IMFSURVEY

International Monetary Fund
VOLUME 32
NUMBER 4
March 3, 2003

www.imf.org/imfsurvey

In this issue

49 Aninat on Latin America

49 Group of Seven meets in Paris

54 Krugman on a possible depression

56 Age and economic transition

58 Why transparency matters

60 Reform priorities for CIS–7

62 Global economic linkages

and . . .

55 Recent publications

57 New on the web

58 Selected IMF rates

Aninat views Latin America at turning point, not "tipping" point

Aninat: "A turning point will come in 2003: growth will clearly resume in the region."

When IMF Deputy Managing Director Eduardo Aninat traveled to Latin America in January, he proposed a three-pronged self-help agenda for the continent that internalizes the lessons learned from the recent spate of crises. What follows are updated excerpts from remarks given at conferences at the University of Viña del Mar in Chile and at the central bank in Lima, Peru.

Latin America's economic performance has long lent itself to hyperbole, and the troubles of the past few years have been no exception to this practice. The U.K. newspaper *The Guardian* spoke of the failure of "neoliberalism, the global marketplace, and the adoption of IMF policies" in an article last November entitled "A Continent on the Edge of a Volcano." Some others have likewise expressed the view that because of the region's economic weakness of the past couple of years, Latin America is at a tipping point—a point of sudden and major policy changes in the region.

The truth may be somewhat more banal. Latin America is not at a tipping point, but at a cyclical turning *(Please turn to the following page)*

G-7 ready to respond if world economy weakens

Finance ministers and central bank governors of the Group of Seven industrial countries said at the conclusion of a meeting in Paris on February 22 that they were ready to act if the world economy weakened. The officials—referring obliquely to tensions in the Middle East and elsewhere—recognized that "geopolitical uncertainties have increased," but said their economies remained "resilient."

"We will continue to cooperate closely. If the economic outlook weakens," they said, "we are prepared to respond as appropriate." The officials said they would monitor exchange markets closely and act as needed.

Amid indications of weaker-than-expected growth in the Group of Seven economies this year, the IMF will release its six-monthly projections for the global economy on April 9, ahead of the spring meetings of the World Bank and the IMF in Washington.

French Finance Minister Francis Mer (left) speaks with U.S. Secretary of the Treasury John Snow at the Group of Seven meeting in Paris.

Ministers and governors at the Paris meeting recognized the need for higher growth and resolved to take steps to achieve it. "To this end," the statement said, "Europe is committed to accelerating labor, product, and capital market reforms to achieve a more flexible economy; Japan has reiterated its commitment to structural reforms, including in the financial and corporate sectors; and the United States is implementing action to create jobs, encourage capital formation and *(Please turn to page 53)*

Aninat proposes self-help agenda

(Continued from front page) point—moving from a slowdown induced in part by the global economic cycle to a position of recovery. So it is wrong to view recent economic performance as reflecting either the failure of policies of the 1990s or the dangers of globalization. Were it not for many of the policies put in place during the 1990s, this region might have encountered even greater turbulence during the global slowdown. And far from turning their backs on globalization as a result of recent events, countries should design national strategies "to take advantage of the potential [of globalization] and meet the requirements associated with greater integration into the world economy," as a United Nations regional agency noted in a recent report.

In Hermosillo, Mexico, Ford workers prepare auto parts for assembly.

It is wrong to view recent economic performance as reflecting either the failure of policies of the 1990s or the dangers of globalization.
—Eduardo Aninat

Global linkages

The region's economic weakness over the past two years owes much to the global cycle, particularly the slowdown in U.S. activity during 2001. In 2000, the performance of the region was, on average, only a bit below global growth. Of the 33 countries in the Latin America and Caribbean region, only two were in recession, Argentina and Uruguay. The others had modest to reasonable growth, with Brazil, Chile, and Mexico being at the top of the league in that year.

Toward the end of 2000, we came to the end of what was a very long expansion in the global economy and the United States. There was a global slowdown during much of 2001, the effects of which were of course felt in this region, which is already quite integrated with the United States through several links.

This is best exemplified by Mexico. Former Mexican President Porfirio Díaz—to whom the remark about Mexico being "so close to the United States and so far from God" is generally attributed—could scarcely have imagined that his more recent successors would launch a deliberate policy of moving the country even closer to the United States, particularly through the signing of the North American Free Trade Agreement (NAFTA). Remarkably, the correlation between 12-month changes in U.S. and Mexican industrial production has risen from under 0.15 in the pre-NAFTA era to 0.9 in recent years—a near-perfect correlation. Mexico was thus among the first to feel the effects of the U.S. slowdown; economic activity there contracted slightly in 2001. But Mexico also rebounded quickly—mirroring the pickup in the United States during 2002. In 2003, Mexico is expected to grow about 3 percent, according to the latest private sector forecasts.

Economic activity in many other countries in the region displays a similar qualitative pattern: growth slowed in tandem with the global slowdown, and there are signs of recovery again in 2003 as global conditions improve.

But the region of course needs to do more than just wait for the global recovery to lift all boats. I propose a three-part agenda of self-help for countries in the region: first, making the macroeconomic and financial framework more "crisis proof"; second, accelerating the structural reforms needed to boost growth (and—in some cases—also to help with crisis prevention); and, third, taking better advantage of globalization.

Crisis proofing

Making Latin American countries less crisis prone will require, at the very least, exchange rate flexibility (combined with inflation targeting as a monetary anchor), conservative limits on public debt, and a move away from excessive dollarization of the debt.

While exchange-rate-based stabilization regimes in the early 1990s were successful in lowering inflation, over time the regimes bred rigidities that constrained responses to internal and external shocks. They also encouraged capital inflows and balance-sheet mismatches through indirect dollarization. While economic activity initially increased as a result of capital inflows, competitiveness was undermined over time by real exchange rate appreciation. The encouragement of capital flows also undermined fiscal discipline. Similarly, the momentum of trade liberalization was undermined because of the lack of exchange rate flexibility needed to adjust to the effects. So Latin America, learning from experience, should shy away from inflexible exchange rate regimes, which, almost everywhere, have proved disastrous.

Another common vulnerability leading up to recent crises has been rising levels of public indebtedness and the currency composition of the debt. While not yet remarkably high by some international

standards, debt-GDP ratios in Latin American countries have often concealed important weaknesses. For instance, in some countries, debt ratios drifted systematically up during the 1990s, even during good times, indicating a lack of budget discipline. Moreover, a lack of credibility led to reliance on dollar-linked or dollar-interest-linked debts. And overvalued real exchange rates meant that, from a medium-term perspective, debt-GDP ratios were understated and also wrongly assessed.

Rising debt is a result of deeper weaknesses in fiscal systems. Such weaknesses include narrow revenue bases and weak collection mechanisms; rigidities in current spending (exemplified by the majority of spending that is subject to earmarking and floors); and inflexible arrangements with subnational levels of government. Fiscal structures and institutions must be improved to make policy implementation more flexible, support increased social spending, and boost long-term growth. In fact, improving institutions is now at the core of the agenda for change in Latin America.

Overcoming reform fatigue

Structural reform efforts in many key areas, such as trade liberalization and tax policy reforms, faltered in the second half of the 1990s and now need to be revitalized.

Trade integration in Latin American countries has lagged behind capital market opening. This has resulted in greater vulnerabilities, particularly in the form of very high ratios of foreign debt to exports—in particular of public debt to exports—overshadowing the generally lower ratios of foreign debt to GDP. Growth potential has been affected. The evidence suggests that countries with high trade shares grow consistently faster than those with more inward-looking trade structures. Latin American trade shares are generally half those of East Asian countries, and their long-term growth rates have also been consistently lower.

