent critics, and IMF First Deputy Managing Director Stanley Fischer to discuss reforming the Bretton Woods institutions. Much of the debate centered on the IMF.

Meltzer, who chaired the AEA panel, complimented the IMF on recent steps to reduce the number of lending facilities, improve precautionary lending arrangements, and increase transparency. But he reiterated his concern that in its response to crises in the 1990s, the IMF had moved well beyond its original mandate and had become a lender of first resort, and in effect was now bailing out everyone. The IMF, he said, must allow profligate countries to fail, and lenders must bear their losses. He regretted that the IMF had not accepted the full logic of the Meltzer Report and cited its recent efforts in Turkey and Argentina as evidence that the IMF had not taken the report's criticisms to heart.

Charles Calomiris of Columbia University suggested that the discussions of reforming the IMF really consist of two debates: a narrow one preoccupied with means and objectives and a broader and more important one to determine whether the IMF and the World Bank should serve as tools of U.S. and Group of Seven foreign policy. He argued that the constraints the Meltzer Report recommended—namely, respect for sovereignty, distinct tasks for these organizations, credible boundaries on goals, effective external evaluation, transparent accounting, and fair burden-sharing across countries—would thwart the use of these organizations as ad hoc foreign policy tools and have met fierce resistance from the U.S. Treasury and the Group of Seven. Failure to restrict lending to economic goals, he cautioned, damages the credibility of these institutions and subverts U.S. congressional oversight. Specific problems in need of reform, Calomiris said, are, among other things, the institution's poor track record on conditionality; the "weeks and months" it takes to negotiate programs with countries facing liquidity crises; the huge bailout costs that are, he said, funded by citizens and represent a transfer to cronies; and operations that in his view still resist accountability and transparency, notably an obfuscatory accounting system. Joseph Stiglitz, a former Chief Economist of the World Bank who is now at Stanford University, argued that the IMF and the World Bank are indeed political institutions and suggested the Meltzer Report did not go far enough in addressing governance issues at these organizations. He also questioned what he termed the antidemocratic nature of apportioning voting rights according to GDP.

Fischer pointed to areas in which he was in agreement with the Meltzer Report—notably the basic goals of the IMF and the need for precautionary lending—but emphasized that there were also serious areas of disagreement. In particular, he argued that the relationship between politics and decision-making in the international financial institutions was more complicated than Calomiris allowed. Fischer noted that the

to commend it, according to Fischer. In that framework, exchange rate movements are taken into account to the extent that they are expected to affect future inflation. An alternative framework for greater exchange rate flexibility is the use of wide and adjustable bands within which the exchange rate is allowed to float. An example of this is the "BBC" (band, basket, and crawl) arrangement recommended by John Williamson of the Institute for International Economics. Fischer argued, however, that "it is not at all clear" why such a system is preferable to an inflation targeting framework.

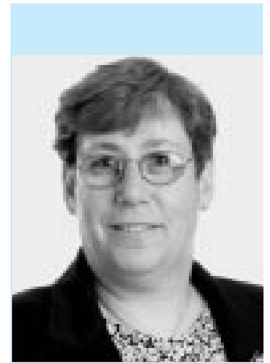
Mundell on exchange rate regimes. The topic of exchange rate regimes was also center stage at the luncheon to honor Robert Mundell. Andrew Rose of the University of California, Berkeley, puzzled over why Mundell had been in favor of the euro, since the euro area did not satisfy many of Mundell's own criteria for establishing an optimum currency area. Rose reckoned that the euro area had Mundell's support for two reasons. The first was that the establishment of a common currency area can provide tremendous savings in transactions costs and an expansion of trade that make it worthwhile to bear the risks of entering into what may be an unsustainable currency area. And, second, the criteria for an optimum currency area are "endogenous." For instance, he said, the establishment of a currency area can further labor mobility—one of the criteria for a successful currency area.

Rudiger Dornbusch asked if Mundell's support of the gold standard as an exchange rate regime was serious or was intended simply to be provocative. Mundell replied that it was only through the contrivance of gold that the world had achieved monetary unity without political unity. Mundell recommended a move toward a single world currency area in the future; he said the optimum number of currencies for the world, like the optimum number of gods, "should be an odd number, preferably less than three."

Financial crises

The crisis-wracked 1990s continue to fuel interest in the nature of financial crises and to spur the search for effective "early warning systems" and appropriate policy responses.

Early warning systems. The development of systems that could alert policymakers of impending problems is now a cottage industry. For those wishing to enter the industry, the IMF's Hali Edison provided a user's guide to the literature. An assessment of leading early warning systems led her to conclude that while not foolproof, they offered a useful diagnostic tool for predicting crises. The U. S. Federal Reserve Board's Steven Kamin presented an early warning system geared to identifying the roles of



Hali Edison

Bretton Woods institutions took shape in response to the horrors of the Great Depression and World War II. These institutions, he said, "are based on the interactions of economics and politics. It is patently obvious that if the international economic system is incapable of delivering reasonable performance to the countries in it, then the political and economic system that we support and that is conducive to human freedom will not survive." He added that "we would live in a different world if we did not have an international economic system that provides the benefits of stability to countries that participate in it on the basis of rules set up by mutual consent."

Fischer stressed the accountability the IMF already has to its member countries through its Executive Board. Some decisions the IMF makes inevitably have a political element, and that is one of the key reasons an accountability of management and staff to member governments is so critical. That accountability, he said, is achieved via the Executive Board, representing all 183 member governments—and the IMF very rarely goes ahead without near unanimous support in the Board.

