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Latin America needs higher, more durable growth

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Latin America has recently made great strides in boosting growth and reducing inflation, and several countries have been able to repay loans to the IMF ahead of schedule. In an interview, new IMF Deputy Managing Director Murilo Portugal discusses Latin America's political economy landscape and how its repayment of IMF loans will change its relationship with the IMF. He says higher growth is essential to improve social conditions and support sound economic policies.



Stephen Jaffer/IMF

WTO membership strengthens Vietnam's outlook

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On January 11, Vietnam became the 150th member of the World Trade Organization (WTO). Leading up to its accession, it had already greatly increased its trade openness and more than tripled its export market share. WTO membership is likely to strengthen its economic performance and facilitate its integration into the global economy. Vietnam is also likely to benefit from reforms being introduced to meet WTO commitments.



HOANG DINH NAM/AFP/Getty Images

Helping women may provide fillip for economy

page 28

A new IMF study that explores the policy effects of gender finds that women's lack of opportunities, both absolutely and relative to men, inhibits economic growth. Reducing gender inequality and improving the status of women may contribute to higher rates of economic growth and greater macroeconomic stability. Thus, macroeconomic policies should take into account the benefits of reducing gender inequalities, especially in the lowest-income countries, where these differences are most pronounced.



Vladimir Zinny/TAR-TASS

New study finds 35-hour week mainly negative

page 32

Seven years ago, France instituted a 35-hour workweek. The intention was to create more jobs and increase welfare. But a new IMF study finds that the law has failed to achieve its overall objectives. It did not create more jobs and generated a mainly negative reaction from both companies and workers as they tried to neutralize the law's effect on hours of work and pay. And while the French now work shorter hours, this does not seem to have made them happier.



Uwe Gerg

What's on

FEBRUARY

7–8 2nd OECD Forum in Mexico: International Forum on Public Policies for the Development of Mexico, organized by OECD, World Bank, UNDP, Inter-American Development Bank, and Economic Commission for Latin America and the Caribbean, Mexico City, Mexico

9–10 G7 Ministerial Meeting, Essen, Germany

13–15 Global Forum: Building Science, Technology, and Innovation Capacity for Sustainable Growth and Poverty Reduction, World Bank, Washington, D.C., United States

MARCH

4–6 Institute of International Bankers' 2007 Annual Washington

Conference, Washington, D.C., United States

19–23 7th Annual Conference of the Parliamentary Network of the World Bank, Cape Town, South Africa

24–25 G20 Deputies meeting, Pretoria, South Africa

APRIL

2–4 3rd Secondary Education in Africa Regional Conference, Ghana Ministry of Education, Accra, Ghana

3 1st Global Forum Plenary Meeting on "Policy Reform Options for Effective Development Finance," OECD, Paris, France

14–15 2007 Spring Meetings of the World Bank Group and the IMF, Washington, D.C., United States

26–27 "New Perspectives on Financial Globalization," conference sponsored by the IMF Research Department and Cornell University, Washington, D.C., United States, see www.imf.org/external/np/seminars/eng/2007/finflo/042607.htm

MAY

9–14 IMF High-level seminar on Macroeconomic Management and the Japanese Experience in Economic Development, Tokyo, Japan

20–21 European Bank for Reconstruction and Development,

Annual Meeting and Business Forum, Kazan, Russia

JUNE

6–8 G8 Summit, Heiligendamm, Germany

JULY

6–8 APEC Meeting of Ministers responsible for Trade, Queensland, Australia

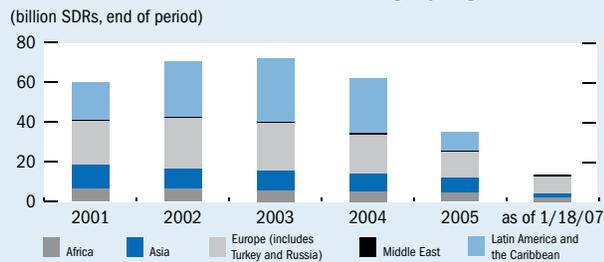
6–8 Seminar organized by "Cercle des Économistes," Aix-en-Provence, France

IMF Executive Board

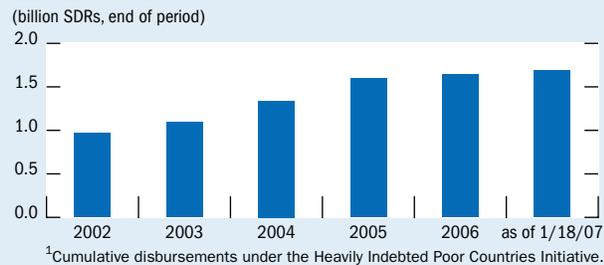
For an up-to-date listing of IMF Executive Board meetings, see www.imf.org/external/np/sec/bc/eng/index.asp

IMF financial data

Total IMF credit and loans outstanding, by region



HIPC debt relief¹



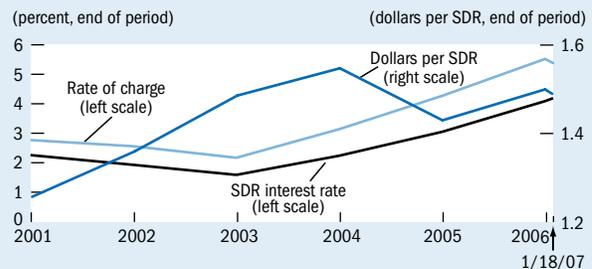
Note: Special Drawing Rights (SDRs) are an international reserve asset, created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also

Major currencies, rates per SDR

	January 24, 2007	Year ago (January 24, 2006)
Euro	1.150	1.187
Japanese yen	180.75	167.21
U.K. pound	0.757	0.817
U.S. dollar	1.50	1.457

Related rates

SDR interest rate, rate of charge on IMF nonconcessional loans outstanding, and dollars per SDR



serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies.

Montenegro becomes IMF's 185th member

The former Yugoslav republic of Montenegro joined the IMF on January 18, becoming the institution's 185th member. The Articles of Agreement were signed in Washington, D.C., by Ljubiša Krgović, President of the Council of the Central Bank of Montenegro. Montenegro's Finance Minister, Igor Luksic, attended the signing ceremony.

The IMF was founded in 1944 and began with 45 member countries.

IMF Managing Director Rodrigo de Rato said that Montenegro's membership marked "another decisive step in the process of nation building. Montenegro is claiming its place as a respected member of the global community of nations, and it is demonstrating its commitment to meet the responsibilities and reap the benefits of international cooperation."

Montenegro's initial quota in the IMF is 27.5 million Special Drawing Rights (SDRs) (about \$41.2 million). With the admission of Montenegro, total members' quotas in the IMF rise to SDR 216.75 billion (about \$325.01 billion).

Each member country is assigned a quota, based broadly on its relative size in the world economy. A member's quota determines its maximum financial commitment to the IMF and its voting power and also has a bearing on its access to IMF financing. ■

IMF working on Lebanon package

The IMF is working with Lebanese authorities to assemble an Emergency Post-Conflict Assistance (EPCA) program to support the strife-torn nation's efforts to deal with its massive debt, rebuild and reform its economy, and undertake sound macroeconomic policies to maintain financial stability.