The still relatively small trade sectors of Latin American economies and concentration of exports in a few commodities amplified problems of rising external debt, fragile financing structures, and exchange rate rigidities. With exports representing a small share of GDP, large real exchange rate movements were needed to improve external positions to meet higher debt-servicing payments or other shocks, adding to concerns about maintaining external solvency. In contrast, Asian countries were able to rebound faster after their 1997–98 crises because of their open economies, which allowed for greater export responses to devaluations.

Structural reforms in trade, fiscal, and other areas will not yield their full benefits, however, unless they are accompanied by governance reforms. Widespread corruption has hampered growth and undermined support for reforms, with several Latin American countries ranked among the most corrupt in the world. Visibly reducing corruption would clearly be desirable to sustain support for the reform process, as it would add to a more fair and equitable society. The quality of foreign investment has also been shown to depend on transparency and absence of corruption. Reforms, for example in privatization, should be structured to minimize scope for illegal appropriation of the benefits. Establishing an independent and responsible judiciary is central to increasing the credibility of the rule of law and improving the environment for the operation of market forces.

A global consensus?

In an integrated world economy, countries not only need to pursue their own domestic agendas but also have to be aware of how best to capture the gains of globalization. The gains from trade are by now widely appreciated. That more trade has meant faster economic growth and higher standards of living is most clearly seen in East Asia: real incomes in Korea, for instance, have doubled every 12 years since 1960. Along with the expansion of trade, capital market integration has also advanced in recent decades. Private capital flows to emerging market and developing countries now exceed public overseas development aid many times over. Openness to capital flows, when combined with sound domestic policies, gives countries access to a much larger pool of capital with which to finance development. But the emerging consensus view—including that of the IMF—is that developing countries need to have a set of preconditions in place to benefit from financial globalization and to avoid an increased probability of a currency or banking crisis. That is why capital account liberalization is being approached with much greater caution: as the IMF's Economic Counsellor, Kenneth Rogoff, puts it, developing countries are targeting how they "can drink from the waters of international capital markets without being drowned by them."

Certainly, foreign direct investment (FDI) should be encouraged because it is more stable than other types of external finance and speeds up capital accumulation and absorption of foreign technologies. Like trade, FDI has been shown to promote economic growth. Foreign holdings of equities, while sometimes unstable, provide benefits in terms of risk sharing. And their instability may have had more to do with having

Widespread corruption has hampered growth and undermined support for reforms, with several Latin American countries ranked among the most corrupt in the world.
—Eduardo Aninat

in place rigidly fixed exchange rates than with some intrinsic property of cross-border holding of equities. The issue of restrictions, therefore, arises more in the case of debt instruments—both short-term flows (that is, hot money) and certain types of long-term flows (for example, debt payable in foreign currency or indexed to short-term domestic interest rates). Debt lacks the desirable risk-sharing properties of FDI and equity, and can make countries susceptible to reversals of sentiment, causing reversals of fortunes, and, in some cases, even to insolvency problems.

We can learn from the experience of the 1990s and of the past few years to make the region more crisis proof and to have more vigorous growth.
—Eduardo Aninat

Staying connected

International trade and cautious access to foreign capital are two important ways for developing countries to tap into the benefits of a globalized world. But, increasingly, developing countries will have to find ways to take advantage of technological advances abroad.

During the early years of the twentieth century, Latin America missed out on opportunities for rapid growth in industries such as forestry and mining that were exploited by similarly endowed countries such as Australia, Canada, the countries of Scandinavia, and—to some extent—the United States. Why? A recent World Bank study suggests two answers. First, the monopoly power created by inward-looking industrialization policies was a barrier to innovation and technological adoption. Industries preferred the guaranteed monopoly rents granted to them by government fiat to competing for profits by gaining a technological edge over competitors.

Second, human capital and networks of institutions that facilitate the adoption and creation of new technologies were deficient relative to other nations. An indication of this is the much lower percentage of engineers in Latin America than in other regions around the turn of the twentieth century. U.S. and Australian successes in mining were helped considerably by intellectual networks linking world-class mining universities and by private as well as government research efforts. Likewise, Scandinavia's excellence in forestry owed much to knowledge networks—clusters of universities and private and public think tanks that furthered productivity growth. It is perhaps not an accident that Finland's earliest pulp mill was located in a place called Nokia, today the site and symbol of the country's leadership in telecommunications. Of course, exceptions can be found in a few of the Latin American experiences.

Today's Latin America is different. Most countries in the region have moved to a clear outward orientation. And many have made new investments in improving human capital and the quality of educational institutions. Moreover, access to information technology (IT) permits countries to close the knowledge gap with advanced nations faster than was previously possible. With IT, education can potentially be delivered at much lower expense to a much wider group of people. People on the margins of domestic and international markets can be brought into the mainstream through the provision of better information and the reduction of transaction costs.

IT expenditure rose, albeit from a low base, throughout the 1990s for most developing countries and for many of them at a rate significantly greater than in advanced economies. Moreover, the rate of diffusion of IT to developing countries has been rapid compared with earlier all-purpose technologies. In short, developing countries—in Latin America and elsewhere—are making the kind of investments in IT that will enable them to stay connected.

Summing up

There is no denying that this region has had a tougher time over the past few years than many other regions. It has, of course, suffered the consequences of the global slowdown. But special factors have also been at work in some countries—for example, Argentina's disorderly exit from an exchange rate peg, along with fiscal disarray; market perceptions of policy uncertainties during an election year in Brazil in 2002; acute political strife in Venezuela; and so on. But our forecast is that a turning point will come in 2003: growth will clearly resume in the region.

Some have used the region's troubles of these past few years to argue that we should turn the clock back on the economic policies of the 1990s and on the advance of globalization during the past few decades. I have very little sympathy for such views! The 1990s were a decade of much achievement in Latin America, as many of us know and as many citizens in the region actually experienced.

Of course, no era is perfect—there are always things that could have been done better. And the 1990s, while good, were very far from the level of achievement that was required. So we can learn from the experience of the 1990s and of the past few years to make the region more crisis proof and to have more vigorous growth.

Nor should the region turn its back on globalization. Despite the vocal protests in some quarters, there is actually a consensus building about how developing countries can take advantage of globalization. Developing countries—including in Latin America—should embrace globalization wholeheartedly while adapting to it in a variety of more sophisticated ways. ■

G-7 ready to give substantial help to Africa

(Continued from front page) savings, and raise productivity growth."

Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States make up the Group of Seven; Russia also participates in some of the meetings of the group (which becomes the Group of Eight), as do representatives from the World Bank, the IMF, and the European Union.

The finance ministers and central bank governors, meeting ahead of a planned summit of the Group of Eight heads of government in Evian, France, in June, said they were implementing an April 2002 action plan to prevent and resolve financial crises in emerging market countries. Progress had been made in ensuring greater discipline through clarifying normal and exceptional access to official finance in crisis situations.

Referring to recent major IMF program cases, they welcomed Brazil's "pursuit of sound economic policies and social reforms" and looked forward to Argentina's "restoring contract enforcement and engaging in a dialogue with its private creditors" as it moved ahead with fulfilling its commitments agreed with the IMF. Also welcomed was Turkey's commitment to economic and financial stabilization as agreed with the IMF.

