

IMF SURVEY

International
Monetary Fund
VOLUME 33
NUMBER 7
APRIL 12, 2004

www.imf.org/imfsurvey

IMF–World Bank spring meetings

Ministers to focus on sustaining global recovery

When the world's top financial officials meet at the IMF's headquarters on April 24, a strengthening global economy will provide the backdrop for discussions on sustaining the recovery, sharpening IMF surveillance, strengthening the prevention and resolution of crises, and enhancing IMF support for low-income member countries.

Under the chairmanship of U.K. Chancellor of the Exchequer Gordon Brown, the International Monetary and Financial Committee (IMFC)—whose 24 governors represent constituencies or groups of countries corresponding to the IMF's Executive Board—is expected to stress the opportunities that a growing global economy can present. In this context, the IMFC is likely to examine the concerted and collabo-

orative steps that can be taken to give solid momentum to the recovery, manage risks more effectively, and bolster country resilience.

More specifically, IMFC discussions are expected to follow up on issues raised during the 2003 annual meetings in Dubai and to set out an agenda for the

lead-up to the 2004 fall meetings in Washington, D.C. Among the topics likely to be reviewed are improvements in the tools used to assess policy and conduct IMF surveillance, progress in identifying vulnerabilities early, and measures that could be

taken to better define the IMF's role in low-income countries, including a proposed debt sustainability framework. In addition, there will be progress reports on efforts to combat money laundering and the financing *(Please turn to the following page)*



Interview with Mark Allen

IMF needs to do far more to help countries learn from each other's successes and failures



Allen: "We still need to achieve a stronger internal consensus on the role of IMF financing in crisis resolution—that is, when it's appropriate for us to intervene."

Mark Allen, a U.K. national, took over the reins as Director of the IMF's Policy Development and Review (PDR) Department in December 2003. After joining the IMF in 1974, he gained experience with member countries worldwide, serving chiefly in PDR (and its earlier incarnations), but also doing stints in the African Department and as Senior Resident Representative in Poland and Hungary. Laura Wallace spoke with him about the IMF's efforts to inject more stability into the global economy by better staving off financial crises and resolving those that do occur more quickly and less painfully.

IMF SURVEY: At last year's Annual Meetings, the IMF was called upon to improve the quality, effectiveness, and persuasiveness of its surveillance. Anything to report?

ALLEN: We've been making a major effort to strengthen our annual consultations with member countries, bringing in a number of new elements—the balance sheet approach; a greater emphasis on the financial sector, drawing on internal vulnerability exercises; standards and codes of best practices; and more analysis *(Please turn to page 99)*

In this issue

97
Spring meetings
preview

97
Mark Allen on
financial crises

98
IMF, ECOSOC
officials to focus on
Monterrey follow-up

102
Keeping debt
sustainable in low-
income countries

104
April World Economic
Outlook on industrial
country reforms

107
Global Financial
Stability Report

109
Botchway on
rethinking
development

111
Robert Shiller on
what motivates
economic behavior

and...

101
New on the web

102
Recent publications

110
Selected IMF rates

Debt sustainability on spring meetings agenda

(Continued from front page) of terrorism; initiatives on crisis resolution; developments on IMF quotas, voice, and representation; and the activities of the Independent Evaluation Office. A press conference by Acting Managing Director Anne Krueger and IMFC Chair Gordon Brown will conclude the IMFC proceedings.

The IMFC meeting will be followed on April 25 by a session of the Development Committee—a joint committee of the IMF and the World Bank governors. The Development Committee agenda is expected to be topped by the Global Monitoring Report on progress made toward achieving the UN Millennium Development Goals (MDGs). The discussion, which is scheduled to be chaired by Trevor Manuel, South

Africa's Minister of Finance, is likely to also take up the background paper "Education for All" and a report on financing modalities for the MDGs. The Development Committee, like the IMFC, is expected to discuss the proposed framework for long-term debt sustainability for low-income countries.

A number of events will take place in advance of the formal IMF–World Bank spring meetings. Among these are the release, on April 21, of the IMF's latest *World Economic Outlook* and, on April 23, the meeting of the ministers of the Group of 24, representing developing countries, under the chairmanship of Conrad Enill, Trinidad and Tobago's Minister of Finance.

For additional information about the spring meetings, please see the IMF's website (www.imf.org). ■

IMF and ECOSOC officials refine agenda for Monterrey Consensus follow-up



Among those attending the preparatory meeting from the IMF were, left to right, Executive Director Willy Kiekens, Deputy Managing Director Agustín Carstens, IMF Special Representative to the UN Reinhard Munzberg, Executive Director Nancy Jacklin, Senior Advisor to Executive Director Siradiou Bah, and Executive Director Moises Schwartz.

On March 23, a delegation of UN Economic and Social Council (ECOSOC) ambassadors met with members of the IMF's Executive Board, management, and senior staff to discuss the format and specific themes of a formal April 26 meeting that will also involve the World Bank, the World Trade Organization, and

representatives from other agencies and civil society. The formal meeting, which will take place at UN headquarters in New York and is the seventh such annual gathering, will this year focus on bolstering implementation of the Monterrey Consensus—commitments made in 2001 for developing countries to improve macroeconomic and financial policies and for the international community to mobilize more international resources for the fight against poverty.

The informal preparatory session heard first from Finnish Ambassador Marjatta Rasi, President of ECOSOC, who explained that the theme of the April meeting—"Coherence, Coordination, and Cooperation in the Implementation of the Monterrey Consensus"—took its inspiration from the UN General Assembly's desire to ensure effective follow-up to commitments made in Monterrey, Mexico. The April meeting will focus on three specific issues: the impact of private investment and trade in development financing, the role of multilateral institutions in reaching the UN Millennium Development Goals, and debt sustainability.