The IMF's effort comes as major donor countries pledged on January 25 in Paris to provide about \$7.6 billion in aid to help Lebanon rebuild following a month-long war last year between the Lebanese group Hezbollah and Israel, fought on Lebanese soil.

Under the EPCA program, the IMF works closely with donor organizations, such as the World Bank, and donor countries to provide technical assistance, economic policy advice, and financial assistance.

The 2006 war led to a substantial setback on the economic front. According to official estimates, infrastructure damage was around \$2.8 billion. Real GDP, which was expected to grow by 5-6 percent in 2006, is estimated to have contracted by around 5 percent, which implies a loss of income of over \$2 billion. Much productive capacity has been lost, and there has been a massive displacement of the population, including the exodus of many professionals.

Mohsin S. Khan, Director of the IMF's Middle East and Central Asia Department, said the package would help Lebanon "significantly in implementing a comprehensive five-year reform program. Provided politics does not derail it, the program should enable Lebanon to develop into an efficient and dynamic services-oriented regional center. The donor financing will be phased over five years based on progress in completing the reforms." ■



New member: Ljubiša Krgović, President of the Council of the Central Bank of Montenegro, signs the Articles of Agreement on January 18, 2007.

Peru to get precautionary new IMF loan

On January 26, the IMF approved a new loan for Peru totaling about \$257.7 million (SDR 172.4 million), which Peru plans to treat as precautionary. The 25-month Stand-By credit will support the Latin American country's economic program, including consolidating macroeconomic stability. The approval by the IMF's Executive Board makes \$238.6 million (SDR 159.6 million) immediately available.

The main objectives of the Fund-supported program are to build on the current economic expansion, enhance the poverty reduction strategy, strengthen the resilience and depth of the financial system, and press ahead with growth-enhancing reforms.

The new loan follows the early repayment to the IMF by several Latin American countries over the past few years. ■



Palace visit: Indonesian President Susilo Bambang Yudhoyono greets IMF Managing Director Rodrigo de Rato (left) at the presidential palace in Jakarta. De Rato, on his second visit to Indonesia, was on a tour of three Asian countries, including Japan and China.

Interview with Murilo Portugal

Latin America needs still higher but durable growth

In December 2006, Murilo Portugal of Brazil joined the IMF's four-member management team as Deputy Managing Director, with broad responsibilities in running the IMF—including overseeing the technical assistance [TA] initiative. Portugal, who until recently was Brazil's deputy finance minister, had previously served as an IMF Executive Director (1998–2005) representing a Latin American constituency and as a World Bank Group Executive Director (1996–2000). He shared his thoughts with Laura Wallace of the IMF Survey on Latin America's economic outlook and the TA effort.

IMF SURVEY: The whirlwind round of about a dozen presidential elections in Latin America is nearly over, just Argentina later this year. How do you see the political economy landscape shaping up? Any thoughts on negotiating programs with Peru and Nicaragua, now headed by 1980s presidents who had been extremely vocal critics of the IMF?

PORTUGAL: Democracy is thriving in Latin America—in fact, it's one of the most positive changes in the region of the past two or three decades—and presidential elections are a vital part of the process. Elected leaders not only have greater legitimacy, but they also have greater political strength to implement needed reforms. And the strengthening of democracy has gone hand in hand with better macroeconomic management and sound macroeconomic policies. Inflation has fallen, the increase in the public debt has been halted and even started to be reversed in many countries, and the region is more open and integrated with the world economy.

In addition, there's a widespread understanding that to improve social conditions a country needs to maintain macroeconomic stability. This thinking has held up even when there's been a shift in political power to more left-leaning governments, as in Chile, Uruguay, and Brazil. The two leaders you mentioned—President Garcia of Peru and President Ortega of Nicaragua—also exemplify this situation because they've both given very encouraging statements about the need to maintain macroeconomic equilibrium as a basis to continue to make progress on social issues. In fact, the IMF just concluded negotiations with the new Peruvian authorities on a new precautionary loan (see story on page 19). And we've had very good initial contacts with President Ortega.

IMF SURVEY: When Uruguay last year followed Brazil and Argentina in paying the IMF off early, there was talk of Latin America choosing to distance itself from the IMF. How do you see the IMF's relationship now with both the big and small countries in the region?



Portugal: "There's a widespread understanding that to improve social conditions a country needs to maintain macroeconomic stability."

PORTUGAL: Early repayments to the IMF should not, and need not, be interpreted as a choice of the country to distance itself from the IMF. Rather, it should be seen as a sign of financial strength that a country wishes to give to the markets. Some countries have made a deliberate effort through public statements to indicate that early repayment shouldn't be interpreted as an abandonment of existing policies or a distancing from the Fund. In fact, Uruguay insisted on having the last review of its program—which contained an important new tax reform—finalized.

As for the IMF's new relationship with countries in the region, whether large or small, I expect it to be based increasingly on surveillance, which is the bread and butter of the Fund, and technical assistance. That's why it's important that we continue to strive to improve the effectiveness of our surveillance—providing the highest-quality policy advice based not only on solid theoretical ground but also on a wealth of cross-country experiences.

IMF SURVEY: Can Latin America as a whole maintain the 4–5 percent growth of the past few years, and will that be enough to make a dent in poverty and inequality? And can the region finally claim victory over out-of-control inflation, especially in light of recent developments in Argentina and Venezuela?

PORTUGAL: Some Latin American countries have maintained a very high growth rate—higher than the 4–5 percent range. But the region's average growth record so far is still disap-

pointing, considering its potential and its needs. Higher growth is essential for the region to improve social conditions, maintain political support for sound macroeconomic policies, and further reduce vulnerabilities. But this growth has to be achieved while preserving macroeconomic stability or it won't be durable. And for that to happen, countries have to move faster in carrying out structural reforms and social policies that would contribute to social inclusion and poverty reduction.

As for inflation, there's been major progress in the region, with a declining trend since the mid-1990s. There have been periods when inflation increased, as a result of either external shocks or domestic shocks, but it was soon brought back to a declining path. It has certainly helped that there have been a series of institutional improvements in the framework for monetary policymaking—such as the adoption of inflation targeting and greater independence for central banks. Price controls are more an exception than the rule. We know that they work, at best, only temporarily and only in exceptional circumstances when there are substantial market failures, such as natural monopolies. They're not a lasting solution because they only repress inflation, rather than eliminate it, and lead to a buildup of cost pressures, create inefficiencies in the use of economic resources, and depress investment.

IMF SURVEY: How high a growth rate does the region need?

PORTUGAL: It will need to go higher than the 4 percent range—maybe 5, 6, or 7 percent—but there's no magic number.

IMF SURVEY: You've worked with the IMF in many different capacities—as an Executive Board member, as Brazil's deputy finance minister, and as a government official in one of the IMF's most active program countries. What have you learned from these interactions that will guide your dealings now with member countries?