Complementary debt proposals

Turning to the IMF's initiative to introduce a collective framework for restructuring unsustainable sovereign debt, the finance ministers and central bank governors recognized that there were several sides to the debate and a variety of possible solutions. "We welcome the positive response of the private sector to collective action clauses and its ongoing work with the public sector on model clauses. We look forward to the early adoption of effective collective action clauses and to the discussion of a concrete proposal from the IMF on a sovereign debt restructuring mechanism at its spring meeting," the statement said. "As a complement, we welcome work on a code of good conduct based on negotiating principles. We urge the IMF to enhance crisis prevention, including by making its surveillance more effective."

Proposals to introduce collective action clauses in bond contracts got a fillip on February 24, when Mexico announced that its planned $1.0 billion bond issue would include such clauses, which allow a majority of investors to decide how to renegotiate a country's debt if it runs into difficulty in making payments. Welcoming the move, the IMF said the Mexican decision was "an important step toward establishing the inclusion of collective action clauses as a standard market practice in the New York and other markets, in line with practices long established in London and Luxembourg." The inclusion of such clauses was complementary to its proposed sovereign debt restructuring mechanism, the IMF added.

The officials did not refer explicitly in their statement to a plan proposed by U.K. Chancellor of the Exchequer Gordon Brown for a new financing facility that would double aid to the world's poorest countries to $100 billion a year by 2015. But they said that the challenge of global poverty had to be addressed vigorously.

The Group of Seven officials said they were ready to provide "substantial support to African countries that implement New Partnership for Africa's Development principles and are committed to improving governance and demonstrate solid policy performance." ■

Proposals to introduce collective action clauses in bond contracts got a fillip on February 24, when Mexico announced that its planned $1.0 billion bond issue would include such clauses.

Spotlight on combating terrorism financing

The Group of Seven industrial countries has urged the IMF and the World Bank to intensify their work in helping countries thwart the financing of terrorism. A joint IMF–World Bank interim report on this will be delivered to the spring meeting of the two institutions.

"We urge all countries to implement and enforce laws to combat the financing of terrorism," said finance ministers and central bank governors at the conclusion of their February meeting. "We will continue to provide technical assistance to countries that lack appropriate measures to combat terrorist financing. We urge the IMF and the World Bank to step up their assessments and their provision of technical assistance in coordination with the United Nations."

In November, the IMF's Executive Board approved a 12-month pilot project that would significantly advance the IMF's contribution to the international efforts to combat money laundering and the financing of terrorism. The Board added the Financial Action Task Force 40 Recommendations on an effective anti-money-laundering framework and 8 Special Recommendations on Terrorism Financing to the list of areas and associated standards and codes that were incorporated into the operational work of the IMF.

The task force is an intergovernmental body with a secretariat in Paris whose purpose is the development and promotion of policies to combat money laundering and the financing of terrorism. The Group of Seven urged the task force to foster effective action to freeze terrorist assets. "We encourage more effective oversight of informal financial institutions and charities, and we look forward to revised Financial Action Task Force recommendations by June," the statement said.

Razin lecture by Krugman

World on the verge of an economic breakdown?

Krugman: With all the major engines of growth faltering, the threat of a severe world economic breakdown cannot be ruled out.

The U.S. recovery is tepid, the recent economic figures for Europe are weaker than expected, and Japan has been in a decade-long slump. For Princeton University's Paul Krugman, the possibility that the world is on the verge of a serious economic breakdown cannot be ruled out. In a recent lecture at Georgetown University, he expressed frustration that policymakers are not acting vigorously enough to forestall the possibility of another Great Depression, even though the way to prevent one is well known.

Delivering the Razin Economic Policy Lecture, Krugman noted that early in the twentieth century, recessions were treated "very nearly as an act of God or as punishment for previous excesses." The Great Depression changed all that. It is more common now to think of recessions as, in some part, disasters of human origin that can be undone by policymakers.

Looser monetary policy needed

How did this turnaround come about? Krugman said that instead of reviewing economic history, it was more instructive to reflect on the experience of the Capitol Hill Baby-Sitting Co-op of Washington, D.C. This was an organization through which, in the 1970s, 150 couples agreed to baby-sit for one another. To keep track of who owed whom, the co-op adopted a system of "scrip"—pieces of paper each worth one-half hour of baby-sitting time. Couples could accumulate scrip by baby-sitting for others and use it later when they wanted an evening out.

In its initial days, according to Krugman, the co-op managed to work its way into a recession. There was so little scrip to go around that couples were reluctant to squander it by going out. Those who wanted to go out but didn't have scrip were desperate to get baby-sitting jobs. The couples, many of whom were lawyers, according to Krugman, tried amending the rules of the co-op to work their way out of the recession. For instance, some thought that the root of the problem was that some members were displaying antisocial behavior by not going out enough. So the co-op made a rule that everyone had to go out at least once every few months. But such legal solutions proved futile.

What was needed was the solution economists would have advocated—issuance of more scrip, or, in economic jargon, a looser monetary policy. Each member of the co-op was allotted 10 additional hours of scrip, and new members were offered more generous terms when they joined. Liberated from the fear that they would run out of scrip, couples became more willing to go out, opportunities for those who wanted to baby-sit and build up a balance of scrip increased, and the recession was over.

The economy's baby-sitters

The solution to the Great Depression of the 1930s, Krugman said, turned out to be just as simple as the solution to the recession of the Capitol Hill Baby-Sitting Co-op. In a memo to U.S. President Franklin Roosevelt, economists proposed "issuing more scrip" but this solution was dismissed as being "too easy." Ultimately, he said, the baby-sitters of economies, their central bankers and finance ministers, had to adopt looser policies to get the world economy out of the depression.

Current economic circumstances, according to Krugman, are not quite as dire as they were in the period preceding the Great Depression. Nevertheless, all the major engines of the world economy—the United States, the euro area, and Japan—are faltering, and the threat of a severe world economic breakdown cannot be ruled out. Economic policymakers in all three regions should try to eliminate this threat by easing their monetary and fiscal policies.

Krugman argued that, while policymakers had been taking the right steps, their actions had not been vigorous enough. Japan has been the worst offender. Its central bank achieved autonomy only six years ago

A family affair

The Razin Economic Policy Lecture is named in honor of Ofair Razin, who succumbed to a battle with multiple sclerosis in 1996, not long after finishing his Ph.D. in economics at Georgetown University. Ofair's father, the noted international economist Assaf Razin (see also "Assaf Razin at 60," *IMF Survey*, April 16, 2001, page 129) endowed an annual lecture in his son's memory. To date, the lecture series has featured addresses by Jeffrey Sachs, Michael Mussa, Elhanan Helpman, and Stanley Fischer.

Krugman said there was no way he could have turned down the invitation to present this year's lecture. With the presence in the audience of Assaf Razin, Georgetown's Susan Collins (and Ofair's thesis advisor), and the IMF's Robert Flood, the event was, for him, very much "a family affair."

and has been determined to follow the responsible monetary policies that would make it the "very model of a modern central bank" of the 1990s. But, at present, he suggested, "doing irresponsible things was the only responsible course of action" for monetary policy. While the Bank of Japan has, with much foot-dragging, pushed interest rates to zero, it needs to take unorthodox measures to pump liquidity into the Japanese economy.

The Europeans, Krugman added, have imprisoned themselves—rigidly following tight monetary and fiscal policies to secure their dream of a common currency. The European Central Bank is overly concerned with price stability, he said. It has not pushed interest rates down far enough even though it has room to do so. The region's fiscal institutions are a straitjacket. Something is wrong, Krugman said, when comments from the European Commission's president lead to the Stability and Growth Pact becoming widely referred to as the "Stupidity Pact."