The IMF participants confirmed that Deputy Managing Director Agustín Carstens and a broad representation of Executive Directors will attend the April 26 meeting. They also emphasized that cooperation between the IMF and ECOSOC—and the United Nations more broadly—should continue to be pragmatic and mutually supportive, with each institution focusing its energies on its own area of expertise and specific mandate. The coordination of postconflict efforts in Burundi and Guinea-Bissau—in which the United Nations took the lead in addressing political and security concerns, and the IMF and the World Bank contributed to broader efforts to restore economic stability and growth—was seen as an example of effective cooperation.

The ECOSOC President will produce a summary of the outcome of the April meeting; this will be posted on the ECOSOC website (<http://www.un.org/esa/coordination/ecosoc>).



Finnish Ambassador and President of ECOSOC Marjatta Rasi addresses the informal meeting. To her right is Bhutan Ambassador and Vice President of ECOSOC Daw Penjo.

IMF's new tools for crisis prevention

(Continued from front page) of the impact of a country's policies on others in a given region. All of these elements give countries the tools to become more resilient to crises. In addition, there have been a number of calls for the surveillance process to take a fresh look at countries' policies, particularly those countries that have had IMF arrangements over an extended period of time. It also would be helpful if we could better disseminate our knowledge of the experiences of other countries in our surveillance.

IMF SURVEY: Can countries, in fact, learn from each other, or do they really learn only from their own mistakes? What should be the IMF's role in disseminating lessons learned?

ALLEN: Confucius said there are three ways to learn wisdom: "First, by reflection, which is noblest; second, by imitation, which is easiest; and third, by experience, which is the bitterest." Now, can countries learn from others? I think it has to be a tenet of faith of the IMF that they can. We sit on this wealth of experience, and we can be fairly criticized for not utilizing it more effectively in our surveillance process. Would countries actually listen? Countries are unique, but it is up to the mission chief to be effective in explaining that there are things to be learned from the way other countries have tackled similar problems—both their successes and their mistakes. Very often we do find receptive ministers of finance and central bank governors who are wrestling with problems they know others have faced, and they look to us for that experience. This is something that we ought to do far more of—it should be a more central feature of our surveillance work.

IMF SURVEY: You mentioned a new "balance sheet" approach to analyzing countries' economies. What does this mean in plain English?

ALLEN: The nature of financial crises has changed over the past 15 years, so we've been trying to understand better the genesis of these crises—what causes them, how they unfold, and what you can do to prevent them. The key element is that these are crises in which creditors lose confidence in some part of the debtor economy. It may be that they lose confidence in the solvency of the government. They may lose confidence in the banking system. They may lose confidence in the corporate sector's ability to pay its debts. The balance sheet approach complements our traditional approach of looking at the flow variables in the economy—how the economy is moving over time—with one that looks at the strength of the various balance sheets in the economy and how these interact. And if some

balance sheets are weak and creditors lose confidence in these sectors, what impact will this have on other sectors? This approach improves our capacity to understand the course of a crisis and provides some framework for vulnerability analysis, so that we can strengthen our ability first to prevent and then to intervene effectively in crises.

IMF SURVEY: Have we used this new approach for a country?

ALLEN: Yes, in a number of recent cases—such as Ecuador, Peru, and Thailand. Indeed, this new approach has helped give useful insight into these countries' situations. It's part of a more general process to understand financial stability, and we see most of the industrial countries now producing financial stability reports of one sort or another. What we are doing is trying to formalize and generalize this process for a broader part of the membership, especially emerging market economies.

IMF SURVEY: How about crisis resolution? Is there anything new to report?

ALLEN: We still need to achieve a stronger internal consensus on the role of IMF financing in crisis resolution—that is, when it's appropriate for us to intervene. Part of the problem is the absence of a consensus at the Executive Board on this issue. We've been trying to improve our analytical tools, including better debt sustainability analyses and clearer procedures for exceptional access—that is, cases when individual countries need to draw very large amounts. There will always be risks in IMF lending, but we need a better handle on the risks we are taking—the timing, the size of packages, and the policy measures that are required, particularly to regain creditor confidence.

As for crises where there needs to be a speedy resolution of debt difficulties with creditors, we've made some progress in the area of collective action clauses. These clauses are now being used more widely. The debate on the Sovereign Debt Restructuring Mechanism [SDRM] has been shelved for the time being. We'll have to see, as we gain more experience—and obviously Argentina's negotiations with its creditors are going to be a key source of experience—what more needs to be done.

A speedy agreement with creditors is very helpful to the country, and I see no reason for reversing that judgment yet. What we're seeing in Argentina, as time moves on, is more litigation of one sort or another. This split in the creditor community may not bode well for a speedy and comprehensive resolution of that country's debt problems.

Very often we do find receptive ministers of finance and central bank governors who are wrestling with problems they know others have faced, and they look to us for that experience.

—Mark Allen

We believe that the single most important thing that could be done to help foster the development process is further trade liberalization by both rich and poor countries under the Doha Round.

—Mark Allen



IMF SURVEY: In Argentina's case, would an SDRM have made a difference?

ALLEN: The SDRM would have provided a framework for expectations on how the problem would be resolved. But it would be an illusion to think that such a mechanism would have resolved all of Argentina's problems with its creditors.

IMF SURVEY: In recent years, there has been a proliferation of initiatives aimed at helping low-income countries—a rethought concessional loan facility, poverty reduction strategy papers [PRSPs], enhanced debt relief for the heavily indebted poor countries, post-conflict strategies, and, now, a new debt sustainability framework. Do these add up to a coherent role for the IMF in low-income countries?