The IMF draws proportionate resources from its membership, and its voting rights reflect the financial stake of these countries in the institution. "That seems to me," he said, "a highly appropriate way for a financial institution to behave."

On conditionality, Fischer suggested, it would be more accurate to say that most of the time countries meet almost all of the conditions attached to IMF loans. The reviews built into IMF loans deal with a fact of life: circumstances change, and sometimes conditions have to be waived in the face of these changes. And as to the byzantine nature of the IMF's former accounting system, Fischer said he could not agree more. The Meltzer Report made an apt and useful criticism of the transparency of IMF financing. But that system has now been overhauled to the point when "even I can understand the accounts," he said. And crisis negotiations do not take weeks or months; in Korea and elsewhere, they were concluded in a matter of days.

Finally, Fischer challenged an assumption in both the Calomiris and the Meltzer presentations that the IMF bails out everyone. It's just not true, he said; many investors in emerging markets took very large losses. It is also naïve to think that there is an ideal solution in which all citizens are shielded from harm and the responsible parties assume the full cost of their mistakes. If a country defaults or a banking system collapses, Fischer explained, there are huge losses for everyone until these matters are righted. IMF lending cannot—and is not intended to—prevent all losses, but it can reduce the costs of adjustment in these countries. IMF lending in a crisis is meant to provide a safety net for citizens. In Korea, for example, funds were transferred to depositors, not bank owners.

Fischer also forcefully challenged the notion that allowing countries to fail would necessarily bring about sought-after reforms. Crises do not inevitably lead to reforms, he observed, and allowing a country to fail and face the consequences is not necessarily the best way to promote better economic policies. He said he was wary, in fact, of critics who find it "much too easy to bear the pain of others."

Caroline van Rijckeghem

Michael Mussa

Joseph Stiglitz

Jagdish Bhagwati

domestic and external factors in emerging market crises. Kamin found that while crises are largely a function of domestic factors, adverse external shocks do play a significant secondary role.

How crises spread. Contagion has many avenues, and a panel chaired by Beatrice Weder of the University of Basel examined four. Sergio Schmukler of the World Bank, presenting a paper coauthored with Graciela Kaminsky and Richard Lyons, looked at the increasing importance of mutual funds in emerging markets. Mutual fund investment, he said, is volatile across time and crises, with country fragility at the heart of withdrawals after crises (notably in Korea and Colombia).

To gauge the impact of trade links in the spread of crises, Kristin Forbes of MIT focused on three potential channels. She found a significant negative impact in terms of competitiveness and income effects, and a positive, but less significant, impact on bargaining effects. Caroline van Rijckeghem of the IMF, summarizing a study coauthored with Weder, asked whether a crisis is spread when banks respond to one problem by reducing exposure elsewhere. There was strong evidence of such a link after the Mexican and the Thai crises, she said, but little evidence of this after the Russian crisis.

And what of the moral hazard criticism that the prospect of an IMF bailout encourages unwise investment? Isabel Goedde of Mannheim University, presenting a study coauthored with Giovanni Dell-Ariccia and Jeromin Zettelmeyer of the IMF, examined investor behavior after Russia was not bailed out in August 1998. They found investors behaved more cautiously—significantly increasing spreads to most emerging markets, particularly those with weaker fundamentals. This finding suggests, Goedde said, that moral hazard was present prior to the Russia crisis, or that more selective crisis lending could increase the depth or likelihood of future crises in some countries, or that a mixture of both was true.

Policy responses. Financial crises and the fear of contagion have generated a variety of policy responses across countries. John Fernald of the U.S. Federal Reserve Bank of Chicago (in a paper coauthored with Loungani) asked if China's policy response during the Asian crisis of 1997–98 offered a blueprint for other countries to counter the contagion effects of future crises. Many expected China to succumb to the Asian crisis, Fernald explained, because of the potential adverse effect on its exports of the real depreciations of neighboring currencies and because its financial system shared many of the same weaknesses as the Asian crisis countries. But neither fear was realized. Competition between China and the Asian crisis economies turned out to be much less adversarial than anticipated. And China's financial sector was insulated from the pressures of adjustment, despite balance-sheet weaknesses, because of the government's support.

Globalization and its discontents?

Dominick Salvatore of Fordham University assembled a distinguished panel to weigh the implications of a process that is bringing about extraordinary changes and stirring extraordinary anxieties. Salvatore offered a look at what made the U.S. economy so competitive in recent years, citing openness to trade and investment, efficient capital markets, and a high level of excellence in management and in science and technology.

Michael Mussa weighed the benefits and risks of capital account openness. The same logic that argues for trade liberalization argues for open capital accounts, he said, although he acknowledged capital markets are more susceptible to distortions and sudden shifts in investor sentiment. The relevant question now, he said, is not whether to liberalize capital accounts, but how to do so prudently. Most countries want open capital accounts. Those that have lost access to capital markets seek to regain it. Those that do not have access are moving toward it. Its risks can be mitigated, he said, through responsible government management of debt (notably short-term and foreign-currency-denominated debt) and an effective regulatory environment.

Globalization can be done right, Joseph Stiglitz of Stanford University suggested, citing the example of East Asia. That region closed the knowledge gap, partook of investment, and emphasized trade, while opting not to eliminate trade barriers or pursue capital market liberalization. The "Washington Consensus" got it wrong, he said, charging that its adherents pushed capital account liberalization for Wall Street's benefit, encouraged full trade liberalization without appropriate safeguards, and supported policies that undermined social cohesion and benefited political elites.