By contrast, the U.S. government showed no fear of deficits, at least at the federal level. But Krugman questioned why the fiscal stimulus plans being considered were aimed at the longer term rather than the here and now. "Why are we stimulating the economy of 2010?" he asked. Moreover, the United States has "its own version of the Stupidity Pact"—requirements in many state constitutions that they balance their budgets year by year. Fiscal contractions at the state level are going to swamp any fiscal stimulus provided at the federal level, he reckoned.

Krugman was more favorably inclined toward the conduct of U.S. monetary policy. The Federal Reserve (the Fed) has aggressively lowered its policy interest rate to 1.25 percent. Moreover, newly appointed Fed governor Ben Bernanke signaled in a speech last year that the Fed would not hesitate to switch quickly to other methods of pumping liquidity into the economy in the event that interest rates hit zero. In that November 2002 speech, Bernanke noted that "the responsibility of preserving price stability . . . most definitely implies avoiding deflation as well as inflation"; hence, the "Fed would take whatever means necessary to prevent significant deflation in the United States. . . . The logic of the printing press example must assert itself, and sufficient injections of money will ultimately always reverse a deflation."

Krugman concluded by noting that the experience of the Great Depression had led to the discovery of a "miracle antibiotic" to ensure that the experience was never repeated. But because recessions since that time have been much milder, people have become used to using other, milder, remedies. The time has come, he said, to abandon "homeopathic remedies" in favor of the antibiotic of vigorous liquidity creation. ■

Prakash Loungani
IMF External Relations Department

For Japanese monetary policy at present, "doing irresponsible things was the only responsible course of action."
—Paul Krugman

Recent publications

Working Papers ($15.00)

03/02: "A Comparison Between Two Public Expenditure Management Systems in Africa," Ian C. Lienert
03/03: "How Much Leverage Is Too Much, or Does Corporate Risk Determine the Severity of a Recession?" Iryna V. Ivaschenko
03/04: "What Determines the Reservation Wages of Unemployed Workers? New Evidence from German Micro Data," Eswar S. Prasad
03/05: "Optimal Monetary Policy in a Small Open Economy with Habit Formation and Nominal Rigidities," Woon Gyu Choi and Yongseung Jung
03/06: "Small African Stock Markets—The Case of the Lusaka Stock Exchange," Heloisa Marone
03/07: "Currency Demand, the Underground Economy, and Tax Evasion: The Case of Guyana," Ebrima A. Faal
03/08: "What Determines the Implementation of IMF-Supported Programs?" Anna Ivanova, Wolfgang Mayer, Alexandros T. Mourmouras, and George C. Anayiotos
03/09: "Inflation Targeting Regimes," Alina Carare and Mark R. Stone

IMF Country Reports ($15.00)

03/23: Federated States of Micronesia
03/24: Nicaragua
03/25: Grenada
03/26: Grenada: Statistical Appendix

Other

Japan's Lost Decade: Policies for Economic Revival, Timothy Callen and Jonathan Ostry ($28.00)
Government Finance Statistics Manual 2001 ($50.00)

Publications are available from IMF Publication Services, Box X2003, IMF, Washington, DC 20431 U.S.A.
Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey's* annual *Supplement on the IMF*, *Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.

IMF Working Paper

The ages of economic transition

A surprisingly large share of older workers could be left worse off by market reforms that stimulated firm creation.

New firms in transition economies seem to have a strong preference for young workers, which may put older generations at a disadvantage as the private sector expands. In a recent IMF study, Svend E. Hougaard Jensen (Director of Research at the Centre for Economic and Business Research), Tobias Rasmussen (Economist, IMF European II Department), and Thomas Rutherford (Professor at the University of Colorado) explored the relationship between the rapid growth of enterprises in the former Soviet bloc countries and age-dependent changes in the distribution of income.

The average age of the members of Estonia's government cabinet is just 46; 2 of the 14 ministers are under 30. Mart Larr, the country's first prime minister following independence in 1991, was only 32 when he took office. This concentration of youth in the upper levels of the Estonian government mirrors the generational upheaval taking place in many of the former centrally planned economies, where the young often seem to have gained at the expense of the old.

The presumption that the young have benefited disproportionately is backed by developments in labor markets. In the Baltic countries, for example, new enterprises overwhelmingly tend to employ younger workers. In 1998, an employee under 30 was, on average, more than twice as likely as someone over 50 to work in a firm established after the late 1980s. Older workers have therefore not profited much from the substantially higher salaries and faster growth of the newer enterprises.

If older generations do not share the benefits of market-oriented reforms, they are more likely to oppose them. Consequently, reforms could be voted down even if the long-run benefits are clear. Jensen, Rasmussen, and Rutherford examined the link between entrepreneur-driven growth and the incomes of different age groups and found that a surprisingly large share of older workers could be left worse off by market reforms that stimulated firm creation.

Age is linked to entrepreneurship

Enterprises, some newly privatized and others created from scratch, are sprouting up all over the former Soviet bloc countries. Market-oriented reforms have boosted incentives for private sector activity, and greater integration with world markets has opened new channels for commerce and dissemination of knowledge. This has meant a boom in firm creation. The private sector now accounts for more than half of these countries' GDP, compared with about one-fourth a decade ago. This development is widely seen as being associated with a more efficient use of resources and a higher standard of living.

The introduction of free enterprise goes to the very heart of the transition taking place in the former planned economies, so it is not surprising that entrepreneurship is important. Indeed, the success or failure of a transition economy can arguably be attributed to its ability to foster private sector entrepreneurs. It is therefore important to understand what is involved in fostering entrepreneurship and the implications of market-oriented reforms for an economy.

Property rights must be protected to encourage entrepreneurs to invest. Establishing a new firm involves a fixed cost, and entrepreneurs must be confident that they will be able to recoup their cost, even if it takes years to turn a profit. Because an economy's productivity depends on the number of people who have chosen to make such investments, it takes a long time before the benefits are felt in full.

Employment patterns in new enterprises suggest that entrepreneurial capacity is linked to the age of workers. The young may be more adventurous, have skills that make them more desirable to the new firms, or be more inclined to acquire the necessary skills. In any case, it is the younger workers who stand to gain. The connection between age and entrepreneurship is evident everywhere, but especially in transition economies, where changes in the business environment have been particularly dramatic and older workers often lack the skills required in a modern workplace.

In 1998 in Lithuania, for example, 44 percent of workers 30 and younger were employed in enterprises established after 1988, compared with only 17 percent of those 50 and older. The median net wage of workers was found to be 8 percent higher in new enterprises than in old enterprises, and, for workers under 30, 9 percent higher than for the population as a whole. There is no reason to expect a much different pattern in other transition economies.

Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 49, 51, 54, 55, 58, 59, 63, and 64; Jacques Demarthon for AFP, page 49; Heriberto Rodriguez for Reuters, page 50; Jean-Paul Pelissier for Reuters, page 53; Valerii Corcimari for Reuters, page 56; and Samuel Otoo for World Bank, pages 60 and 61.

The investment aspect of firm creation and the role of the different age groups in new enterprises are both related to knowledge formation. An entrepreneur who develops a local Internet-based service and a teenager who decides to learn the latest software programming techniques are both making an investment in new knowledge. The business infrastructure of an economy is thus an embodiment of knowledge in much the same way that the skill base of its population is. In the end, what matters for economic progress is increasing the stock of productive knowledge.

Although encouraging knowledge creation, in a broad sense, is fundamental to rising prosperity, it will not necessarily benefit older people. First, older generations are unlikely to secure any of the high-paying new jobs and will not reap the benefits of higher incomes over the long term. Second, a dramatically changing economic environment may make traditional skills obsolete and reduce the value of knowledge held by older workers.