ALLEN: I certainly hope so. The IMF is deeply involved in its developing member countries. The IMF clearly has a role in helping countries improve the quality of their policymaking, strengthening some of the fundamental institutions for managing the economy, and helping them integrate sound macroeconomic and stable financial policies with strategies for development and poverty reduction. In other words, ensuring the consistency of this policy set.

The IMF also has a financing role, but not to finance development itself. Rather, it's to help countries get through difficult periods, especially outside shocks—thereby saving the country from being forced into an adjustment that may very well worsen poverty and retard development. At the same time, however, we have to recognize that these countries—especially the poorest of them—have very limited capacity to service debt. While the IMF has concessional resources, they cannot be made sufficiently concessional for these most fragile countries. Rather, these countries need to mobilize other forms of financing, particularly grants.

IMF SURVEY: What is the IMF doing to convince countries of the merits of trade liberalization?

ALLEN: We believe that the single most important thing that could be done to help foster the development process is further trade liberalization by both rich and poor countries under the Doha Round. We have been concerned about the stalling of the round, and as you know our former Managing Director and the President of the World Bank have written to heads of government around the world with some proposals for reinvigorating it. Some countries are concerned that if liberalization takes place under this round, they may suffer at least a temporary worsening in their balance of payments. For that reason, the IMF recently agreed on a "trade integration mechanism," which will

enable it to support countries that face loss of preferences in the multilateral trade liberalization process.

IMF SURVEY: You've worked at the IMF for a long time now. What do you think are its greatest strengths and weaknesses?

ALLEN: One strength is an institutional structure that allows the IMF staff to have a regular dialogue with member countries. A second strength is the dedication and quality of the staff. A third is that when there is a crisis, we move really quickly. On the weakness side, the flip side of the last strength is that without a crisis in a member country, things do take quite a long time to change. Another weakness is that staff are a bit inward looking, with a "not invented here" syndrome—in other words, we're not always as open as we could be to work being done elsewhere. We could strengthen our work with a better understanding of some of the insights that political science and anthropology afford.

IMF SURVEY: The IMF is often criticized for being either too soft or too tough, and sometimes even a bit of both with the same country at different points in time. Do you think this is true?

ALLEN: We certainly make mistakes. Sometimes we make mistakes by being too tough, sometimes by not being tough enough. The real temptation is to be not tough enough, even if you have a clear goal in mind. Certainly, there are significant pressures to accommodate. That might occur because of an identification of IMF staff with the country policymakers and a very real appreciation of the difficulties those policymakers are facing. But the IMF's effectiveness isn't judged on the basis of its empathy with policymakers but on whether it has supported policies that worked and not those that failed.

IMF SURVEY: From the vantage point of a department responsible for evaluating and formulating the IMF's policies and procedures, what do you think of the external Independent Evaluation Office's [IEO] first three reports? Are the recommendations changing the way the IMF goes about its business?

ALLEN: The reports are very good for us. They have been very well researched and are very professional. For a small staff, the IEO has done an extraordinary job. In some cases, it's given a new spin to problems by asking questions that IMF staff find it awkward to ask. In other cases, it's highlighted things that we already knew, spurring us into action where we might have let matters rest. For example, the study on prolonged use of IMF resources reinforced the idea that surveillance should take a fresh perspective on coun-

tries' problems. As a result, we've established a system of ex post assessments after a number of years of prolonged use, which has great potential for improving the quality of our decision making. Another case has been the fiscal report, which noted that we were often not sufficiently clear about how the fiscal adjustment in a program fitted into the macroeconomic objectives. This was a justified criticism. In other areas, the IEO has reminded us about the overoptimism of the growth projections in IMF program documents, and this is a matter that we're planning to take up in our conditionality review.

IMF SURVEY: Over the past three years, Brazil, Turkey, and Argentina accounted for over two-thirds of general borrowing from the IMF. Does the IMF have sufficient resources to cope with future threats to the stability of the international financial system? Does this concentration put the IMF at the mercy of its biggest borrowers? Some critics argue that Argentina has been able to exploit this apparent weakness.

ALLEN: It's a very expensive business to help emerging markets through capital account crises, and this has led to very large exposures of the IMF to several countries—currently, Argentina, Brazil, Turkey, and, for the size of its economy, Uruguay. At the moment, we do have the resources to handle crises in middle-income countries. But global financial stability depends on far more than just what happens in these countries, and we don't have the financial resources to handle crises in industrial countries or, more broadly, in world markets. What can we do about the

IMF's very high exposure to a few countries? One thing is to improve our decision making when such an operation is contemplated. While we have to be careful, we can't let our lending operations and our conditionality be held hostage to a fear of arrears. For that reason, we also need to have adequate precautionary balances, which is why the Executive Board recently decided to increase these balances.

IMF SURVEY: Looking ahead, what do you think should be the IMF's top priorities?

ALLEN: There are three top priorities for the IMF in my view. The first is to monitor vulnerabilities in the world economy, in the financial system, and individual countries and come up with concrete proposals for actions to correct vulnerabilities. This is where a better dissemination of experiences fits in. The second is to improve the effectiveness of our crisis intervention—whether it be through improving how IMF financial assistance is provided or trying to ensure that mechanisms exist for getting debtors and creditors to resolve their problems quickly.

Following the upcoming spring meetings, we plan to discuss the role that precautionary arrangements can play in preventing capital account crises and the access that is required for this insurance to be meaningful. In other words, we'll be looking for a successor to the recently ended Contingent Credit Line Facility. The third is to help create the conditions for development and achieving the Millennium Development Goals, which requires close integration with donor countries in supporting the PRSP process. ■

The IMF recently agreed on a "trade integration mechanism," which will enable it to support countries that face loss of preferences in the multilateral trade liberalization process.