Jagdish Bhagwati of Columbia University argued that globalization was a positive force that too often lacked a human face. As globalization proceeds, he said, institutions both domestic and international will need to be rethought. But countries and civil society will also need to rethink the means they use to redress wrongs. He worried that the future of the World Trade Organization could be imperiled by trade sanctions and social clauses.

If globalization can speed up growth in the leading economies and provide enormous opportunity for catch-up in the poor countries, why, asked Paul Romer of Stanford University, is there such hostility to it? In part, he said, it is because higher growth is often equated with greater damage to the earth. That is wrong, he argued, but economists must do a better job of explaining the benefits of growth and demystifying how markets work. He also urged economists to be mindful of the potential for collateral damage when they debate policy choices. He feared that broader goals could be undermined if the public misconstrues fractiousness over details as condemnation of globalization as a whole. ■

Aninat calls on China to continue to prepare domestic enterprises for global competition

Following are excerpts from a speech by Eduardo Aninat, IMF Deputy Managing Director, before the Foundation for Globalization Cooperation's Second Globalization Forum, held in Sanya City, Hainan Island, China, on January 14.

This is a critical point in China's remarkable development. In the coming months and years, China must make decisions that will determine how well it integrates further into the global system. There is no longer a question of *whether* to integrate, but only of *how.*

Globalization offers enormous benefits, in the form of higher productivity and living standards. But it also poses daunting challenges—navigating volatile capital markets and ensuring that the benefits of the globalized economy are shared by all. In the end, China, like all nations, must find its own way, true to its culture and institutions. The IMF, along with the rest of the UN family, can help by providing a safer environment to do so.

The bottom line is that countries have no choice but to integrate into the global economy. Not to do so risks marginalization at a time when there is already a huge and growing gap between rich and poor countries. Yet the process of opening up must be handled in a carefully sequenced, prudent manner, with existing structural weaknesses tackled and prudential regulations strengthened.

China: on the threshold

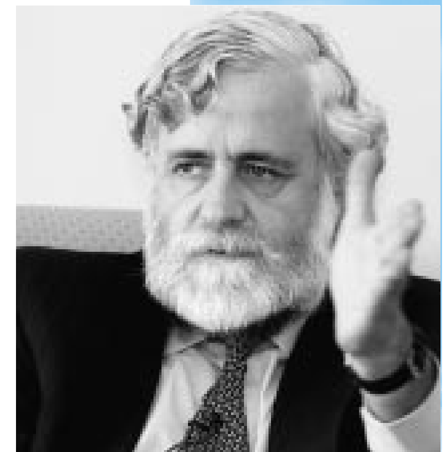
China recognizes that the benefits of integration into the global economy far outweigh the costs. Two decades of reform bear this out, with growth averaging around 9 percent since 1980—an extraordinary performance by any standard. In addition, it weathered the Asian crisis much better than most in the region, thanks to a timely easing of fiscal and monetary policies, a strong external position, a prudent approach to capital account liberalization, and financial reforms. The outlook for 2001 remains good, with growth expected to be around 7 percent.

But China is now at a critical juncture. It is ready to dramatically step up its integration into the global economy and become a major player on the international economic scene. This is evident in its decision to join the World Trade Organization [WTO] and in its actions to keep its currency a pillar of stability during the Asian financial crisis. Yet with this greater responsibility comes the urgent need to accelerate reforms; indeed, WTO accession could well prove to be a watershed for a new generation of reforms.

China's decision to further open up its economy should help to make domestic industry more efficient, spur the development of the legal and regulatory framework necessary for a market economy, and increase foreign direct investment. But it will also give rise to major short-term dislocations in the transition—possibly including higher unemployment and greater income disparities. It will certainly increase competitive pressures in a number of sectors (agriculture, automobiles, and certain capital-intensive producers, such as telecommunications), all of which should work in the right direction for the longer term.

For these reasons, it is essential that China continue to prepare its domestic enterprises and banking system for global competition. This will entail establishing a government social security system, strengthening the banking system, and further liberalizing interest rates. As the effects of increased competition feed through into efficiency and productivity gains, reversing the declines of recent years, the benefits will be seen in higher living standards for China's people.

Will China's economy benefit from WTO accession? We believe the answer is yes. China's exports are concentrated at the relatively low end of the value-added ladder, such as apparel, footwear, and household products, but it is moving up the ladder, with exports increasingly in the high-tech realm, and further liberalization can only serve to its benefit.



Aninat: "China is ready to dramatically step up its integration into the global economy and become a major player on the international economic scene."

There will necessarily be adverse short-term impacts in some sectors of China's economy, but these account for a small portion of output and trade. Imports will rise, but so, too, will exports as the effects of greater enterprise efficiency and quota elimination under the WTO Agreement on Textiles and Clothing are felt. In addition, from an early stage, China should attract higher foreign direct investment—especially in the services sector—leaving the balance of payments not greatly affected. It is the crucial gains to efficiency that hold the promise of sustained benefits for real incomes and living standards.

While a new generation of reforms will clearly be beneficial to China, there is also no question that industrial countries should practice what they preach and open up their own economies more decisively and extensively. They are the ones who will benefit the most from their own trade liberalization. They should liberalize particularly in areas where developing countries have a clear and demonstrated comparative

advantage (agriculture, processed foods, textiles and clothing, and light manufactures). A reduction in trade barriers by 50 percent globally would yield welfare gains of an estimated $400 billion annually for the global economy—with developing countries capturing one-third of these gains. That is why developing countries should push for a new global trade round. In the meantime, the IMF supports calls for the poorest countries to have duty- and quota-free access to industrial country markets. It also supports giving developing countries credit, in future global trade rounds, for the unilateral steps they take.