Jensen, Rasmussen, and Rutherford set up a model to analyze changes in the intergenerational distribution of income stemming from market-oriented reform and firm creation. Their results indicated that the transition to a higher income level could result not only in greater inequality but also in an absolute reduction in the income of older generations. In some cases, more than half of the initial population is made worse off by a policy that benefits all future generations.

Voting for reform

The implication that growth-enhancing policies may impose a burden on the old is quite stark. Market-oriented reforms meant to stimulate private sector activity may well be voted down, even if the reforms are widely understood as necessary for future prosperity.

An intergenerational conflict over objectives thus emerges as a likely obstacle to market reform. Older generations may fear the emergence of a dynamic private sector because they do not expect to be in a position to exploit the employment opportunities or enjoy the resulting long-term benefits. They may also find themselves sidelined by large changes in the economic environment. In general, older generations are less adaptable and therefore more likely to resist radical change than the young. These arguments may help explain why market reforms in transition economies have been slow to come and why older generations often seem to support old-guard politicians.

Jensen, Rasmussen, and Rutherford have shown that changes in the intergenerational distribution of income have played a role in hindering market-oriented reform in the transition economies. If policymakers are to secure broad support for reform, they are advised to pay attention to the concerns of both older and younger segments of the population. This could entail channeling some of the proceeds from reforms—for example, privatization proceeds or higher tax revenues—into programs designed to help those who are being made redundant by the changing economic landscape. ■

Tobias Rasmussen
IMF European II Department

Copies of WP 02/180, "Economic Transitional, Entrepreneurial Capacity, and Intergenerational Distribution," are available for $15.00 each from IMF Publication Services. See page 55 for ordering information. The full text is also available on the IMF's website.

Changes in the intergenerational distribution of income have played a role in hindering market-oriented reform in the transition economies.

Available on the web (www.imf.org)

Press Releases

03/18: IMF Completes Sixth Review of Cambodia's PRGF Program and Approves $12 Million Credit, February 20

03/19: IMF Completes in Principle Second Review Under the Three-Year PRGF and Approves Request for Waiver of Performance Criterion for the Kyrgyz Republic, February 21

03/20: IMF Staff and Uruguayan Authorities Agree on Basis of an Economic Program for 2003, February 21

03/21: IMF Staff and Bolivia Agree on Economic Framework for 2003, February 22

03/22: IMF Completes First Review and Approves $5 Million Tranche under PRGF for Albania, February 26

03/23: Arrears Clearance by the Islamic State of Afghanistan, February 27

03/24: IMF Completes Third Review of Lithuania Under Stand-By Arrangement, February 27

Public Information Notices

03/13: IMF Concludes 2002 Article IV Consultation with Cyprus, February 14

03/14: IMF Concludes 2002 Article IV Consultation with St. Vincent and the Grenadines, February 14

03/15: IMF Concludes 2002 Article IV Consultation with Maldives, February 19

03/16: IMF Concludes 2002 Article IV Consultation with Barbados, February 21

Transcripts

Press Briefing by Thomas C. Dawson, Director, IMF External Relations Department, February 13

Interview with R. Gaston Gelos and Shang-Jin Wei

Transparency may help in countering extreme volatility in emerging markets

In a crisis, investment managers tend to flee less transparent countries to a greater degree than more transparent ones
—R. Gaston Gelos

The economies of developing countries can be destabilized by the abrupt withdrawal of capital from their markets. How can emerging markets stanch such volatile outflows? Two IMF economists think they have part of the answer. R. Gaston Gelos and Shang-Jin Wei argue that greater transparency can reassure portfolio investors and make them more likely to ride out market downturns. The IMF Survey *spoke to them.*

IMF SURVEY: Why did you take up the question of transparency and investor behavior?

GELOS: There has been a lot of talk at the IMF, starting with the Mexico crisis and particularly after the Asian crisis, about the importance of transparency in preventing crises in emerging markets. The general view is that transparency should be promoted among member countries, and the IMF has also become more transparent itself. Surprisingly, there is hardly any empirical work that documents the relationship between financial market volatility, the incidence of crises, and the behavior of international investors on the one hand, and transparency on the other.

WEI: The IMF has been doing a lot of work in promoting more transparency in member countries, particularly through its Reports on the Observance of Standards and Codes (ROSCs). One of the measures of transparency in our project is based largely on information collected from the ROSCs. Our project suggests that greater transparency, as partly measured by ROSCs, has a significant impact on a country's ability to attract international investment.

IMF SURVEY: What types of transparency did you examine?

WEI: Our paper talks about three types of transparency: transparency of corporate operations, and two aspects of government transparency—the way macroeconomic information is collected and released, and the way monetary and fiscal policies are conducted. Our research findings suggest that fund managers obviously care about all three dimensions, as indicated by the fact that they seem to allocate more investment to countries that score high on transparency in each of those three dimensions.

IMF SURVEY: What is preventing countries from becoming more transparent, if it is in their own interest?

WEI: Sometimes a country may not realize the benefits of being more transparent. The IMF's work on standards and codes tries to help countries understand the value of transparency and develop the technical capacity to be more transparent. Our work shows that it is good for a country to be more transparent. This does not necessarily mean that people who are in the privileged positions of government would benefit from greater transparency. In general, countries with better governance, better institutional setups, are more likely to pursue greater transparency.

IMF SURVEY: Is there a distinction between transparency and the accuracy or credibility of information?

WEI: Transparency includes accuracy and comprehensiveness. Timely release of false information won't make a country more transparent, though it might seem to be so. It's very difficult, however, to measure the quality of information. Investors have to disentangle true information from noise. In less transparent countries, a particular piece of news would have a higher noise-to-information ratio, and people would tend to discount a given announcement.

IMF SURVEY: Why should fund managers favor transparency? Don't they gain an advantage in a nontransparent country if they have good contacts?

WEI: Transparency is a mechanism for being fair. Individual investors might have access to some privileged information, so a particular person would probably prefer to keep that information privileged, but that's bad for the country as a whole. Investors collec-

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 17	1.82	1.82	2.33
February 24	1.81	1.81	2.32

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 euro, the Japanese yen, the pound sterling, and the U.S. dollar, which 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.

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

Data: IMF Treasurer's Department

tively suffer from not having information. So what transparency does, essentially, is address the fairness question by making information available equally to all investors. By definition, only a very small number of people can have access to privileged information in an opaque environment. Most investors will choose to stay away, and the consequence for that country is that the prices of its assets will fall.

GELOS: It depends on the exact nature of the information asymmetry—what's known to whom. You could think that these fund managers are professionals in overcoming such informational barriers, and they might, in fact, benefit from them because they might be better placed than others to overcome these issues. Thus, if we find any effect of transparency on this class of international investors, it is most likely to represent the lower bound of the effect. If these fund managers dislike opacity in emerging markets, individual investors will dislike it even more. And what we find is that emerging market equity funds hold fewer assets in less transparent countries.

IMF SURVEY: Do fund managers focus more on the reporting of individual companies that they invest in or on the overall macroeconomic data of a country?

GELOS: They are interested in both. Particularly in emerging markets, country factors—the general macroeconomic situation and policies—are a big determinant of returns. A fund manager might know 100 percent about all the companies, but if the government, out of the blue, pursues some distorting policies, it will adversely affect companies' returns.

IMF SURVEY: In what way does greater transparency help during a crisis?

GELOS: Investment managers tend to flee less transparent countries to a greater degree than more transparent ones. Typically, funds are reallocated across countries.

WEI: Countries with lower transparency appear to induce international investment funds to engage in herding behavior—when funds imitate each other's trading patterns—which has been alleged to contribute to greater volatility in the market. So this suggests that greater transparency would moderate herding behavior, which, in turn, would contribute to more stable domestic financial markets.