—Mark Allen

Available on the web (www.imf.org)

Press Releases

- 04/59: IMF Executive Board Completes Sixth Review of Brazil's Stand-By Arrangement, March 26
- 04/60: IMF Mission Statement on Discussions in Serbia and Montenegro, March 29
- 04/61: IMF Acting Managing Director Krueger Proposes Rob Edwards as Director of the IMF's Statistics Department, March 29
- 04/62: IMF Approves 12-Month Stand-By Arrangement for Ukraine, March 29
- 04/63: IMF Completes Review Under Benin's PRGF Arrangement and Approves \$2 Million Disbursement, March 29
- 04/64: Statement by the G-11 Executive Directors of the IMF on the Selection Procedures for Appointing the IMF Managing Director, March 31
- 04/65: IMF Executive Director Shaalan Nominates Three Candidates for the Post of Managing Director of the IMF, March 31

PRGF=Poverty Reduction and Growth Facility

- 04/66: Statement on the Second Forum on Poverty Reduction Strategies for the Balkans, March 31
- 04/67: IMF Statement on the Conclusion of 2004 Article IV Consultation Discussions with Zimbabwe, March 31
- 04/68: Kiribati Formally Begins Participation in the IMF's General Data Dissemination System, April 1
- 04/69: IMF Staff Statement on the Delay in the Completion of the Fourth Review of Azerbaijan Republic's PRGF Arrangement, April 1
- 04/70: IMF, World Bank Enhance Efforts at Combating Money Laundering, Terrorist Financing, April 2
- 04/71: IMF Executive Board Completes Second Review of Jordan's Stand-By Arrangement, April 2

Public Information Notices

- 04/23: IMF Concludes 2003 Article IV Consultation with Djibouti, March 19
- 04/24: IMF Concludes 2003 Article IV Consultation with Portugal, March 22
- 04/25: IMF Concludes 2003 Article IV Consultation with Jamaica, March 23

Keeping debt sustainable in low-income countries

Low-income countries face significant challenges in meeting their development objectives, notably the UN Millennium Development Goals (MDGs). A key prerequisite for achieving the MDGs is maintaining debt sustainability, and that, in turn, requires an early, proactive strategy. A paper jointly prepared by the staffs of the IMF and the World Bank “Debt Sustainability in Low-Income Countries” proposes an operational framework, addresses these needs, and weighs policy implications for the two institutions, for other creditors and donors, and for the low-income countries themselves. On the side of the donors, financing will need to be provided on increasingly concessional terms—with a substantial shift toward grant financing—to reduce the risk of renewed debt distress. For the low-income countries themselves, the framework highlights the need to strengthen policies and institutions to make more effective use of official financing. The IMF’s Executive Board discussed the paper, and a recently released IMF Public Information Notice (PIN) summarizes that discussion. Below are background on the issue and excerpts from the PIN.

Although low-income countries are a diverse group, most rely mainly on official financing. Nevertheless, excessive debt in low-income countries poses serious problems. A debt overhang may undermine urgently needed progress on policy reforms and discourage private investment. And lenders may be

forced to allocate scarce concessional resources to keep high debtor countries afloat, often at the expense of other deserving countries.

Donors and creditors can help low-income countries achieve debt sustainability, but the primary responsibility lies with the countries themselves. As they strive to reach the MDGs, low-income countries will need to preserve debt sustainability by keeping new borrowing in step with their ability to repay, adopting better policies and institutions that help accelerate growth, and gradually increasing resilience to exogenous shocks.

What the IMF–World Bank paper proposes is a framework that aims to guide the borrowing decisions of low-income countries in a way that matches their need for funds with their current and prospective ability to service debt. At the same time, the framework also provides guidance for the lending and grant-allocation decisions of official creditors and donors. It is designed to serve as a forward-looking analytical tool beyond the Heavily Indebted Poor Countries (HIPC) Initiative and will have no bearing on the implementation of the initiative itself.

Main elements of proposed framework

The proposed debt sustainability framework is based on two pillars: an analysis and careful interpretation of actual and projected debt-burden indicators in a

Recent publications

IMF Working Papers (\$15.00)

- 04/29: “Inflation Dynamics in the Dominican Republic,” Oral Williams and Olumuyiwa S. Adedeji
- 04/30: “Fiscal Sustainability in Heavily Indebted Countries Dependent on Nonrenewable Resources: The Case of Gabon,” Joseph Ntamatungiro
- 04/31: “Imperfect Capital Mobility in an Open Economy Model of Capital Accumulation,” Vladimir Klyuev
- 04/32: “The Decentralization Dilemma in India,” Catriona M. Purfield
- 04/33: “An Option-Based Approach to Bank Vulnerabilities in Emerging Markets,” Jorge Chan-Lau, Arnaud Jobert, and Janet Kong
- 04/34: “The Determinants of International Portfolio Holdings and Home Bias,” Hamid Faruquee, Shujing Li, and Isabel K. Yan
- 04/35: “Liberalized Markets Have More Stable Exchange Rates: Short-Run Evidence from Four Transition Countries,” Ales Bulir

- 04/36: “China: International Trade and WTO Accession,” Thomas R. Rumbaugh and Nicolas R. Blancher
- 04/37: “Competitiveness in Bulgaria: An Assessment of the Real Effective Exchange Rate,” Dimitar Chobanov and Piritta Sorsa
- 04/38: “The Political Economy of Conditional and Unconditional Foreign Assistance: Grants vs. Loan Rollovers,” Alexandros T. Mourmouras and Wolfgang Mayer
- 04/39: “Autocorrelation-Corrected Standard Errors in Panel Probits: An Application to Currency Crisis Prediction,” Andrew Berg and Rebecca N. Coke
- 04/40: “And Schumpeter Said, ‘This Is How Thou Shalt Grow’: Further Quest For Economic Growth in Poor Countries,” Philippe Beaugrand
- 04/41: “Forecasting Commodity Prices: Futures Versus Judgment,” Chakriya Bowman and Aasim M. Husain
- 04/42: “Public Expenditure Management in Francophone Africa: A Cross-Country Analysis,” Yaya Moussa
- 04/43: “India in the 1980s and 1990s: A Triumph of Reforms,” Arvid Panagariya

baseline scenario and in the face of plausible shocks, and indicative country-specific external debt-burden thresholds related to the quality of the country's policies and institutions. These two pillars, in combination with other relevant country-specific considerations, provide an informed basis for the design of an appropriate borrowing strategy.