IMF: spreading the benefits

Of course, China's economic outlook will also be shaped by global developments. The strong global expansion of the past two years is losing steam. A slowdown has been expected, of course, but world growth this year now seems likely to be significantly lower than was projected in the last *World Economic Outlook*. However, the timely cut in interest rates by the Federal Reserve will help ensure that the current slowdown in the United States takes the form of a "soft landing," particularly as there is further room for maneuver on both the monetary and fiscal policy fronts. Europe and Japan can also help by stepping up reform efforts—Europe in the labor and pension areas, and Japan in the corporate and financial sectors.

Asia has undergone a remarkable recovery in the past two years, but political and economic uncertainties within the region, as well as the slowdown in the rest of the world, are lowering confidence and future growth prospects. This underlines the need to maintain supporting sound macroeconomic policies and to accelerate reforms.

But short-term prospects aside, China and the rest of the world also need a stable environment in which to prosper. What can the IMF do to help bring this about?

First, the IMF should promote lasting, noninflationary growth for all. The emphasis is on growth that is accompanied by adequate human capital investment—especially in education and health. Growth is our best hope for poverty reduction—the world's single, greatest development challenge. Growth is also a vital source of financing for targeted social outlays.

Second, the IMF should be the center of competence for the stability of the international financial system. We are strengthening our work on capital markets and banking systems; undertaking initiatives to improve other institutions, markets, and practices that governments, businesses, and individuals use when they carry out economic and financial activities; and rethinking the way we monitor national economies and the global monetary system.

One particularly promising initiative under way, jointly with the World Bank, involves thorough health checks of a country's financial sector. After a successful pilot project for 12 countries, the Financial Sector Assessment Program (FSAP) has recently been expanded to cover 24–30 countries a year.

Third, the IMF should work closely with the other international institutions set up to protect global public goods. Each institution needs to concentrate better on its areas of responsibility and expertise to be more efficient and accountable. For the IMF, this means a more intensive focus on providing advice on monetary, budget, and exchange rate policies, along with financial sector issues, and overseeing the functioning of the international monetary system.

Since 1989, the IMF has provided technical assistance to support China's reform efforts, covering public

The IMF supports calls for the poorest countries to have duty- and quota-free access to industrial country markets.
—Eduardo Aninat

Available on the web (www.imf.org)

Press Releases

01/02: IMF Approves in Principle Second Annual PRGF for the Central African Republic, January 10

News Briefs

01/02: IMF Completes First Review of Benin Program and Approves $5 Million Credit, January 8

01/03: IMF Completes Second Review of Burkina Faso Program and Approves $7 Million Loan, January 10

01/04: IMF Completes First Lithuania Review, January 10

01/05: IMF Managing Director Horst Köhler Opens Hong Kong Suboffice, January 11

Public Information Notices (PINs)

01/01: IMF Concludes Article IV Consultation with Haiti, January 5

Letters of Intent and Memorandums of Economic and Financial Policies (date posted)

Malawi, January 3

Bosnia and Herzegovina, January 8

Central African Republic, January 10

Lithuania, January 12

Speeches

Remarks by IMF First Deputy Managing Director Stanley Fischer, "Remembering Herb Stein: His Contributions as an Economist" American Economic Association, New Orleans, January 6

Remarks by IMF First Deputy Managing Director Stanley Fischer, "Exchange Rate Regimes: Is the Bipolar View Correct?," American Economic Association, New Orleans, January 6 (see page 26)

Remarks by IMF Managing Director Horst Köhler, Opening of the IMF's Hong Kong SAR Resident Representative Office, Hong Kong, January 11

Reports on the Observance of Standards and Codes (date posted)

Sweden, January 8

Azerbaijan, January 9

expenditure management, tax administration and policy, monetary policy, the exchange system, and statistics.

Fourth, the IMF should be an open and learning institution, continuously adapting to the evolving needs of the membership in order to perform better. It means not only being open to proposals from our 183 member governments, but also increasingly reaching out to groups ranging from nongovernmental organizations and civil society generally to the private financial sector.

In closing, I would like to point to the IMF Executive Board's recent proposal to increase China's quota at the IMF, following its resumption of the exercise of sovereignty over Hong Kong, effectively enhancing China's voting power and access to credit. When this increase comes into effect, China's quota will be the eighth largest. This is further recognition by the international community of China's growing role as a major player in the world economy. ■