IMF SURVEY: Herding behavior implies some irrationality in the mind of the investor, doesn't it?

GELOS: Herding can be very rational, depending on how the market first learns about some information. If every investor receives unclear information, it might be rational for individual investors to rely merely on what other investors are doing and, in the extreme, to completely disregard their own information.

WEI: Herding could be individually rational, but it is socially inefficient. Some of our work shows that herding in emerging markets, such as in Korea during the Asian crisis, goes beyond just responding to common fundamental information. This suggests that at least part of the correlated trades are likely to be due to reasons other than common information. Correlation in trading, which is a necessary condition for herding, seems to be systemically related to those countries' level of opacity.

IMF SURVEY: What should governments focus on to become more transparent for international investors?

WEI: Corporate and macropolicy transparency probably have the biggest impact on international investment behavior.

GELOS: More specifically, governments can try to follow some of the IMF's guidelines on how to make the fiscal process and the conduct of monetary policy more transparent. On the corporate side, the government can set the rules of the game for a wider range of measures—from accounting standards to the implementation of regulations for stock markets.

IMF SURVEY: What are your key conclusions?

WEI: Since the Asian crisis, many people have commented that international capital flows are very volatile, and international investors, including mutual funds and pension funds, often engage in herding and other activities. That seems to portray emerging markets as helpless, innocent bystanders who just got sucked into these volatile international capital flows. One important message of our project is that different emerging markets may very well experience different degrees of volatility of capital flows. These differences are systematically related to the countries' own characteristics, such as transparency. That has important policy implications. A developing country cannot simply say "the world outside my door is so messy that if I open up I will get into trouble." The capacity to minimize such trouble is related to a country's transparency and other policies. Therefore, we should be thinking of domestic reform to improve transparency as a crucial element in a strategy to embrace financial globalization. ■

Copies of IMF Working Paper 02/174, "Transparency and International Investor Behavior," by R. Gaston Gelos and Shang-Jin Wei, are available for $15.00 each from IMF Publication Services. See page 55 for ordering information. The full text is also available on the IMF's website (www.imf.org).

A developing country cannot simply say, "the world outside my door is so messy that if I open up I will get into trouble."
—Shang-Jin Wei

Lucerne conference

Country ownership, regional cooperation among keys to raising living standards in CIS-7 countries

Ten years after abandoning central planning, Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan—the seven poorest members of the Commonwealth of Independent States, or the CIS-7—still find themselves a long way from having the kind of economic structures and institutions needed to sustain strong growth and improve living standards. What are the priorities for the region and the international community for the future? Meeting in Lucerne, Switzerland, on January 20–22, representatives from the governments and civil society organizations of the CIS-7, multilateral organizations, donor countries, academia, and international nongovernmental organizations stressed donor coordination, good governance and country ownership of reforms, capacity building, and regional cooperation.

By the beginning of this decade, it was clear that more vigorous measures would be needed if the CIS-7 countries were to maintain the macroeconomic stability they had achieved in the 1990s, deal with mounting external debt in some countries, and spur growth and reduce poverty. The CIS-7 Initiative, as IMF Deputy Managing Director Shigemitsu Sugisaki noted in opening the conference, was born from a recognition that a new partnership would be needed to help solve the region's problems. Firm country commitments to implement needed reforms would have to be matched by the international community's readiness to provide financial and technical assistance.

Part of this initiative involves taking a fresh look at the lessons of the past 10 years—including the role of the international community—and developing a new momentum to move forward. The Lucerne conference was designed to facilitate this effort. Keynote addresses were delivered by Kaspar Villiger, Swiss Finance Minister; Yegor Gaidar, former Prime Minister of Russia and currently head of the Institute for the Economy in Transition; George Soros, head of the Soros Foundation; and Chingiz Aitmatov, distinguished author and currently the Kyrgyz Republic's Ambassador to the European Union and NATO. Academics and policy practitioners presented background papers that were discussed by senior government officials and representatives of civil society organizations. The debate crystallized into a fairly clear consensus on priorities for both country authorities and the international community.

In retrospect

What lessons can be gleaned from the CIS-7 experience to date? Among the questions participants took up were whether the international community could have done more to facilitate the transition process and whether a buildup in external debt could have been avoided. There was a clear sense that the international financial institutions—and the international community in general—had underestimated the extent of the disruption caused by the breakup of the Soviet Union and the time needed to establish the institutional capacity necessary to effectively implement reforms. Initial projections for a rapid return to growth reflected this overoptimism. Background papers criticized some aspects of the role played by the international community in the early stages of transition—notably, what form its financing took—but did not suggest any fundamentally different policy approaches for the region.

CIS-7 government representatives acknowledged the value of the policy advice, capacity building, and financial assistance their countries had received from the international financial institutions, but participants were also in broad agreement that, to make reform programs work, policymakers needed to chart their own course based on their country's experience. Gaidar argued that the true turning point for Russia's reform effort came only when country officials took the lead in designing strategies. The country's tremendous success with tax reform in recent years stands in sharp contrast, he noted, to earlier efforts that were frustrated by a lack of country ownership.

Also, as Marat Sultanov (member of parliament, Kyrgyz Republic) remarked, the international financial institutions had helped build debt as well as institutions. Indeed, the ability to borrow sizable amounts from the international financial institutions contributed to the rapid buildup of external debt in several of these countries. For energy-importing countries, an additional problem was their failure to aggressively restructure the energy sector, resulting in substantial quasi-fiscal deficits that were ultimately converted into government obligations.

Participants concluded that external debt burdens could have been eased by a financing mix more heavily tilted toward grants and concessional lending during the early stages of transition. In the absence of "soft" financing, these countries had to borrow money to avoid a further decline in living standards.

Gaidar argued that the true turning point for Russia's reform effort came only when country officials took the lead in designing strategies.

As it was, discussants noted, living standards fell sharply during the early years of transition before stabilizing in the second part of the decade.

Remaining challenges

The reform agenda for the CIS-7 countries remains challenging and critically important, especially given that long-run prospects for growth and poverty reduction depend crucially on the governments' ability to implement structural reforms. In particular, countries will need to ensure that any acceleration in growth translates into reduced poverty and improved living standards. The following reform areas have the highest priority.

Governance and institutions. Panelists agreed on the need to tackle corruption, improve governance, and strengthen ownership of the reform program. Better donor coordination, possibly through the Poverty Reduction Strategy Paper (PRSP) process, and a more focused reform agenda would also boost the reform effort.

Expenditures and revenues. All seven countries face difficult trade-offs in public expenditure, given existing financing constraints. An especially challenging task is to balance the competing needs of raising social expenditure, keeping current on external debt service, and maintaining sustainable fiscal positions. Country participants acknowledged the need to improve resource allocation and increase the efficiency of their spending, but they also appealed for enhanced donor support to help resolve their policy dilemmas. Significant improvements have been made in both tax policies and tax administration, but there is still room to broaden the tax base and administer existing taxes more effectively. Calls to reduce the tax burden were muted, perhaps reflecting a realization that there was little room for additional streamlining on the expenditure side of the budget.

Private sector development. Participants saw private sector development, with its potentially large impact on growth, as a critical item on the reform agenda. The past couple of years have seen a significant improvement in the business environment and a decline in corruption, but CIS-7 countries still lag behind the transition economies of central and eastern Europe. There was broad support for making reduced government intervention in the economy a high priority and for removing impediments to business to stimulate higher foreign investment flows to the region. As the Georgian delegation noted, countries must still change the underlying mentality to one that supports development after privatization.