The proposed framework also suggests important policy implications for donors and creditors. First, creditors and donors would need to review current financing policies to ensure that they appropriately reflect countries' risk of debt distress. An increase in the overall concessionality of financing to low-income countries, including a larger volume of grants, is almost certainly required. Second, since an appropriate mix of concessional loans and grants may improve a country's ability to absorb large, unforeseen exogenous shocks only to a limited extent, creditors and donors may also wish to consider new or modified instruments to deal with such eventualities.

Excerpts of Executive Board assessment

Executive Directors viewed the development of the proposed framework as an important step toward ensuring that borrowers and lenders share a common approach that maintains low-income country indebtedness on a sustainable track, while contributing to the achievement of sustainable growth and the MDGs.

Directors broadly endorsed the key elements of the debt sustainability framework. In view of the heterogeneity of low-income countries, they saw the ability

of the framework to incorporate country-specific information and judgments in the assessments as one of its key merits. Overall, most believed that the proposed framework could strike an appropriate balance between rules and discretion, provided that care is taken to ensure that the indicative debt-burden thresholds are used as a guide and not as a rigid ceiling.

While supporting the general thrust of the framework, Directors noted a number of issues on which further consideration would be needed before the framework could become fully operational. These issues fall in three main categories: the modalities for implementing debt sustainability analyses, the specification of indicative thresholds, and the operational implications for the IMF and for other international financial institutions and donors. Directors stressed that, in applying the framework to lending decisions and program conditionality, it would be important for the IMF and the World Bank to reach consistent positions and, more generally, to coordinate their work closely and to involve other multilateral development banks in their work.

Directors had a wide-ranging discussion of the broader implications of the proposed framework. A key implication of the debt sustainability framework for donors is that they will be expected to tailor the terms of new external financing to countries' risk of debt distress. Directors called on donors to make a stronger effort to provide good performers at high risk of debt distress with the necessary grant financing, in line with the Monterrey Consensus.

04/44: "Debt Crises and the Development of International Capital Markets," Andrea Pescatori and Amadou N. Sy

04/45: "A Multivariate Filter for Measuring Potential Output and the NAIRU: Application to the Czech Republic," Jaromir Benes and Papa N'Diaye

04/46: "Domestic Debt Markets in Sub-Saharan Africa," Jakob E. Christensen

IMF Country Reports (\$15.00)

(Country name represents an Article IV consultation)

04/18: Indonesia: Eleventh Review Under the Extended Arrangement

04/19: Nicaragua: Joint Staff Assessment of the PRSP Second Progress Report

04/20: Vietnam: PRSP Progress Report

04/21: Lesotho

04/22: Albania: Third Review Under the Three-Year Arrangement Under the PRGF, Request for Waiver of Nonobservance of Performance Criterion, and Financing Assurances Review

04/23: Lesotho: Selected Issues And Statistical Appendix

04/24: Pakistan: PRSP

04/25: Vietnam: PRSP

04/26: Georgia: Ex Post Assessment of Georgia's Performance Under IMF-Supported Programs

04/27: Bangladesh: First Review Under the Three-Year Arrangement Under the PRGF and Request for Waiver of Performance Criteria

PRGF=Poverty Reduction and Growth Facility

PRSP=Poverty Reduction Strategy Paper

Publications are available from IMF Publication Services, Box X2004, 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.

Directors noted that the treatment of shocks is an important issue requiring further consideration. They generally supported the ex ante approach discussed in the paper: prudent planning on the basis of stress tests, complemented by various other policies to increase economic resilience to shocks. At the same time, a number of Directors encouraged the staff to explore the feasibility of complementary ex post mechanisms, including innovative financial instruments, that would strengthen countries' ability to deal with those shocks that occur.

Directors shared the view that low-income countries themselves bear the primary responsibility for achieving their development objectives without compromising debt sustainability. Besides a careful approach to new borrowing and improvements in debt management, they believed that countries could best boost their resilience to debt distress by strengthening policies and institutions. In this context, Directors highlighted the importance of providing the right incentives and

resources, including technical assistance, for countries to become strong policy performers.

Directors also addressed the relationship between the proposed debt sustainability framework and the HIPC Initiative. They stressed that the HIPC Initiative, which establishes a uniform set of rules for coordinating action to deal with an existing debt overhang, should be implemented in full. In contrast, they noted, the proposed new framework serves as forward-looking country-specific guidance on new borrowing policies.

Finally, Directors asked staff to prepare papers for further discussions, including one giving further consideration to issues related to the sustainability framework itself, and one examining the operational implications for the IMF especially in setting debt limits in IMF-supported programs. ■

The full text of Public Information Notice No. 04/34 and the IMF–World Bank Staff Paper that was the basis for the Executive Board discussion are available on the IMF's website (www.imf.org).

World Economic Outlook analysis

How can industrial countries overcome obstacles to structural reform?