Stand-By, EFF, and PRGF arrangements as of December 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-by arrangements				
Argentina[1]	March 10, 2000	March 9, 2003	10,585.50	8,997.67
Bosnia and Herzegovina	May 29, 1998	May 29, 2001	94.42	13.99
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	113.38
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Nigeria	August 4, 2000	August 3, 2001	788.94	788.94
Pakistan	November 29, 2000	September 30, 2001	465.00	315.00
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	56.66
Romania	August 5, 1999	February 28, 2001	400.00	260.25
Turkey[1]	December 22, 1999	December 21, 2002	8,676.00	5,832.20
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			**32,172.69**	**19,346.28**
EFF arrangements				
Bulgaria	September 25, 1998	September 24, 2001	627.62	104.62
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
FYR Macedonia	November 29, 2000	November 28, 2003	24.12	22.97
Indonesia	February 4, 2000	December 31, 2002	3,638.00	2,786.85
Jordan	April 15, 1999	April 14, 2002	127.88	91.34
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	September 3, 2001	1,919.95	1,017.73
Yemen	October 29, 1997	March 1, 2001	105.90	65.90
Total			**9,112.57**	**6,758.51**
PRGF arrangements				
Albania	May 13, 1998	July 31, 2001	45.04	9.41
Benin	July 17, 2000	July 16, 2003	27.00	20.20
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	27.94
Cambodia	October 22, 1999	October 21, 2002	58.50	41.79
Cameroon	December 21, 2000	December 20, 2003	111.42	95.50
Central African Republic	July 20, 1998	July 19, 2001	49.44	32.96
Chad	January 7, 2000	January 7, 2003	36.40	26.00
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	13.63
FYR Macedonia	November 29, 2000	November 28, 2003	10.34	8.61
Gambia, The	June 29, 1998	June 28, 2001	20.61	6.87
Ghana	May 3, 1999	May 2, 2002	191.90	120.85
Guinea	January 13, 1997	January 12, 2001	70.80	15.73
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Guyana	July 15, 1998	July 14, 2001	53.76	28.88
Honduras	March 26, 1999	March 25, 2002	156.75	64.60
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	28.69
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2002	46.65	33.15
Mauritania	July 21, 1999	July 20, 2002	42.49	30.35
Moldova	December 15, 2000	December 14, 2003	110.88	101.64
Mozambique	June 28, 1999	June 27, 2002	87.20	33.60
Nicaragua	March 18, 1998	March 17, 2001	148.96	33.64
Niger	December 14, 2000	December 21, 2003	59.20	50.74
Rwanda	June 24, 1998	June 23, 2001	71.40	19.04
São Tomé and Príncipe	April 28, 2000	April 28, 2003	6.66	4.76
Senegal	April 20, 1998	April 19, 2001	107.01	42.80
Tajikistan	June 24, 1998	December 24, 2001	100.30	34.02
Tanzania	March 31, 2000	March 30, 2003	135.00	95.00
Uganda	November 10, 1997	March 31, 2001	100.43	8.93
Zambia	March 25, 1999	March 28, 2003	254.45	224.45
Total			**2,870.28**	**1,676.05**
Grand total			**44,155.54**	**27,780.84**

[1]Includes amounts under Supplemental Reserve Facility
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Members drawing on the IMF "purchase" other members' currencies, or SDRs, with an equivalent amount of their own currency.

IMF Institute seminar

Drazen analyzes reasons for popular resistance to reform and role of crises in policy change

Economic policy reform has long been a prominent subject of analysis. The analysis has focused mostly on the design of reforms, implicitly assuming that once the optimal course of action is known, implementation is a simple technical matter. Allan Drazen, professor of economics at Tel Aviv University and the University of Maryland, challenged this conventional view at a seminar held at the IMF Institute on December 12, 2000. His presentation, "Political Economy of Reform and Crisis," drew on material from his recent book, *Political Economy in Macroeconomics*.

Beneficial reforms are often not adopted or are adopted after a considerable delay, even when there is agreement on what needs to be done, Drazen observed. For example, it has been long understood that hyperinflation is usually a budgetary problem, that arises when the government monetizes the budget deficit (that is, the government finances the deficit by expanding the money supply). To combat hyperinflation, the government must therefore reduce the deficit, but it often puts off implementing this simple and effective strategy until the difficulty develops into a full-blown crisis. Drazen argued that to understand why governments respond this way, we need to incorporate political aspects of the reform process into our analysis.

People delay necessary reforms much as a patient with a toothache delays a necessary visit to the dentist.
—Allan Drazen

Drazen defined reforms as socially beneficial changes—that is, changes that benefit most or all of the population. Such reforms can be divided into two types. The benefits from "stage-one" reforms (for example, macroeconomic stabilization) are widely distributed. In contrast, "stage-two" reforms (for example, labor market restructuring) clearly harm some groups. Stage-one reforms are usually implemented first—hence the name—because opposition to them is weaker. In the course of the seminar, Drazen concentrated on the difficulties of implementing stage-one reforms because, given the beneficial effect of such reforms, those difficulties are the most puzzling.

Conventional approach to reforms

To demonstrate the inadequacy of viewing the implementation of reforms as a technical matter and to motivate his analysis, Drazen first reviewed conventional economic models of the reform process. One class of such models argues that reforms may be delayed until circumstances are more favorable and society can withstand the shock of reforms more easily. For example, it is easier to cut the budget deficit (reduce spending and raise taxes) in good times than it is during recessions. If this were true, the reforms would primarily be implemented during periods of economic expansion. A casual observation suggests that this is not the case. In fact, reforms are often introduced in bad, even critical, times.

Another explanation is that people are irrational, in the sense that they delay necessary reforms much as a patient with a toothache delays a necessary visit to the dentist, Drazen said. Irrationality, however, seems a flimsy basis for an economic model. Alternatively, the individuals may be rational, yet society as a whole may not be. This, of course, invites the question of what makes people who are individually rational behave irrationally as a group. This discussion suggests that to fully understand the difficulties of implementing beneficial reforms, one must turn to models that incorporate political as well as economic considerations—that is, models of political economy.

A canonical political economy approach, Drazen noted, holds that reforms are not carried out because the politically influential groups who stand to lose block their implementation. Economist Mancur Olson, in his seminal 1982 book, *The Rise and Fall of Nations*, has shown that the emergence of such groups is likely to be a common outcome because the dynamic reform processes create vested interests that oppose further reform. This insight, however, fails to explain why countries do not adopt stage-one reforms, whose benefits are widely distributed.