Regional cooperation. CIS-7 country representatives welcomed the increased emphasis that international financial institutions were placing on regional cooperation. They cited many areas—notably trade, transport, water, energy, the environment, and the fight against HIV/AIDS and TB—where improved cooperation could yield benefits. While greater cooperation on trade has proved especially difficult, participants considered it vital because many of the CIS-7 economies are fairly small, landlocked, and a substantial distance from industrial country markets. As one step toward improved cooperation, the international financial institutions are organizing a series of regional workshops to be held later this year. The workshops will bring together technical experts to share their experiences in designing and implementing solutions to common problems in financial sector reform, tax administration, public expenditure management, and social sector reform.

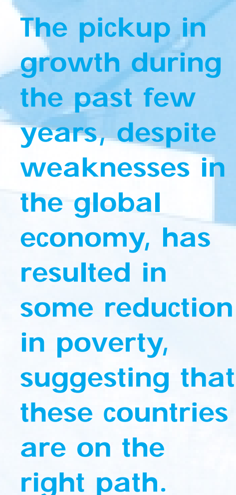
Greater access, more aid. Country representatives also insisted that stronger growth depended on external factors. They called for improved access to industrial country markets, especially the European Union (EU). Indeed, Zinaida Gracianai (Minister of Finance, Moldova) noted the need for Moldovan exports to be granted preferential access to the EU market. Participants stressed that additional donor support would be needed to help the CIS-7 countries strengthen their institutions and respond more effectively to the challenges of implementing reforms.

Long road ahead

While the conference highlighted the long road ahead for the CIS-7 countries as they sought to become full-fledged market economies and improve living standards for their people, the country delegations were broadly optimistic about the future. Indeed, the pickup in growth during the past few years, despite weaknesses in the global economy, has resulted in some reduction in poverty, suggesting that these countries are on the right path.

In closing remarks, Shengman Zhang, Managing Director of the World Bank, underscored the consensus that further concerted action was needed to enhance donor coordination and financial assistance—including debt relief where necessary—for countries following appropriate policies; improve governance and strengthen country ownership and implementation of reform programs, particularly through the PRSP process; foster capacity building to improve the design and implementation of reforms; and increase regional cooperation, especially on trade and energy. ■

Marta Castello-Branco and David O. Robinson
IMF European II Department



The pickup in growth during the past few years, despite weaknesses in the global economy, has resulted in some reduction in poverty, suggesting that these countries are on the right path.

IMF Economic Forum

Do global links call for global economic policy?

In developed markets, global industry factors now dominate country factors, whereas in emerging market countries, country factors determine more of the volatility of stock market returns.
—Stefano Cavaglia

How important are the international links associated with trade and capital flows for investors, policymakers, and international financial institutions? The answer, it seems, is very important, although the underlying economic relationships are often complex and do not suggest easy policy prescriptions. Following a two-day conference focused on the economic links between countries (see box, page 64), the IMF convened representatives from government and the private sector to discuss the policy implications of this phenomenon. The panel comprised Stefano Cavaglia, Executive Director, Equity Strategy, UBS Asset Management; Randal Kroszner, U.S. Council of Economic Advisers; and Vincent Reinhart, Director of Monetary Affairs, Board of Governors, U.S. Federal Reserve System. Anoop Singh, Director of the IMF's Western Hemisphere Department, related the discussion to Latin America's situation.

Moderator Ashoka Mody, IMF Research Department, summarized the conference results to provide a context for the policy discussion. Research shows, he said, that there has been increasing co-movement across national stock markets, and more so for the seven largest industrial countries than emerging markets. No similar trend is apparent in co-movement of real activity, however: among both developed and developing countries, the correlation of GDP growth rates has remained remarkably stable over time. Indeed, in the research literature, there is some debate as to whether the synchronization of the real economy has risen, declined, or remained unchanged.

Underlying this contrast is a corresponding contrast between the steady rise in trade between countries and the much greater increase in financial openness. Conference participants explored the explanations for and the implications of these developments in financial and trade links, including how they may be related to each other. Mody emphasized that large global shocks, such as the recent stock market bubble, could cause financial markets to move together temporarily. This should not be interpreted as a sign of greater international integration, he noted.

Global links and stock prices

Increased global links are also of concern for private financial market participants. Asset managers have asked themselves what determines stock prices—country factors or global industry factors? According to Stefano Cavaglia, in developed markets, global industry factors now dominate country factors, whereas in emerging market countries, country factors determine more of the volatility of stock market returns. Over time, however, industry factors are becoming more closely correlated internationally. Thus, the technology sector is increasingly behaving like the same sector in the developed and emerging market countries. Are stock price movements linked to fundamentals? Cavaglia said they were. "The fundamentals are very much in line with the prices that we see in the marketplace." If asset prices provide information about productive capital, he said, they may also provide information about employment. Thus, sector share price indices in the move toward globalization would be a good leading indicator for sectoral unemployment—something that policymakers can act on.

Lessons for macroeconomists

Vincent Reinhart, speaking as a macroeconomist and not as a U.S. Federal Reserve official, outlined what he thought a macroeconomist should have learned from the conference. He addressed three issues—financial openness and the volatility of real GDP, differences in corporate governance internationally, and the way increased financial links affect monetary policy–makers in the country at the core of the global financial system—that is, the United States.

Noting that the volatility of GDP growth in the United States started to decline in 1982, Reinhart said that a macroeconomist would attribute the decline to changes in investment behavior, changes in purchases of durable goods, and different cycles in the auto industry. That spin, he said, centers on the U.S. experience and does not explain why the drop in volatility is even more evident in world GDP. He noted it was also possible that the deepening of financial markets might explain the reduced volatility of real GDP growth. But that might be true only for mature countries with developed financial infrastructures, whereas emerging market countries may be more prone to financial crisis. This raises the question of whether there is something about the structure of the markets that might indicate that some countries can reap the macroeconomic benefits of tighter financial linkages while others cannot.

Discussing corporate governance, Reinhart noted the differences between countries at the core of the global financial system and those at the periphery. The latter face a local cost of funds that is much higher than their world cost and will thus invest less capital. This runs counter to theory, which says that, as an economy opens, the cost of funds falls from high local

to lower global rates—increasing the capital stock and making emerging markets better off. But the volume of capital flows from the core to the periphery is inadequate in light of the latter's large development needs, according to Reinhart. Suppose, he said, that there is more managerial misuse of borrowed funds at the periphery, which adds to the cost of total capital. When the periphery opens up, the capital stock will be lower, suggesting the need for improved corporate governance at the periphery, as well as international codes and standards to establish best practices.

Finally, Reinhart asked whether U.S. monetary policy lost its effectiveness as global financial links increased. It's difficult to predict how international monetary arrangements are affected, he said, but under either fixed or floating exchange rates, U.S. economic conditions are more likely to be influenced by foreign factors. The Federal Reserve will have to gauge the effects of those influences on U.S. activity and inflation and set its policy accordingly. For economies at the periphery, U.S. monetary policy has always been an important influence and, thus, "increasing global financial linkages provide no reason for a major change in the conduct of policy" in emerging market countries.

Lessons for Latin America

Anoop Singh discussed the effect of closer economic links on Latin America. While noting that the IMF generally made the case for liberalization (trade, capital account, and capital market) with reference to its impact on efficiency and growth, he said that the *balance* between trade and capital integration had implications for countries' vulnerability and susceptibility to crises. And the balance in Latin America is different from that observed in some other regions, with Latin America much more open to capital than to trade.