Many industrial countries are in dire need of structural reform if they are to successfully address multifaceted challenges to their societies, including aging populations, rising pension and health care costs, and increasing global competition. But though the need for and benefits of reforms are widely recognized, actual reforms have frequently been less ambitious than was desirable. What are the obstacles to reform? And what can be done to overcome them? For the April 2004 *World Economic Outlook (WEO)*, IMF staff researched structural reforms in industrial countries over the past three decades to distill lessons from past experience. One key lesson is that economic recoveries—such as the one currently under way—provide a favorable policy environment for launching reforms. Thomas Helbling of the IMF's Research Department and coauthor of the chapter on fostering structural reforms in industrial countries, outlines this and other significant findings below.

Structural reforms have generally been associated with the notion of increasing the role of market forces, including competition and price flexibility. The term is often used interchangeably with deregulation—that is, reducing the extent to which government regulations or ownership of productive

capacity affects the decision making of private firms and households. This perception clearly reflects a broad global trend during the past two to three decades, when structural reforms often focused on replacing general, across-the-board restrictions on competition and entry by new firms with more targeted, less intrusive restrictions. This broad policy shift mirrored a variety of factors, including growing evidence that not only markets but also governments can fail because of problems such as asymmetric information, management and incentive problems, and the pernicious influence of vested interests on regulatory policies.

It would, however, be misleading to equate structural reforms with the goal of abandoning regulation altogether. Fundamentally, structural reforms aim at creating institutional frameworks and regulations that allow markets to work better. Some markets are prone to market failure or inefficiency. In these situations, well-designed government regulations can prevent less than desirable market outcomes.

Labor markets, tax systems lag others

There is broad consensus about the benefits of reforming tax systems and liberalizing product and labor markets, the trade system, and the financial sector. However, the *WEO's* research revealed that in all the

countries included in the study (see box, page 106), some sectors were more likely to undergo more reform than others (see chart, this page). Substantial reforms were recorded in the financial sector, selected product markets, and international merchandise trade, where the very nature of the policy environment has changed in many countries. In contrast, minor reforms were made in labor markets and tax systems.

What explains these differences? The research team's basic hypothesis was that they reflect differences in political viability. An important reason for this could be that the benefits of reforms tended to materialize over time while the costs they inflicted were immediate. More generally, some groups in society often lose out from structural reforms; lower protection from competition and increased price flexibility may, for instance, result in temporary unemployment. These groups often represent key electoral constituencies that have strong incentives to mobilize against reforms. Given the typical length of election cycles and electoral uncertainty, policymakers will choose to focus on the short-term costs of reforms while discounting the long-term benefits.

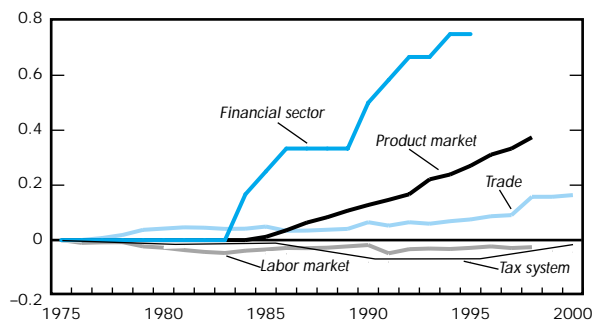
Comparing the dynamic effects of reforms on growth and unemployment across sectors, the research team suggests that the uneven distribution of benefits over time indeed played a role, as countries appear to have primarily implemented reforms that yielded the most immediate benefits with the least uncertainty. This would also explain why labor market reforms have lagged other areas. The *WEO's* research team found that though labor market reforms usually increase growth and lower unemployment in the long term, they often lower growth and increase unemployment in the short term.

For other reforms, particularly of the financial sector and tax systems, the distribution of benefits was not as skewed toward the long term, and the *WEO* analysis also revealed two other important factors behind the sectoral differences. First, the distributional impact of reforms appears to matter. In the labor market and tax domains, reforms inflict immediate costs on more households and firms than in other areas and involve visible—and often contentious—redistribution effects. And, fiscal sustainability considerations often require that tax reforms be accompanied by politically difficult expenditure adjustments.

Second, competitive pressures can enhance the viability of reforms. Labor markets and tax systems have so far been less exposed to international competition than, for instance, product markets and trade, reflecting the limited mobility of labor and of much of the tax base. In other areas, competitive pressures have been stronger. Similarly, changes in the domestic

In some sectors, substantial reform efforts reduced overall restrictiveness

(Median; cumulative changes in structural policy indicators from 1975 (positive changes are reforms); distribution across 20 industrial countries)



Data: IMF staff calculations

environment can also increase competition, which, in turn, weakens opposition to reform. This is because interest groups have fewer incentives for costly political mobilization when increased competition reduces their pricing power. Unlike financial and product markets, labor markets have only recently been exposed to such pressures.

Why have some reformed more?

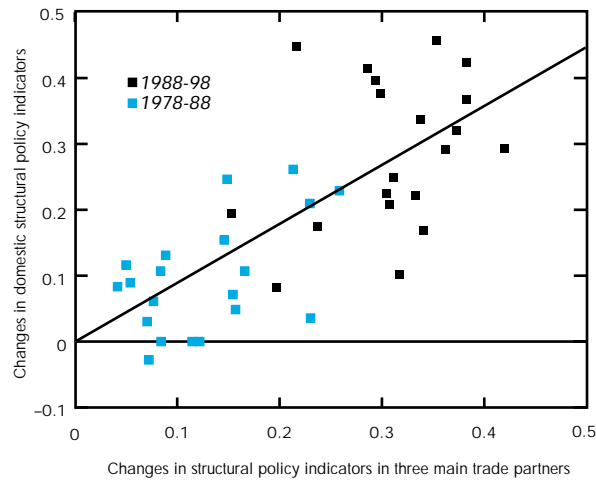
Some countries have been stronger reformers than others. The *WEO's* empirical analysis highlighted four reasons for the differences:

- First, some countries' structural policies were initially more restrictive than others'. Those countries have generally tended to reform more over the past three decades than those that started out with less restrictive structural environments. This corroborates the view that in highly regulated economies, the incentives to reform are higher than in less regulated ones because restrictions are more likely to be seen as reducing overall welfare (see chart, page 106).