New political economy models of reforms

Drazen devoted the rest of the seminar to a discussion of three classes of new political economy models that deal with reforms. The first class of such models views the adoption of reforms as a public good. Although adoption is costly, once reforms are adopted everyone in society benefits, including those who did not bear the costs of reforms. Therefore, reforms may never be adopted, or may be adopted only after a delay, because of disagreement over who shoulders the costs. Drazen used a simple static model to demonstrate that individuals would be unwilling to bear the costs of reform if they believed that someone else would be likely to bear those costs. As a result, reforms are not adopted even if, for each individual, the benefits of reforms outweigh their costs.

Drazen illustrated this logic with an example of a cold room. To warm up the room, someone needs to adjust the thermostat. Suppose there is just one person in the room. If, for that person, the benefits of a warmer temperature outweigh the costs of getting up and adjusting the thermostat, he or she will adjust the thermostat. Now suppose there are 40 people in the cold room, and for all of them the benefits of a warmer

temperature outweigh the costs of getting up. If, however, everyone believes that someone else will get up and adjust the thermostat, then nobody will get up and the room will stay cold.

The static public good approach explains why reforms are not adopted but does not explain delays in adoption. What makes individuals or groups who were initially unwilling to share the burden of adoption eventually give in? To explain this phenomenon, Drazen introduced two new elements into the model: deterioration of economic conditions over time and uncertainty about the strength of one's opponents. A group may initially be unwilling to assume the burden of reforms because the economic situation is still tolerable and because it believes that its opponents will assume the burden. As time passes and conditions deteriorate, it becomes clear that the opposing groups are politically and economically strong enough to hold out. Then, after a delay, the weaker group will find it beneficial to assume the burden of reforms. To use the cold room analogy again, as the temperature drops, the person most sensitive to cold will eventually give in and adjust the thermostat.

Delays, Drazen observed, can also be explained by individuals' desire to postpone the pain of reforms. The weaker group may know that eventually it will have to bear the burden. Yet, in an attempt to preserve its current standards of living, it may choose to incur the costs later rather than sooner.

In the second class of models Drazen described, uncertainty about the benefits of reforms is the crucial factor leading to nonadoption or delay of reforms. Because, as a rule, people do not like risk, they may be unwilling to adopt reforms that, while increasing average welfare, lead to widely dispersed individual outcomes. Moreover, a majority may reject even those reforms that are known to benefit the majority of the population. This can happen if different segments of a population have different prospects in the new, reformed economy.

To illustrate his point, Drazen gave an example of an economy comprising two sectors and 100 people. In general, no single person knows how she or he will fare after reforms are adopted, but everyone knows the odds of personal success or failure in his or her own sector. The first sector consists of 49 people, all of whom are expected to benefit from the reforms. Accordingly, all 49 will vote in support of them. The second sector consists of 51 people, of whom 25 will benefit and 26 will lose. On average, therefore, the people of the second sector will lose, so all 51 will vote against the reforms. The reforms will then be defeated by a 49–51 vote, even though the beneficiaries of reforms will outnumber the losers by 74 to 26.

In the third class of models, Drazen noted, the inability of policymakers to communicate the benefits of reforms to the general public is the explanation for countries' nonadoption or delay of reforms. Policymakers may know that reforms are good for the economy, but the public may instead believe that the reforms will benefit only the policymakers' narrow political base. This insight sheds light on why right-wing policies are often undertaken by left-wing policymakers and vice versa. When, for example, a left-wing policymaker pushes for right-wing economic reforms, the public is more inclined to believe that the reforms will indeed benefit society as a whole rather than serve narrow political interests.

Drazin: "Crisis may actually be necessary for major reforms to be implemented."

Applications

Concluding the seminar, Drazen focused on two applications of the theory: the role of crises and the transition from socialism. A crisis often appears to induce policy change. While conventional economic models cannot explain why, new political economy models can. Rapidly deteriorating conditions make the bargaining parties more amenable to a compromise. The swift deterioration also makes people more willing to accept the uncertainty associated with reforms: even though the postreform environment is unknown, the present decline is no longer an attractive alternative. Thus, crisis may actually be necessary for major reforms to be implemented.

According to Drazen, the challenge of transition stems from the combination of economic and political constraints to reforms. Political reality may render nonviable the speed and sequence of reforms that are optimal from the economic standpoint. The duress accompanying the transition process in many countries can be traced to policymakers' desire to avoid political obstacles to the adoption of reforms. Often, the politically feasible path of reforms turns out to be suboptimal from an economic standpoint, leading to disruption of economic activity and hardship. ■

Dmitriy Gershenson
IMF Institute

Members' use of IMF credit
(million SDRs)

	During December 2000	January–December 2000	January–December 1999
General Resources Account	4,089.63	7,178.02	10,010.09
Stand-By Arrangements	3,782.63	5,794.31	7,480.40
SRF	1,735.20	1,735.20	3,636.09
EFF	190.07	1,266.79	1,849.30
CFF	0.00	0.00	680.40
EMER	116.93	116.93	0.00
PRGF	99.35	492.50	736.78
Total IMF credit	**4,188.98**	**7,670.52**	**10,746.87**

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

Data: IMF Treasurer's Department

When markets fail

Tirole discusses why banking regulation is needed and why IMF's role should be well defined

In November 2000, Jean Tirole, visiting professor of economics at the Massachusetts Institute of Technology, Scientific Director of IDEI in Toulouse, and author of several important economic studies, gave a course on banking regulation to participants in the IMF Institute in-house training program. Tirole spoke with the IMF Survey *about the material covered in his course and related issues.*

IMF Survey: What is the rationale for regulating banks? Has this rationale changed over time?