PORTUGAL: The first lesson is that you need to have the right set of policies to deal with the situation. If the policies aren't appropriate, the program won't work. A good example is Brazil's 1998 program, which was based on maintaining a fixed exchange rate. There was strong government ownership, but the policy was inappropriate. As a result, the program didn't work until Brazil shifted to a floating exchange rate. The second lesson is that there needs to be strong government ownership. Otherwise, even if you have a well-designed program, there's a chance that the implementation won't happen or will be weak. The third lesson is that countries also need financing. Economic policies take time to generate results, so there's a gap between the time a country

starts to implement policies and the time the results start to appear. And if the IMF puts its own money at risk, that also sends a positive message to economic agents that may not

have sufficient information to judge whether the policies are appropriate or the government has strong ownership.

IMF SURVEY: You mentioned TA, which currently takes up about 25 percent of the IMF's budget. Do you expect it to continue at that level?

PORTUGAL: I don't see any reason why the level of TA we provide would be reduced. TA is a core output of the IMF (see Boxes 1 and 2). While it helps mainly the recipient country, it also has elements of an international public good in the sense that improvements in the performance of the recipient country may benefit its neighbors. And although the IMF is a relatively small provider of TA compared with other donors, it works closely with them to increase synergies.

IMF Survey: About 25 percent of all TA is externally financed, and for field delivery only, it's about 50 percent.

Box 1

IMF inaugurates India training program

The IMF Institute has opened a new training center in Pune, India—its seventh training program to be established outside its headquarters in Washington, DC. The others are located in Abu Dhabi, Austria, Brazil, China, Singapore, and Tunisia.

John Lipsky, IMF First Deputy Managing Director, and Rakesh Mohan, Deputy Governor of the Reserve Bank of India (RBI), formally inaugurated the Joint India-IMF Training Program (ITP) on January 24.

The ITP provides policy-oriented training in economics and related operational fields to officials in India, and in other countries in South Asia and East Africa. Courses will cover macroeconomic management and policies, financial programming, monetary policy, bank supervision, financial sector issues, public finance, exchange rate policy and foreign exchange operations, and statistics. Costs are shared by the IMF, the RBI, and the Australian government.

Lipsky noted that training is a major part of the IMF's efforts to strengthen policymaking capacity in member countries. He hoped that the new Institute would "help disseminate the policy lessons learned in other parts of the world and provide a forum for discussing regional issues. My IMF colleagues and I are very pleased that India is our partner in this new enterprise," he said.

Box 2

Role of IMF technical assistance

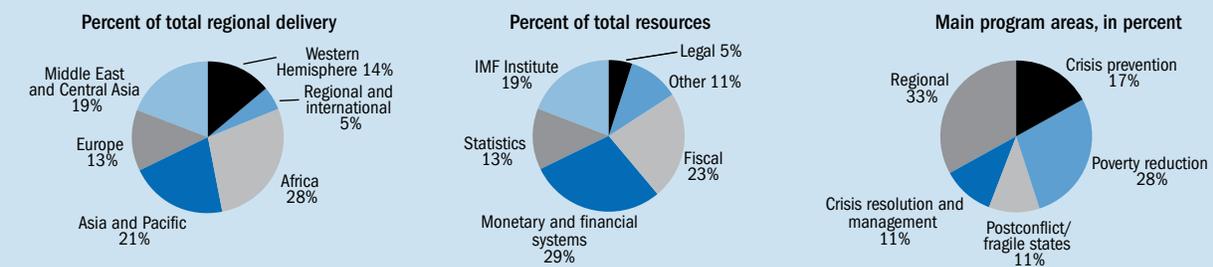
Technical assistance (TA) and training are key components of the IMF's capacity-building strategy, especially for developing countries. The goal is to help countries strengthen their human and institutional capacities to design and implement sound economic policies. TA and training are provided mainly in the IMF's core areas of expertise, such as macroeconomic policy, tax and revenue administration, public financial management, financial sector reforms, and macroeconomic and financial statistics. Key facts about IMF TA:

- About 90 percent goes to low- and lower-middle-income countries to reduce poverty through sustained growth. Postconflict countries are also major beneficiaries.

- Time spent: in FY2006, the IMF devoted the equivalent of 429 person years (one person year equals 260 working days) to delivering TA.
- An increasing proportion is being provided through regional TA centers. The IMF has set up six centers in the Pacific islands, the Caribbean, Africa, and the Middle East. Managing Director Rodrigo de Rato opened the third center in Africa in Gabon this month.
- The IMF operates with other donors to help finance and provide TA.
- Neighboring countries benefit from the improved economic performance of the TA recipient countries, and this contributes to macroeconomic stability.

Technical assistance by region (left), by department (center), and by program areas (right)

(FY2006 in effective person years)



Source: IMF.

Do you expect external finance to play a more important role in TA?

PORTUGAL: There has to be financing, whether it comes from donors or recipients. Thus, it's vital that the IMF continue to mobilize external financing. We've got to strengthen our dialogue with donors and continue to improve the quality of our TA—which is why we've been working hard to implement the suggestions from the IMF's Independent Evaluation Office in its review of our TA in early 2005. We also need to prove to donors that we're cost-effective in delivering TA, and we need to perfect our mechanisms to monitor, manage, and evaluate TA.

IMF SURVEY: How do you see the IMF balancing its own institutional priorities with those of donors and dealing with donors' expectations to see concrete and monitorable results?

PORTUGAL: I don't see a major problem, because the IMF is a multilateral organization and our priorities are established by the Executive Board, on which the donor countries are represented. But TA, even when it's financed by donors, must continue to be driven by the priorities of the recipients and the institutional

priorities of the IMF—not the priorities of those who are financing it, if those happen to be different. The IMF's priority now is to help countries overcome the problems identified in our surveillance or program work, especially macroeconomic and financial sector vulnerabilities. Another important aim is to help them build or strengthen economic institutions. TA has an important role to play to help achieve these two aims.

IMF SURVEY: The IMF has taken an increasingly regional approach to TA by establishing regional TA centers, most recently in central Africa. How well is this approach working, and are there any plans for more centers?

PORTUGAL: It's working very well. Once you have a local center, it allows you to respond more quickly to country requests and better tailor the TA to the country's needs. It also allows for greater ownership by the recipients, because they participate in the center's steering committees. We're now in a period of consolidating our six centers. I know that there have been requests for additional centers, but we've haven't decided about them yet. ■

WTO accession will help Vietnam strengthen economy

Vietnam became the 150th member of the World Trade Organization (WTO) on January 11, 2007. Before joining, Vietnam had made great strides toward integration with the global economy. Since 1993, the sum of exports and imports in relation to GDP has more than doubled, and its export market share has more than tripled. With exports becoming a leading engine of growth, GDP growth has averaged more than 7½ percent a year, and poverty has fallen sharply. Given this impressive performance, an obvious question is how the WTO will offer new opportunities and challenges for Vietnam's future.

Improved access

WTO accession will facilitate Vietnam's further global integration. Vietnamese exporters' access to foreign markets should improve as other WTO members are expected to remove remaining quantitative restrictions on imports of Vietnamese textiles and footwear. To be sure, Vietnam will also face greater competition from foreign producers in its domestic market for garments and footwear because its import tariffs and subsidies will be substantially reduced upon accession. However, with improving access to imports of cheaper raw materials and semi-processed inputs, these sectors are broadly expected to preserve their comparative advantage. The realized benefits for export performance, however, could be tempered by the 12 years it will take Vietnam to gain full "market economy" status.