- Second, countries' macroeconomic conditions varied. It is often argued that difficult economic conditions—especially full-blown crises or prolonged recessions—act as a catalyst for reform. The *WEO's* research team found empirical evidence in favor of this “back-against-the-wall” argument during the most recent period. Difficult economic conditions made the costs of maintaining the status quo so obvious that opposition to reform weakened.

- Third, fiscal positions were important in determining the success of structural reform. Offering compensation in the form of government transfers is a frequently used strategy to secure political support for reforms, and the scope for compensation is obviously greater when fiscal positions are strong. Industrial countries' experiences over the past three decades confirmed that reforms were more likely to

Domestic product market reforms are up in response to trading partners' reforms



Data: IMF staff calculations

take place when the budgetary situation allowed losers from reforms to be compensated through the budget, especially in the labor market and tax systems.

- Fourth, varying degrees of openness contributed to differences in reform efforts. Countries tended to reform more if their main industrial country trading partners had recently implemented reforms, if they were bound by international commitments, and if they were open to trade. This shows that peer pressure, exerted through international arrangements such as free trade agreements, plays an important role in reform efforts. Countries can also learn from each other, with some countries leading the way. Finally, policies of some countries that reduced competitiveness in other countries induced the latter to undertake reform as well.

How to overcome opposition to reform

Great benefits can be derived from structural reforms, especially if the reforms are packaged to create maximum synergies. However, there is often

strong opposition to reform because of short-term losses to specific groups within society. Overcoming these obstacles can be difficult, and many determining factors, such as the international economic climate, are not under the control of policymakers. Nevertheless, the *WEO's* research team identified four factors that help determine reforms' success:

- A recovery from a downturn is a good time to start reforms. Difficult economic conditions often make the need for reform more obvious, thereby weakening traditionally strong interest groups and creating a more fertile environment for reform. Historically, reforms that coincide with economic recoveries tend to be more ambitious in scope than reforms implemented during good times.
- Since reforms feed on each other, it is important to invest political capital in launching the reform momentum. Experience shows that reforms in other areas can foster reform in labor markets and tax systems—politically the most difficult sectors to reform. Combining reforms can create important synergies and reduce short-term costs, which makes them more acceptable politically.
- Countries should seek to improve their fiscal positions to have the fiscal flexibility needed to support reforms. Experience shows that reforms are more likely to succeed when fiscal positions allow for compensation to those most negatively affected.
- Finally, policymakers should use outside competitive and peer pressure to advance reforms. For example, if a specific market is still relatively sheltered from international competition, it might be a good idea to open up the sector to competition before proceeding with other reforms. ■

Copies of the April 2004 *World Economic Outlook* are available for \$49.00 (\$46.00 academic price) from IMF Publication Services. See page 103 for ordering details. The full text of the Report is also available on the IMF's website (www.imf.org).

How research was carried out

Using time series of aggregate structural policy indicators, the April 2004 *World Economic Outlook (WEO)* considered some important regulatory reforms that took place over the past two and a half decades in 20 industrial countries (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States). The study covered reforms in five areas: the financial sector, international merchandise trade, labor markets, selected product markets, and the tax system.

In each area, the indicator series categorized the degree of restrictiveness of government regulation and policies in key dimensions on the basis of actual policy instruments. Changes in an aggregate indicator provided a picture of the overall sectoral regime change. In line with the recent broad trend noted in the main text of the *WEO*, policy changes that reduced the degree of restrictiveness were usually considered reforms. Since the development of structural policy indicators has only recently begun, the time-series indicators were limited in scope. Nevertheless, they were helpful in illustrating broad trends and developments and in identifying determinants of reforms.

Improved financial market conditions offer scope to make timely structural reforms

International financial market conditions have improved in response to strengthened fundamentals and the impact of low interest rates on investor behavior and asset prices, according to the latest issue of the IMF's semiannual *Global Financial Stability Report*. This analysis of capital market developments and risks finds brighter prospects for both mature and emerging markets, although vigilance is urged in view of the potential for excessive asset valuations in a low interest rate environment and the continued risks associated with large global external imbalances. In addition, the April 2004 report inaugurates a series designed to assess the implications of transferring risk from the banking sector to other financial intermediaries. The report also examines the increasingly important role that domestic and international institutional investors are playing in emerging markets.

Improved economic fundamentals and stimulative monetary policies in the major financial centers contributed significantly to the global equity market rally and to the reduction in credit spreads of mature and emerging market bonds in 2003. The stronger fundamentals are rooted in firming global economic growth, rising corporate earnings, and strengthening balance sheets in the household, corporate, and banking sectors as the corporate and household sectors continue to build up liquidity and rising asset values buoy net worth.

A number of key emerging market countries have also taken steps to put their public finances on a sounder footing and increase their resilience. Many countries have used the favorable external financing environment to raise funds on international capital markets and improve the structure of their public debt by lengthening maturities and reducing the share of outstanding obligations indexed to foreign currencies and short-term interest rates. In addition, many emerging market countries have benefited from increased demand for their exports and higher commodity prices. The consequent gains in credit quality and low interest rates in the major financial centers contributed to an impressive compression of spreads on emerging market bonds last year (see chart, this page).