Tirole: Thirty or forty years ago, the banking industry was highly regulated, and banking activity was less risky than it is now, operating mostly at the national level and prevented, by various regulations, from competing against each other. But with more financial markets, derivative instruments, greater openness and deregulation, and exposure in capital markets, banking activity became more risky. In response, the Basle Committee instituted new banking regulations, including minimum standards, both for credit risk and risk management in 1996, and is proposing further reforms.

Why do we need a banking regulator? To make a case for regulation, you first have to ask, where is the market failure? That is true for banking regulation and it is also true for international regulation.

Once you have identified the market failure, you can start thinking about the mission that you give to the regulator, which is basically to correct this market failure. My approach as a theorist is to go back to the underlying market failure to better analyze the kind of mission you give to the regulator.

Most bank debt is held by small creditors—you and me. In the view of many bankers and central bankers, regulation is motivated, in particular, by the need to protect these small depositors who are, by and large, unsophisticated and unable to understand the intricacies of the balance-sheet and off-balance-sheet activities of their banks. Furthermore, we are all free riders, because we don't monitor our banks.

Therefore, there is a *potential* market failure, in that a public good—monitoring the bank—has to be supplied. Because individual depositors don't have an incentive to monitor the bank, someone has to do that for them. The banking regulator thus represents the depositors. These monitoring activities can be ex ante—seeing to it that the bank meets capital adequacy requirements to ensure that there's enough equity within the bank to protect the depositors, and making sure that the bank is doing the right thing in terms of risk management. They can also be ex post—in case of a crisis—intervening by closing or restructuring the bank.

To make a case for regulation, you first have to ask, where is the market failure?
—Jean Tirole

Private or market solutions have been considered as alternatives to a banking regulator who acts for the depositor, but these solutions have some drawbacks. Self-regulation by the industry, for example, raises competitive issues. Incumbents have an incentive to control entrance to the club and may basically collude to keep everyone else out. Another issue is systemic risk. With insured deposits, if one bank fails, the shortfall will be covered by the other banks. But what if there is a systemic shock?

Another possibility is private rather than public deposit insurance. But that also has drawbacks. If a bank starts to have problems, insurers may not want to insure anymore or may raise the deposit insurance premium. But if the troubled bank has little cash, it also has the incentive to gamble for resurrection. So that's no good. And who is going to check that the insurer is capitalized? If I am a depositor and my bank fails, I don't want to discover, once my bank fails, that the insurer of the bank is also broke. Someone has to monitor the capital adequacy of the insurer as well.

IMF Survey: Government deposit insurance is said to pose a moral hazard risk. Is there nevertheless a valid reason for retaining it?

Tirole: It's very hard to get rid of retail deposit insurance, even though it may create some moral hazard. We, as depositors, are not going to monitor our banks even if we are not insured. We could use ratings, but I don't want to have to rely on a possibly imperfect rating that may send me running off to the bank fearful that I might lose everything. We have no expertise, and it would be very wasteful to spend all our days and nights monitoring the banks—directly or indirectly. Also, deposit insurance can head off bank runs that could lead to a major recession or worse. By supplying liquidity through nonindexed deposit insurance, the government can help the economy in a recession because the banks can still borrow.

So, I don't think we should get rid of deposit insurance. But we do need a strong regulator who will intervene by limiting asset growth and enforcing capital adequacy requirements when the bank is in trouble.

IMF Survey: What about the too-big-to-fail argument?

Tirole: The too-big-to-fail issue is related to the existence of mutual exposures. For example, in the case of a bank like Continental Illinois in 1984, which held large deposits of hundreds of other banks, closing the big bank would have meant lots of spillovers to other banks. In contrast, when Barings went broke, it had a low systemic impact on the rest of the banking indus-

try, so the reaction was "too bad for you." The way to limit too-big-to-fail is to monitor a big bank very carefully for potential trouble and for interbank exposures.

***IMF Survey:* Much attention is given to finding ways to prevent or limit financial crises. What is the role of international financial institutions like the IMF?**

Tirole: Recommendations have been made—from many of the best minds in economics and policymaking. What worries me is the number of different goals proposed for the IMF. For instance, the IMF should help avoid financial crises, help resolve them, not be too intrusive, protect foreign investors, respect countries' sovereignty, limit output volatility, prevent contagion, facilitate a country's access to funds, promote long-term growth, insist on structural reforms, and so on. And that isn't counting the traditional IMF objectives centered on the current account, international reserves, and inflation. That is just too many goals.

One thing we have learned from incentive theory is that an agency should have a focused mission. Recent work in political science also suggests that an agency should not try to do everything. It should have a mission and build a reputation for fulfilling this mission and avoid the problem of conflicting missions. Another lesson from incentive theory is that it is not always bad to have a biased mission. The mission of the banking regulator—protecting the depositor—is almost by definition biased. In my view, the IMF and other international financial institutions should not try to solve every problem in the world.

There are, of course, other goals that I think we should be treating more seriously and spending more money on—AIDS, poverty, and the environment. But these are not necessarily the IMF's most natural missions. To refocus the IMF's mission, these goals have to be taken up somewhere else, ideally by institutions that could devote their total resources to them.

***IMF Survey:* If the IMF should focus on one mission, what should it be?**

Tirole: Again, start from fundamentals. If markets worked perfectly well, we wouldn't need these international financial institutions. So look at market failure. In corporate finance and banking, you have someone who wants to borrow. In the case of a country, the borrowers want access to international markets. We also know from corporate finance that the lenders will always be worried about whether they will get their money back. Corporate covenants make it more likely that the investors will get their money back. So it is actually good for the borrower to have these constraints. There are two types of covenants: ex ante conditions, which encourage good behavior on the part of the borrower, and ex post conditions, which allow for intervention in case of financial distress.