Import barriers in most other sectors would also decline. As shown in the table, Vietnam has committed to bound tariff rates (or legal ceilings) on most products ranging from zero to 35 percent, although tariffs on cars and motorbikes are to remain somewhat higher, and certain sensitive products (such as eggs,



A woman checks shoes made for export on a production line in Vietnam.

tobacco, sugar, and salt) will be subject to tariff quotas (higher duties for quantities outside the quotas). Reductions in most bound rates—from 17.4 percent on average in 2007 to 13.6 percent by 2019—are to be phased in gradually.

But some heavily protected industries, notably auto assembly and motorbike plants, and some services will require significant reforms to remain viable. In particular, fully owned foreign banks will be allowed to compete on an equal footing with domestic banks from April 2007. In this process, there may well be a compression of profit margins and, possibly, some labor shedding in declining industries. The authorities will need to put in place adequate retraining programs and social safety nets to prevent any severe dislocation. Importantly, they will need to accelerate the reform of the state-dominated banking system to enable it to meet the new competitive challenges and improve efficiency in the allocation of capital.

From a broader perspective, WTO accession should have positive long-run effects. Although lower import tariffs can be expected to erode import duty receipts, this should be tempered as the removal of trade barriers spurs import growth. Cheaper imports should also help contain inflation and increase consumer welfare. With access to world export and capital markets improving, the overall balance of payments should remain strong.

Vietnam is also likely to derive important benefits from the other market-friendly reforms it is introducing to meet WTO commitments. Recently adopted laws to unify the regulatory framework for domestic and foreign enterprises and to harmonize rules on trading rights, together with the prospect of accession, have already bolstered the investment climate in Vietnam, and approvals of foreign direct investment reached a record-high \$10 billion in 2006. In all, Vietnam seems well placed to capitalize on the opportunities offered by its ongoing international economic integration. ■

Patrizia Tumbarello

IMF Asia and Pacific Department

Falling tariffs

Vietnam's lower tariffs will be phased in over several years.

	2005 tariff rates ¹	WTO initial bound rate	WTO final bound rate	WTO implementation
Simple average	18.5	17.4	13.6	up to 12 years
Agricultural products	29.4	27.3	21.7	up to 5 years
Nonagricultural products	17.0	16.0	12.5	up to 12 years
Steel	9.7	17.7	13.0	up to 2 years
Petroleum	14.6	27.2	27.1	up to 2 years
Manufactures				
Textiles and clothing	36.6	13.6	13.5	upon accession
Footwear	45.0	35.8	27.2	upon accession
Cars	63.6	84.8	58.7	up to 12 years
Motorbikes	100.0	100.0	74.3	up to 12 years
Electronic machinery	13.3	13.9	9.5	5 years
Minimum tariff	0	0	0	
Maximum tariff	150	150	85	
Number of lines	10,689	10,444	10,444	

Sources: WTO, Vietnamese authorities; and IMF staff calculations.

¹Rates applicable to most imports from countries outside Southeast Asia.

Colombia: from crisis to recovery

Following its worst economic crisis in 30 years, Colombia has successfully turned the economy around through a combination of fiscal reform and consolidation that has trimmed public debt, policies that substantially reduced inflation, and actions to strengthen the financial system (see box). The policies that have been adopted since 1999, supported by three successive IMF arrangements, have sought to place the country on a path of sustainable growth and reduce inflation while substantially reducing poverty and unemployment. Since 2002, Colombia's economy has also benefited from a marked improvement in the security situation, although it remains a source of concern. After seven years of IMF economic programs, Colombia exited formal IMF support in November 2006.

Economic recovery

After an initially slow recovery, real economic growth rose to 4 percent by 2004 and accelerated to an estimated 6½ percent in 2006, helped by strong private investment (see chart). This stronger growth, aided by a favorable global economy, has been accompanied by large declines in unemployment and poverty, as well as improved macroeconomic stability and a reduction of vulnerabilities (see table):

- With the recovery in the economy, unemployment declined from 20 percent in 2000 to about 12 percent in 2006, while poverty fell from 64 percent in 1999 to 49 percent in 2005.
- At the same time, inflation fell to its lowest level in decades, to about 4.5 percent in 2006, with the effective implementation of an inflation targeting framework.
- Aided by the fiscal reforms and increased oil prices, the combined public sector deficit was reduced from 5.5 percent of GDP in 1999 to a projected 0.4 percent of GDP in 2006. This performance—together with the real appreciation of



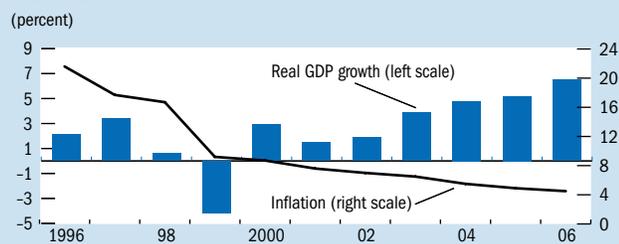
A Colombian coffee worker collects coffee beans near Bogota. Coffee is one of Colombia's main exports.

the peso since 2004—helped reduce gross public debt from 57 percent of GDP in 2002 to 45 percent in 2006. In addition, public sector deposits reached an estimated 13 percent of GDP in 2006, up from 8 percent of GDP in 2002.

- Improvements in public debt management have reduced financing costs, diversified funding sources, lengthened the maturity of debt, lowered foreign exchange rate exposure, and enhanced liquidity in the domestic bond market. Since 2004, Colombia has issued about \$1.6 billion of global peso-denominated bonds.
- The external sector strengthened, led by sustained growth in exports and a recovery in capital inflows. Net international reserves reached \$15 billion (over 150 percent of short-term external debt at remaining maturity) in 2006.
- The health of the financial system recovered, as loan quality improved and bank profits increased. The nonfinancial corporate sector reduced leverage and managed currency risk more prudently, encouraged by the flexible exchange rate regime.

A more stable environment

Colombia's policies have helped raise economic growth and reduce inflation.



Colombia: selected vulnerability indicators

	2002	2006
External sector		
Current account balance (percent of GDP)	-1.7	-1.6
Net FDI inflows (percent of GDP)	1.6	2.9
Gross international reserves in percent of short-term debt at remaining maturity ¹	103.3	153.3
Public sector		
Public sector gross debt (PSGD, in percent of GDP)	57.0	44.5
Exposed to rollover risk (percent of total PSGD)	12.0	9.7
Exposed to exchange rate risk (percent of total PSGD)	56.3	44.4
Financial sector (FS)		
Nonperforming loans to total loans	8.7	2.8
Foreign currency deposits held by residents (percent of total deposits)	1.3	1.7
Government debt held by FS (percent of total FS assets)	15.3	16.7

Sources: IMF staff estimates and projections; Colombian authorities.

¹August data for 2006.