As a result, Singh said, although the debt-to-GDP ratios in Latin America do not appear to be out of line with those in other parts of the world, the ratios of debt to exports (especially public debt to exports) are much higher—a clear indicator of vulnerability. As for the policy implications of this imbalance, Singh said that, as exchange rates adjusted, Latin America could have difficulty mustering the type of export-led recovery that occurred in East Asia. Latin American economies could also have difficulty managing fiscal sustainability because of the possible effect of exchange rate changes on revenues and spending in government budgets.

What, then, is the next step? It is clear, Singh said, that there needs to be more focus on trade liberalization, which has been shown to improve economic efficiency and stimulate growth. Moreover, industrial countries can play an important role in increasing market access. It is also clear that economies cannot make radical changes overnight. Overall, Singh said, these considerations suggest that it will take time for some countries in Latin America to recover fully from their current difficulties. [For more on Latin America's prospects, see remarks by IMF Deputy Managing Director Eduardo Aninat on p. 49.]

From left, Economic Forum panelists are Anoop Singh, Ashoka Mody, Randal Kroszner, Stefano Cavaglia, and Vincent Reinhart.

U.S. report looks at other countries

Randal Kroszner spoke of the 2003 *Economic Report of the President*, which discusses for the first time the role of U.S. policies in assisting economic development.

He noted that, in emerging market countries, global linkages might either cause instability, which could harm growth, or provide greater integration, which could promote growth. In connection with the increase in capital flows, a theme raised by Reinhart, he reiterated that countries at the periphery had to establish good governance and the rule of law, without which capital would not flow to them. Reviewing numbers for trade and GDP, Kroszner noted that world merchandise trade volume had nearly quadrupled since the mid-1970s—an increase from about 15 percent of world GDP to about 25 percent—and that participation in this more extensive trade would help reduce instability and foster growth.

Revisiting the subject of monetary policy and inflation, also discussed by Reinhart, Kroszner noted that inflation had come down over the past decade. Despite fears of explosive inflation in Russia, Brazil, and Argentina as these countries grappled with financial difficulties, none of them experienced anything close to historical episodes of hyperinflation. The reasons, he said, are greater currency competition––attributable to globalization––and technological innovations that make it easier to switch large sums of money between currencies and between countries. Kroszner also agreed with Reinhart that U.S. monetary policy was having a greater effect worldwide; it has become more difficult for countries to deviate too far from U.S. inflation levels. Ultimately, he said, "we can push for greater trade openness, because . . . . it sets in motion a virtuous circle in terms of the politics as well as the economics." ■

Laura Wallace
Editor-in-Chief
Sheila Meehan
Senior Editor
Elisa Diehl
Assistant Editor
Jeremy Clift
Assistant Editor
Christine Ebrahim-zadeh
Assistant Editor
Natalie Hairfield
Assistant Editor
Maureen Burke
Editorial Assistant
Lijun Li
Editorial Assistant
Philip Torsani
Art Editor/Graphic Artist
Julio R. Prego
Graphic Artist

Prakash Loungani
Contributing Editor

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 22 times a year, plus an annual *IMF Survey Supplement* and an annual index. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Text from the *IMF Survey* may be reprinted, with due credit given, but photographs and illustrations cannot be reproduced in any form. Address editorial correspondence to Current Publications Division, Room IS7-1100, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to imfsurvey@imf.org. The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged $79.00 annually. Apply for subscriptions to Publication Services, Box X2003, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

Increased economic links have broad policy implications

On January 30–31, the IMF hosted a conference in Washington, D.C., to explore how economic linkages across countries had changed in recent years and what implications these changes had for policymakers in developed and emerging markets. Academics, IMF staff, and policymakers from around the world attended the conference.

Kenneth Rogoff, IMF Economic Counsellor and Director of the Research Department, opened the conference by noting that countries had become increasingly interconnected through trade and financial linkages but that the impact of these linkages on the international transmission of shocks was not yet well understood. In particular, he noted that the implications of these linkages for co-movement across financial markets and for the synchronization of business cycles were often ambiguous in theory, so that a better understanding of the empirical stylized facts on financial and real co-movement was critical.

Papers by Robin Brooks (IMF) and Marco Del Negro (Federal Reserve Bank of Atlanta); Kristin Forbes (MIT) and Menzie Chinn (University of California, Santa Cruz); and Will Goetzmann (Yale School of Management), Lingfeng Li (Yale University), and Geert Rouwenhorst (Yale School of Management) examined the link between financial markets and the real economy. These papers drew their motivation from the recent rise in co-movement across national stock markets. Until the mid-1990s, the correlation coefficient of U.S. stock returns with returns in other developed countries was on the order of 0.4. Since the mid-1990s, however, it has increased substantially, rising to 0.9 in the past two years. All three papers explored the extent to which changes in stock market correlations were linked to real (trade) and financial linkages (capital flows) across countries.

Brooks and Del Negro quantified the firm-level link between international stock market co-movement and the degree to which businesses operated internationally. Their results suggest that a firm that raises the international component of its total sales by 10 percent increases its exposure to global stock market shocks by 2 percent and reduces its exposure to country-specific stock market shocks by 1.5 percent. This is the first time that such a large and significant firm-level link has been found—a result they attributed to a new way of addressing measurement error in the data and a novel estimation approach. Their results suggest that the increasingly global nature of businesses is indeed an important contributor to the recent rise in international stock market co-movement.

The work of Forbes and Chinn, which was based on more aggregate-level data, bore out this finding. They indicated that bilateral stock market correlations had historically been hard to explain in terms of cross-country linkages, such as bilateral trade, bank lending, and foreign direct investment. However, they found that the importance of bilateral trade had increased in recent years, a result paralleling the firm-level evidence of Brooks and Del Negro.

Kristin Forbes

At much longer horizons, Goetzmann, Li, and Rouwenhorst observed that there was a positive association between co-movement across national stock markets and the depth of international linkages. They identified historical episodes during which cross-country linkages were important and found that co-movement in international stock returns was, on average, higher during periods of capital market integration.

The conference also explored the nature of financial linkages at high frequency and investigated the role that these linkages played in the transmission of shocks to emerging markets. Graciela Kaminsky (George Washington University) and Carmen Reinhart (IMF) examined the transmission of extreme stock returns in mature markets to developing countries and found that returns in emerging markets were particularly strongly affected through their regional financial centers. Papers by John Griffin (Arizona State University), Federico Nardari (Arizona State University), and Rene Stulz (Ohio State University) and by Hali Edison (IMF) and Francis Warnock (U.S. Federal Reserve Board) examined equity flows to developing countries and holdings of emerging market stocks, respectively, finding that the global business cycle, cross-listings, and American depositary receipts (ADRs) played an important role in determining equity positions in emerging markets.

Finally, the conference focused on long-term factors that were causing business cycles and financial markets to become increasingly synchronized across markets. On that subject, Jean Imbs (London Business School) argued that the rise in business cycle synchronicity was due in part to closer alignment of sectoral composition across countries, while Ayhan Kose (IMF), Chris Otrok (University of Virginia), and Charles Whiteman (University of Iowa) reported that global co-movement in real activity across developed countries had increased substantially from the 1960s to the 1990s. Andrew Karolyi (University of Chicago) reported that such financial innovations as ADRs were an important institutional factor in easing access to capital markets for firms in emerging markets, although he noted there was also a risk of hollowing out of these markets as the biggest and most liquid stock left for larger exchanges.

Ashoka Mody and Robin Brooks
IMF Research Department
and Kristin Forbes, MIT

For additional coverage of some of the conference papers and the associated forum, see the *Financial Times*, February 4.