There are a lot of analogies between corporate finance, banking, and country financial crises. In every case, you have a borrower who needs money and lenders who want to make sure they get their money back. So, why do we need international financial institutions to supervise, monitor, or help resolve international financial crises? Where is the market failure?

One answer lies in what I call the dual-agency perspective. When foreign lenders or investors lend to a private borrower in a country—a firm or a bank—the investors' return depends on the behavior of the borrower, of course; but it also depends on the behavior of the borrower's government. For example, the government has the ability to affect the value of the domestic currency. In particular, if foreigners have claims that are denominated in domestic currency, then there is a possibility that those claims will be devalued by the government's misbehavior. Governments can misbehave by reducing international reserves, encouraging the production of nontradables (like real estate), failing to promote investments that favor exports (like infrastructure), running fiscal deficits, and so on.

I am not saying that the government wants to devalue the claims of foreigners or does so willingly. The situation is similar to one in which you have fire insurance. You don't set fire to your house, but at the margin you pay less attention and take fewer precautions. It's the same with loan contracts. The government—everything else being equal—would like to repay the foreigners, but when there is a political cost to reducing the probability of nonrepayment, the government may not take the precautions, particularly since foreigners do not vote and have limited political leverage. Of course, a country would like to maintain its reputation in the international markets, but that may not be sufficient incentive to maintain the value of the domestic currency.

In foreign investment, there are two agents, the borrower and the borrower's government. But when foreign investors lend, they contract for corporate covenants only with the borrower itself. So there's a

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
January 8	4.42	4.42	5.12
January 15	4.54	4.54	5.26

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

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

Data: IMF Treasurer's Department

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—Jean Tirole

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missing contract. Somebody has to fill out this contract so the lenders are fully represented. It may be the IMF; it may be another agency. But somebody has to protect the lenders in terms of writing covenants.

Many of these points apply to sovereign debt crises as well. When most of the country's debt is sovereign, the dual-agency problem gives way to a "common agency" problem in which each lender worries about total borrowing. Sovereign borrowers try to commit to limit their borrowing, but contractual commitments go only so far and there is still scope for an investor trustee.

Tirole: The IMF's commitment to impose ex post conditionality may well help the country gain access to international capital.

IMF SURVEY: How does ex ante and ex post conditionality apply to domestic corporate borrowing and to international lending?

Tirole: Ex ante conditionality is like a prequalification. For a bank, there will be conditions having to do with proper risk management, line of business restrictions, and, most important, capital adequacy requirements.

A set of ex post measures comes into play if the bank starts getting into trouble. These measures provide for the banking regulator to intervene in the bank to further reduce the risk of nonrepayment. These conditions serve two purposes: they act as a disciplining device, first by discouraging a bank from getting into trouble and then by taking away the incentive or ability for a bank to gamble on resurrection by taking a lot of risks when it is in trouble. Ex post conditions put some control rights into the hands of the regulator. It is the same in corporate finance; when a firm wants to borrow—either from the bank or from bondholders—it will sign off on a set of covenants and then it will also transfer control rights to those debt holders in case of poor performance—for example, nonrepayment of short-term debt. It's a general theme: any time you have someone who borrows—be it a startup, a bank, or a country—the borrower first offers some guarantees and then, ex post, in case of distress or poor performance, offers further guarantees and transfers further control rights to the investors.

IMF SURVEY: Take this to the level of the IMF and a borrowing country. How do you square country ownership with IMF conditionality?

Tirole: There are two issues here. One is that countries would like to commit not to misbehave and not to get into trouble. But even if they behave well, they may still get into trouble. That is the time when you (the lender) want to secure further guarantees that investors will be repaid. These ex post conditions are not what the country wanted at the time the original loan was contracted, but from an ex ante perspective, they are a good thing because these conditions reassure investors that they will get their money back. Ex ante and ex post conditionality is really a commitment device that makes it more likely that investors will get their money back and, therefore, will continue to want to feed money to the country.

You reconcile ownership and conditionality, so long as you separate them temporarily. You have conditionality ex post, but, ex ante, that is what allows a country to have access to capital markets. Conditionality is not inconsistent with ownership. At any given point in time, they are inconsistent, because you don't have to enforce conditions that imply that the country would do something it would have done anyway.

The management of conditionality is a difficult issue, but the IMF's commitment to impose ex post conditions may well help the country, because this conditionality is what is going to give the country access to international capital, which is what it wants in the first place.

IMF SURVEY: Should certain types of debt be limited, particularly high-risk, short-term debt?

Tirole: There's a broad consensus that we should eliminate dangerous forms of debt—such as short-term debt denominated in dollars or some other foreign currency—that require debtor countries to come up with dollars in the very short term, often at considerable cost to the economy. But this conventional wisdom may be misguided, because it increases government moral hazard. If you try to force government to issue sovereign debt in domestic currency and the private sector to issue its foreign debt in domestic currency, you increase the vulnerability of foreigners holding domestically denominated debt if the government fails to take steps to keep the currency strong. Because foreign investors have little political leverage, the government may have less incentive to support the currency in times of distress, even at the expense of further access to capital markets

As shown by the IMF's Olivier Jeanne, foreign investors are similarly unprotected if government and the private sector are forced to borrow only long term, because this prevents foreign investors from running when the government misbehaves and the economy appears to be in trouble. As with a currency depreciation, the country may avoid a crisis, but further access to capital markets will be difficult. The mistake is to view crisis avoidance as the end result rather than as a way station toward maintaining capital market access. ■