Tackling vulnerabilities

Colombia's medium-term economic prospects are broadly favorable. Sustained higher growth over the medium term is needed to raise living standards and reduce poverty more substantially. The authorities plan to sustain their economic policy strategy, which will likely be supported by a continued favorable external environment. Recognizing the critical importance for prosperity of maintaining low inflation, the authorities have already begun to tighten monetary and fiscal policies, to limit the risk that the economy may overheat. The authorities say they intend to address important policy challenges and continue to strengthen economic performance:

Public finances. The authorities will continue with fiscal consolidation to reduce further Colombia's public debt, which remains relatively high and a potential source of vulnerability. Congress is debating the government's proposal to reform the intergovernmental transfers system, which is crucial to contain future pressures on public finances and preserve the credibility of fiscal policy. There is also scope for reforms to lower other significant revenue earmarking and budget rigidities. At the same time, reducing tax distortions and broadening the tax system's base would be important to lower obstacles to more private investment while protecting revenue collections.

Financial system. Although the financial system is healthy, domestic capital markets need to be deepened and made more liquid. Less-developed capital markets, together with distortionary taxes on financial transactions (the stamp and financial transaction taxes), have contributed to the high cost of capital and deterred investment. The authorities are developing reforms to, among other things, strengthen creditor rights and improve credit bureaus. Steps to enhance the independence of the financial supervisory agency would be important to strengthen further the financial system.

Unemployment and poverty. The authorities are working to ensure that sustained growth translates into further declines in poverty, which remains high. One element will be to stimulate employment, which should, in turn, help reduce poverty. For this, it would be important to continue reforms to increase labor market flexibility and reduce still-high nonwage labor costs to spur job creation in the formal sector of the economy. More broadly, the authorities aim to reduce the poverty rate to 39 percent by 2010 and to 15 percent by 2019 while improving income equality. To this effect, a strategy seeking to extend coverage of primary education and basic health to the entire population by 2010 was launched in 2006. Other plans include doubling the size of Familias en Acción, an extremely successful program that provides nutrition and health care to families in extreme poverty. ■

Lisandro Abrego and Robert Rennhack
Western Hemisphere Department

Colombia at a glance

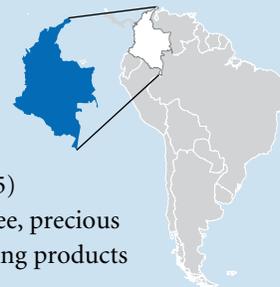
Capital: Bogota

Area: 1.142 million square km.

Population: 46 million

GDP per capita: \$2,688 (2005)

Main products: oil, coal, coffee, precious metals, and light manufacturing products



Major reforms adopted, 1999–2006

Fiscal Policy

- *Taxes.* Several reforms boosted revenues from 17 percent of GDP in 2000 to about 21 percent of GDP in 2006.
- *Fiscal decentralization.* Laws approved in 2001–02 delinked intergovernmental transfers from current revenues and set spending and borrowing limits on territorial governments. In 2004, these entities began to run an overall surplus.
- *Pension reform.* Three reforms were approved in 2002–05 that raised contributions and trimmed benefits, and eliminated special regimes, including for teachers and the military. This reduced the actuarial deficit of the pension system from 200 percent of GDP in 2000 to 148 percent of GDP in 2005.
- *Fiscal responsibility law.* Since 2004, all levels of government have had to justify fiscal targets within a 10-year analysis of the sustainability of public debt.
- *Public sector administration.* Steps have been taken to streamline staffing and improve efficiency of the public health system and of public enterprises, including the state oil company, Ecopetrol, the telecommunications company; and the Cartagena oil refinery.
- *Budget framework.* After congress declined to approve the revised budget code, a 2005 decree implemented many of its elements.

Monetary policy

- *Inflation targeting.* Framework adopted in 2000.

Financial sector

- *Privatization.* Divested all but one public sector bank.
- *Financial supervision.* In 2006, a new financial regulatory agency was formed by merging the agencies in charge of supervising financial institutions and of securities. Provisioning levels brought up to international standards.
- *Capital markets.* A securities market law was approved in 2005 that strengthened clearing and settlement procedures, market integrity, and corporate governance.

Exchange system

- *Exchange rate policy.* In 1999, a flexible regime was adopted.
- *Exchange restrictions.* In 2004, Colombia accepted the obligations of the IMF's Article VIII, on exchange restrictions. Only one restriction is currently in effect, compared with four in 2004.

Why FDI may not be as stable as governments think

A widely shared view among academics and policymakers is that foreign direct investment (FDI) is a stabilizing factor during episodes of financial crisis in emerging market countries. Underlying this view is the notion that FDI is driven by positive longer-term sentiment about the recipient country and, to the extent that it entails physical investment in plant and equipment, is more difficult to reverse than other capital flows. On this basis, it is argued that policymakers should encourage such flows to “insure” against sudden reversals of capital flows.

Empirical evidence broadly supports the hypothesis that FDI flows are more stable than all other forms of capital. However, one should not be too quick to infer from aggregate data that the behavior of direct investment enterprises during crises is necessarily stabilizing from the perspective of the balance of payments. In particular, a narrow look at FDI flows risks providing only a partial perspective on the financing decisions of FDI enterprises. Further improvements in the scope and coverage of FDI data and more analysis at the firm level are needed to better understand the behavior of direct investors and their host country affiliates in the context of a financial crisis.

What the FDI data tell us

Net FDI flows to emerging market countries increased dramatically in the 1990s, making direct investment the predominant source of private external financing for this country group. Moreover, the positive trend prevailed, notwithstanding several financial crises in emerging markets during 1990–2005 (see chart). Indeed, annual net FDI flows to emerging market countries—both in U.S. dollar terms and as a share of recipient countries’ GDP—have remained consistently positive throughout the period and increased steadily, except in 2002–03, when flows to Latin America declined temporarily in the wake of the crisis in Argentina. In contrast, net portfolio investment and other investment registered substantial net outflows from emerging markets during some of the years under review.

A closer look at selected episodes of financial distress at the country level generally reinforces the view that FDI flows are stabilizing. In particular, FDI is typically more stable

than portfolio and other investment flows when the volatility of the respective flows is scaled by their mean size (see table). The data also reveal that in some countries—including Argentina, Indonesia, Brazil, Russia, and Thailand—FDI became the only channel for net private capital inflows immediately after the crisis, a period during which portfolio and other private capital flows exited the country.

Some complications

Despite these findings, capital flows associated with FDI activity are not necessarily more stabilizing than other cross-border capital flows. This is because official FDI data may not adequately capture all the transactions that fall under the definition of FDI. Specifically, while the relevant data compilation practices tend to do a good job of capturing the initial transaction establishing an FDI relationship (the acquisition of at least 10 percent of the ordinary shares or voting power of an enterprise abroad), they are often less accurate at recording subsequent capital transactions between the direct investor

in the source country and the direct investment enterprise in the host country. These subsequent flows include fresh injections of equity capital; a reinvestment of earnings; and other flows, including intercompany loans and suppliers credits.

The information content of FDI data may also be undermined in cases where direct investment enterprises use

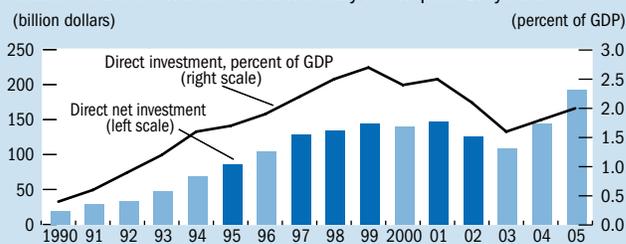
The issue: Are FDI flows a stabilizing factor during a financial crisis?

The bottom line: Yes, FDI flows are generally more stable than portfolio and other investment flows.

What's the problem?: A narrow look at FDI flows risks providing only a partial perspective on the behavior of direct investment enterprises during crises. Moreover, further improvements in the quality and coverage of FDI data are needed to better assess the stabilizing nature of FDI flows.

Surging inflows

Despite several acute financial crises, net FDI flows to emerging market countries increased dramatically in the past 15 years.



Source: IMF staff estimates.

Note: Includes countries in the Emerging Markets Bond Index, India, and Czech Republic. Darker bars indicate the years of financial crisis: 1995-Mexico; 1997-Korea and Thailand; 1998-Brazil, Indonesia, Philippines, Russia, and Ukraine; 1999-Ecuador; 2001-Argentina and Turkey; 2002-Uruguay.

sophisticated financial engineering to manipulate cross-border financial flows with a view to circumventing capital controls or reducing tax liabilities.

More fundamentally, the accounting of FDI needs to be distinguished clearly from the analysis of financing sources of the direct investment enterprise. For example, to the extent that the parent FDI firm finances its investments by borrowing from host country capital markets, the stabilizing effect of FDI would be partially offset by a potentially destabilizing outward portfolio flow. Conversely, the exposure of the parent firm to the domestic affiliate could be underestimated to the extent that the parent firm provides guarantees for the affiliate's borrowing from unconnected foreign sources. Such borrowing would show up as a portfolio inflow, not as direct investment, even though the investment risk is borne by the parent.

Furthermore, surveys of FDI investors reveal that in the context of financial crises, multinational firms encourage their foreign affiliates to borrow more in domestic capital markets based on their own capacity. The scope for such transactions is, of course, critically related to the strength of the affiliate's balance sheet and depends on the continued willingness of banks and capital markets to provide financing during periods of financial distress.

Recent studies indicate that this disconnect between reported FDI flows and the actual financing of FDI enterprises is not just conceptual. For example, economist Alexander Lehmann found in a 2004 IMF Working Paper (WP/04/107) that once all financing from host country and other external sources is included, the balance sheets of U.S. foreign affiliates with majority U.S. ownership are about three times as large as suggested by the FDI data,



A Brazilian worker assembles a car for export at a U.S.-owned plant near São Paulo.

which cover only the debt and equity provided by the parent company. As financing of FDI investments is increasingly sourced in local markets, this gap is likely to grow in the future.

Room for improvement

Despite these potential complications, evidence from a limited number of case studies suggests that the financial decisions of direct investment enterprises in emerging markets tend to contribute to current and capital account stability during periods of financial distress. In particular, local affiliates of multinational firms were found to shift quickly from host country sales to export sales; reduce dividend outflows with a view to strengthening their capital base; and expand economic activity at a time when locally owned firms facing more severe financing constraints were unable to do the same.

Additional firm-level research is needed to build a more solid body of empirical evidence on whether or not the behavior of direct investment enterprises in emerging economies helps avoid or mitigates balance of payments crises. Moreover, weaknesses in existing FDI data point to the need for better statistics. In this context, policymakers can be expected to benefit from work in the area of foreign affiliate trade statistics, as well as from ongoing initiatives aimed at improving the collection of comprehensive and harmonized information on the stock of inward and outward FDI—possibly including the Coordinated Direct Investment Survey conducted by IMF staff in collaboration with other international agencies. ■

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Pockets of stability in turbulent times

In a seven-year window around a crisis episode, the year-on-year variation in FDI flows is typically much lower than that of other investment flows.

	Coefficient of variation	
	Direct investment	Portfolio and other investments
Argentina	0.60	11.50
Brazil	0.50	2.50
Indonesia	3.13	11.96
Korea	8.02	1.24
Mexico	0.38	1.86
Philippines	0.48	1.03
Russia	0.81	0.76
Thailand	0.74	61.33
Turkey	0.90	1.47
Ukraine	0.30	2.72
Uruguay	0.42	8.33

Source: IMF staff estimates.

Note: The coefficient of variation is a widely used measure of the stability of capital flows. For each type of capital flow, it is calculated as the standard deviation of the flow divided by its mean.

Boosting women's status may help strengthen economic growth

A recent IMF Working Paper examined how differences in economic choices between men and women may lead to different outcomes for the macroeconomy and thus have implications for desirable fiscal and monetary policies. Gender-based differences in economic behavior have long been integrated into models of economic development and in the fields of labor economics and public finance. However, in the past two decades, researchers have studied the macroeconomic implications of gender-based differences. The United Nations' Millennium Development Goals have explicitly linked economic progress to the equalization of opportunities for women. These goals thus recognize the importance not only of raising the status of women, but also of narrowing disparities between women and men. These gender disparities are often greatest in the poorest countries.

IMF economist Janet Stotsky explored the impact of gender in macroeconomic policy. She found the following:

- Gender-based differences in behavior that are systematic and widespread can influence macroeconomic variables, such as aggregate consumption, savings, investment, and risk-taking behavior. These differences may also influence public choice and the scope of government, which have macroeconomic repercussions.
- Gender influences consumption behavior in part through differences in behavior within the household. Women tend to devote a larger share of household resources to meeting the household's basic requirements and to fostering their children's potential.
- Gender influences savings and investment and risk-taking behavior. Women tend to have a higher propensity to save and to invest in productive ways. They also show greater caution in their savings and investment behavior, which may often be good for poor households, though it can have mixed effects in the aggregate.
- Women's political empowerment may lead to a greater demand for public forms of social insurance and may also lead to a larger overall role for government.
- Women's lack of education, health care, and economic and social opportunities—both absolutely and relative to men—inhibits economic growth; at the same time, economic growth reduces women's subordinated condition. In coun-

tries with the lowest average income and where agriculture remains the main source of economic activity, women's lack of education, health care, and employment opportunities prevents them from being able to benefit fully from improved macroeconomic environments, hindering economic growth.

- One component of this relationship is that the growth of export-oriented industries in many developing countries, supported by trade and financial liberalization, has stimulated economic growth and created more jobs for women. This has generally established a beneficial relationship between export orientation, improved opportunities for women, and strengthened growth.

Fewer opportunities

One of the motivating forces behind research on gender differences has been the interest in ensuring that the benefits of economic growth are equitably shared. Women remain disadvantaged, especially in the developing world, where opportunities for educational, social, and

economic advancement are usually markedly inferior to those of men. The result is a lower level of educational attainment, a higher rate of infant mortality for girls than boys in many countries, and relative life expectancies that do not accord with biological norms—the so-called missing women phenomenon.

Women also face discrimination in labor markets through a lack of job opportunities and sizable gender wage gaps, and in financial markets through limited access to credit or an inability to retain control over their own property, restricting their opportunities to improve their standard of living and have autonomy in their own lives. The disadvantaged status of women is equally evident in their relative lack of opportunities to participate in public decision making.

Evidence of the relationship between women's inferior status and growth is not fully conclusive—and even measurement of the degree of inequality or disadvantage in relation to men is a complex topic. But it does suggest that societies that increase women's access to education, health care, employment, and credit, and that narrow differences between men and women in economic opportunities increase the pace of economic development and reduce poverty.

Gender differences in behavior also influence how we assess the impact of exchange rate changes (sometimes accompanying IMF- or World Bank-supported adjustment

The issue: What are the implications of gender differences in economic behavior for macroeconomic policy?

The bottom line: Reducing gender inequality and improving the status of women may contribute to higher rates of economic growth and greater macroeconomic stability.

Outcome: Macroeconomic policies should take into account the benefits of reducing gender inequalities, especially in the lowest-income countries, where these differences are most pronounced.



Vladimir Zimin/ITAR-TASS

Women work on a packing line at a Russian ice-cream plant.

programs) and trade and financial liberalization on product and labor markets. In some countries, mainly those still based primarily on subsistence agriculture, inequalities in women's opportunities limit their ability to take advantage

Setting budgets that narrow gender inequalities

In a related working paper (WP/06/232), Stotsky examines "gender budgeting," which refers to the systematic examination of budget programs and policies for their impact on women. Australia was the first country to formally incorporate gender budgeting into its budget process by developing the concept of a "women's budget" to address inequalities between women and men. Government ministries and departments were required to provide an analysis of the impact of the annual budget on women and girls, focusing mainly but not exclusively on public expenditures.

In recent years, a range of countries have undertaken gender budgeting initiatives. In some countries of the European Union, for example, these initiatives are thriving, and analyses of the impact of budgets on women and reducing gender disparities have become an accepted part of the budgetary process. Gender budgeting initiatives have also been tried in a wide range of developing countries, from South Africa to the Philippines, where their success has been more mixed.

The motivation for gender budgeting stems from the observation that women remain disadvantaged relative to men in key economic, social, and political indicators. But in many areas, such as education, the differences are narrowing. Originally, gender budgeting initiatives emphasized ensuring the adequacy and proper targeting of spending for programs to reduce gender inequalities and improve the status of women. More recent initiatives are also focusing on the revenue side of the budget. Gender budgeting is sometimes seen as outside mainstream budgeting. However, this study shows that it fits squarely within that mainstream.

of beneficial macroeconomic and structural policies. This is a particular problem highlighted in research on sub-Saharan Africa, where women are limited mainly to subsistence agriculture. Exchange rate depreciation, geared toward restoring external balance, can impose a harsher adjustment burden on women than on men. When women have broader opportunities, including in export-oriented industries, the adjustment burden may weigh less heavily.

Adjusting IMF programs

Stotsky notes that her study was motivated initially by scholarly critiques of IMF- and World Bank-supported structural adjustment programs looking mainly at the experience of the 1980s and early 1990s. The critiques, which argued that these programs were excessively harsh toward women, tended to focus on the short-term effects of economic austerity, characterized by cutbacks in public spending or increases in fees for public services. Such measures had a direct effect on women but also an indirect effect by raising the amount of unpaid work women had to put in for their families. These critiques often did not account for the medium- or longer-term effect of these programs, which may be more beneficial overall.

Changes in the past decade in the design of IMF and World Bank structural adjustment programs have given greater emphasis to social concerns during the adjustment process. Some recent studies, including those undertaken by staff at the two institutions, show that structural adjustment programs are contributing to a narrowing of differences in education, health care, and employment between men and women. These considerations emphasize that policymakers need to recognize the importance of gender gaps and gender-based differences in behavior in choosing a mix of fiscal and monetary policies that will lead to the greatest success in economic adjustment.

One important implication of the studies is that it is essential to ensure that austerity measures, which may be necessary to stabilize the macroeconomy and reestablish the conditions for sustained growth, do not impose an excessive burden on women or female-headed households. Moreover, efforts must be made to mitigate the harshest effects of economic volatility through well-designed social safety nets and an appropriate pace of fiscal adjustment to ensure that the medium- and longer-term benefits are equitably shared and strengthened through sustained efforts to ensure equal opportunities in economic markets. ■

This article is based on IMF Working Paper No. 06/232, "Gender Budgeting," and on No. 06/233, "Gender and Its Relevance to Macroeconomic Policy: A Survey," both by Janet Stotsky. Copies are available for \$15.00 each from IMF Publication Services. Please see page 32 for ordering details. The full text is also available on the IMF's website (www.imf.org).

Arab states look to institutional change to boost growth and jobs

The Middle East and North Africa (MENA) region is facing a very rapid prospective increase in its labor force over the next decade and a half, dismal prospects for a large number of young unemployed workers unless the growth of output and jobs can be increased substantially, and the need for institutional reforms to boost growth. These issues were the focus of a high-level seminar entitled “Institutions and Economic Growth in the Arab Countries,” organized by the IMF Institute, along with the Arab Monetary Fund, and held in Abu Dhabi, United Arab Emirates, on December 19–20, 2006 (see box). The event attracted high-level government participation—more than a dozen ministers, governors, and their deputies—and scholars and representatives from international institutions and the private sector.

Although economic growth in the MENA region has picked up over the past few years—supported in part by record-high oil prices—the longer-term growth record has been weak. Between 1980 and 2005, annual real per capita GDP growth in the region averaged only 0.5 percent, well below the average annual growth rate of 4 percent in East Asia, and was negative for oil-producing countries. Given the region’s relatively strong labor force growth, such growth rates were not sufficient to prevent a sustained rise in unemployment. A number of papers presented at the seminar argued that the constraints on longer-term growth in the region have been largely institutional. The discussion that followed focused on identifying the mechanisms that could spur a positive and sustained institutional change so that higher growth rates of output and employment could be achieved.

Jobs wanted

High on the to-do list of Arab policymakers is a solution to a demographic time bomb. The region’s labor force, which is young and growing rapidly (see table), is forecast to reach 185

A pressing problem

With the largest labor force growth in the developing world since 1980, the MENA region needs faster GDP growth to create more jobs.

	1970–80	1980–90	1990–2000	2000–10
	(annual percent change)			
Middle East and North Africa	3.1	3.4	3.6	3.4
East Asia	2.4	2.5	1.2	0.8
Latin America and the Caribbean	3.3	3.1	2.5	2.0
South Asia	2.3	1.9	2.4	2.0
Sub-Saharan Africa	2.5	2.7	2.5	2.2

Source: Tarik Yousef, 2004, “Development, Growth and Policy Reform in the Middle East and North Africa since 1950,” *Journal of Economic Perspectives*, Vol. 18 (Summer), pp. 91–116.

million in 2020, about 80 percent higher than in 2000. With current unemployment rates already very high, second only to those in sub-Saharan Africa, the region needs to create close to 100 million new jobs by 2020 to absorb the currently unemployed and the new labor force entrants. This is equivalent to creating as many jobs in the next 15 years as have been created over the past five decades; to achieve that goal would probably require sustained real GDP growth of about 6–7 percent a year, about double the average of the late 1990s.

To make a dent in the pressing unemployment problem, the region must integrate with global markets so that it can achieve higher growth. Expansion of exports in labor-intensive activities could accommodate many new labor market entrants in the region; import liberalization would allow for cheaper access to the capital goods needed for growth; and foreign direct investment (FDI) could potentially be a vehicle for technology transfer, improving productivity and growth.

But, as a number of presentations made clear, the region is having difficulty integrating. Contrasts with other countries are stark. Finland, with a population of about 5 million, has more non-oil exports than the entire MENA region, with a population of more than 300 million people. The non-oil exports of Hungary and the Czech Republic (each with populations of about 10 million people) are each also greater than those of the region. Although FDI inflows to the region have recently increased, they still account for less than 2 percent of global inflows. The combined net inflows of FDI into three East Asian countries (Malaysia, the Philippines, and Thailand) are about four times larger than those into MENA (excluding the Gulf countries). Similarly, net FDI inflows into Bolivia, Brazil, Chile, and Mexico are together also much larger, more than twenty times the inflows into the whole MENA region (excluding the Gulf countries).

Leave it to the markets?

A second problem discussed in the seminar was the region’s governance gap, with several papers arguing that governance is weaker in MENA countries than in other countries with similar income levels. The gap, deeply rooted in the postwar emergence of a preference for the role of the state to that of the market in managing the economy, manifests itself, to a large extent, in institutions that do not facilitate private enterprise. The governance gap covers a wide set of institutional quality indicators, including bureaucratic performance, rule of law, political participation, and accountability. However, there appears to be wide intraregional variation in the indicators, suggesting that some countries could potentially real-

ize substantial gains by achieving the best practice of their regional comparators. For example, Egypt or Syria could gain considerably by meeting the Tunisian standard. Neither country needs to turn into Iceland, which ranks highest in the world for institutional quality. What came out most clearly in the seminar is that leaving everything to the market is not an option: markets cannot work on an uneven playing field with large government institutions; they need a secure and predictable government framework. Therefore, clarity of property rights, contract enforcement, and the like are absolutely essential for growth.

Lackluster growth

The third problem analyzed in the seminar was the MENA region's weak growth performance over the past two decades, which was empirically shown to be rooted in poor institutional quality (the governance gap) and large governments. Poor institutional quality has impeded growth through its detrimental effect on capital accumulation and productivity, and a large public sector has hampered growth by crowding out the private sector—for example, by competing for scarce resources and establishing wages above the equilibrium in the private sector. The policy implications are clear-cut: MENA countries can raise growth by containing the scope of government and improving institutional quality.

Although a more vibrant and dynamic private sector would clearly alleviate the region's employment problem, institutional weaknesses, excessive regulations and red tape, cumbersome business procedures, and a high cost of doing business in general all hinder private sector development and the creation of firms. For example, the minimum capital required to start a business is higher than in any other region and is about five times the world average. Similarly, enforcing a contract requires, on average, 426 days, which is about 50 percent higher than the East Asian average and 60 percent

Exploring institutional reform

The seminar program explored the institutional challenges facing the MENA region; the impact of governance and institutional quality on economic growth in the region and the channels through which they affect growth; the institutional challenges and reforms needed at the micro level; strategies to improve institutions and reduce the obstacles to more rapid economic progress; and the political economy of reforms and how sustainable institutional reform can be achieved.

The views and ideas presented in this article are those of seminar participants.

For a list of participants and the texts of the papers, please see <http://www.imf.org/external/np/seminars/eng/2006/arabco/index.htm>



Creating jobs: shoppers in a mall in Bahrain.

above the industrial country level. Also, it takes 80 percent longer to import a standardized cargo of goods than it does in East Asia and 190 percent longer than in industrial countries. Participants argued that impediments exist across the spectrum of business endeavors and are complicated by weak enforcement of property rights.

A strong reform agenda

What emerged from the seminar was the sense that institutional reforms designed to reduce the cost of doing business in the region need to be accelerated and intensified. Such reforms, by enhancing efficiency, would improve productivity and growth. And, by creating an environment conducive to encouraging entrepreneurship, the reforms would elicit higher rates of both domestic investment and FDI, which should enhance the region's integration with the world economy. These reforms could take the region in the direction of increased growth rates and better absorption of the rapidly growing labor force.

Although entrenched institutions are difficult to change, seminar participants saw that change was urgently needed, and they identified trade liberalization, openness and broader access to information, and external "anchoring" (such as free trade agreements) as levers that could spur institutional change. Opening up trade forces domestic businesses to compete and to lobby for good business conditions; it also induces businesses to look for beneficial complementary partnerships with foreign companies. External trade arrangements would help in this regard. Access to information and more open economic discourse would help establish a culture of accountability. Together, these factors—by ensuring a more open, competitive, and, eventually, robust private sector—would strengthen the domestic constituency for better institutions. As many participants pointed out, however, political will and strong and competent leadership are essential to success. ■

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France's 35-hour week: benefit or straitjacket?

Since the 1950s, the number of hours worked has been declining in Europe when compared with the United States and Japan. Today, the average American works about 400 hours more a year than the average European, although there are significant differences within Europe itself. Different suggestions have been put forward to explain this trend, ranging from tight labor market regulations and strong labor unions to a stronger preference for leisure in Europe.

In France, part of the declining trend in the average number of hours worked is due to laws that limit work time. In 1998, a new law forced companies with more than 20 employees to institute a 35-hour workweek by 2000. Smaller companies with fewer than 20 employees were given until 2002 to implement the measure.

The intention of the law was to create more jobs at a time of high unemployment. But how has it worked in practice? An IMF working paper sheds new light on the French approach to job creation.

Comparing large and small firms

The only way to correctly evaluate the empirical effect of the reduced workweek on employment and welfare is by isolating its effects from myriad political, economic, and social changes that were taking place when the law was enacted. The IMF study asked if the law has succeeded in creating more jobs and if the French were enjoying the extra time off.

The working paper studied the law's effect by comparing the behavior of workers in large and small firms before and after the new rules went into effect. The approach was similar to that of medical experiments: the treatment (the 35-hour workweek) was administered to one group (large firms) and not to another (small firms). By comparing these two groups, the study was able to evaluate the effect of the treatment. It found that the law had a number of unfortunate and unintended consequences:

- The 35-hour workweek reduced rather than increased overall employment for workers directly affected by the law.
- It encouraged workers in large firms to look for second jobs and move to small firms, where the law was implemented later.



Leisure time: enjoying a drink in a street cafe in the south of France.

- Hourly wages increased in large firms compared with small firms. This increase may reflect large firms' need to compensate their employees for working fewer hours.
- There was an increase in the hiring of unemployed workers in large firms when compared with small firms after the law was enacted. This increased job turnover could be the consequence of large companies trying to keep their labor costs down.
- Employment growth in large and small firms in 2000 was running at a similar pace, which suggests that the law did not raise overall employment.
- Finally, French workers did not become happier after their workweek was reduced. Surveys measuring satisfaction and quality of life do not suggest French workers became more satisfied than their counterparts elsewhere in Europe after the enactment of the law.

In sum, the 35-hour workweek appears to have had a mainly negative impact. It failed to create more jobs and generated a significant—and mostly negative—reaction both from companies and workers as they tried to neutralize the law's effect on hours of work and monthly wages. While it cannot be ruled out that individuals who did not change their behavior because of the law became more satisfied with their work hours, simple survey measures do not show increased satisfaction. ■

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This article is based on IMF Working Paper No. 06/251, "Are the French Happy with the 35-hour Workweek?" by Marcello Estevão and Filipa Sá. Copies are available for \$15.00 each from IMF Publication Services.



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