The improved outlook for financial stability is not without risks. The report notes that vigilance is needed, not least because of the potentially interconnected nature of these developments. One poten-

tial source of vulnerability arises from the impact of exceptionally low interest rates on investor behavior and asset valuations. Monetary stimulus aimed at boosting economic growth can encourage excessive risk taking and boost asset valuations beyond levels justified by fundamental economic improvements. Low short-term interest rates and a steep yield curve in the United States provide powerful incentives to boost leverage by borrowing at short maturities to venture out along the risk spectrum.

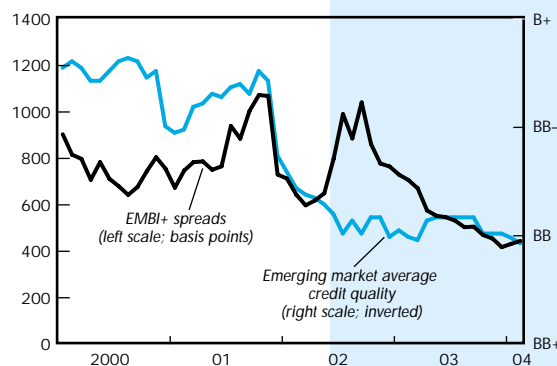
In the current low interest rate environment, the report explains, it is desirable to remain alert to the potential for excessively leveraged or concentrated investor positions (see chart, page 108).

If asset valuations become rooted in expectations of continued low short-term interest rates, an abrupt move to higher rates could be disruptive. Moreover, rising interest rates would increase debt-service burdens, especially in a number of European countries where debt levels in the corporate sector remain high despite some progress in

strengthening balance sheets. A transition to higher interest rates in the major financial centers will eventually need to take place. To facilitate this, the report recommends that policymakers develop forward-looking communication strategies to encourage investors to base their investment decisions on fundamentals.

Another key challenge and a second potential source of risk will be to ensure an orderly reduction in global external imbalances. As the report underscores, the need to attract sizable foreign capital inflows to finance the U.S. external current account deficit poses a potential challenge to the stability of the U.S. dollar and to currency market stability. The possibility that investors may demand an increased risk premium for U.S.-dollar-denominated assets in an environment of a rapid decline of the dollar also raises the risk of broad financial market turbulence. To date, however,

Spreads on emerging market bonds narrowed sharply as credit quality improved



EMBI=Emerging Markets Bonds Index
Data: Bloomberg L.P.; J.P. Morgan Chase & Co.; Moody's; Standard & Poor's; and IMF staff estimates

portfolio flows into the United States have remained quite strong—notably including official flows into the U.S. treasury market—and the decline of the dollar has so far been orderly. Still, a strong and sustained international cooperative effort will be required to ensure a smooth adjustment of global imbalances over the medium term.

Risk transfer and the insurance industry

Improved prospects for global financial stability also afford a window of opportunity for countries to undertake structural reforms that can bolster financial stability over the longer term. With the April 2004 issue, the report inaugurates a series that analyzes how risk is transferred away from the banking sector to other institutions. The series highlights the regulatory and risk management issues that arise as financial risk

intermediation is shifted from the relatively heavily regulated banking sector to other less uniformly regulated parts of the financial sector and beyond.

The first study in this series examines risk transfer in the insurance industry in mature markets. Insurance companies are increasingly taking on credit risk—in part through the use of credit derivatives. The patterns and levels of insurer involvement in credit instruments have,

however, varied widely across countries and regions, largely reflecting the structure of local capital markets and regulation. The report observes that the reallocation of credit risk to the insurance sector, together with improvements in risk management in that sector, appears to have enhanced financial stability. Credit instruments, by virtue of their relatively low volatility and stable cash flow, seem to be an appropriate investment for insurers that are seeking to manage long-term liabilities and related market risks.

But increased investment by insurers in credit instruments will also need to be accompanied by a continued improvement in risk management and regulatory oversight of the sector. In particular, there is scope to widen the adoption of risk-based capital standards, strengthen supervisory resources, increase information sharing among supervisors, and improve disclosure standards. The current debate on interna-

tional accounting standards for insurers represents an important step toward promoting standards that accurately reflect an insurer's financial position.

Key role of institutional investors

Significant progress has been made in recent years in deepening local emerging securities markets; institutional investors, both local and international, have played a key role in this development. Emerging market securities have increasingly attracted investments from pension funds, mutual funds, and insurance companies. The growth of a diverse and stable investor base for emerging markets is likely to dampen market volatility by increasing the stability of capital flows to emerging markets.

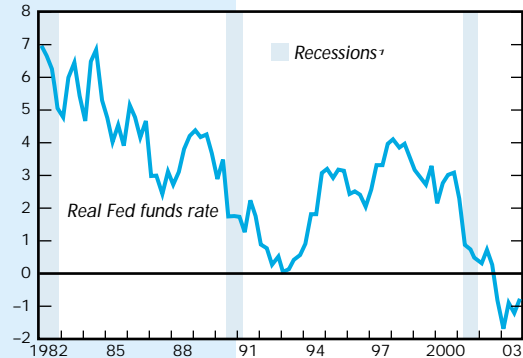
To continue to attract and maintain the interest of international institutional investors in their sovereign and corporate securities, emerging market countries will need to enhance their growth potential and make their financial systems more resilient. The report also recommends measures to improve disclosure and transparency standards, including subscription to the IMF's Special Data Dissemination Standard and regular communication with investors. There is also scope to further deepen domestic financial markets, improve market infrastructure, strengthen clearance and settlement systems, and develop a greater variety of instruments—in particular, bonds of long duration.

The report counsels that such efforts should, in particular, address the needs of domestic institutional investors. To increase the attractiveness of local markets for domestic and international investors, it will also be important to ensure that restrictions on local pension fund managers be designed to encourage the creation of asset portfolios that best match desired risk and return objectives. Restrictions on foreign investments, for example, can work against financial stability when local markets are insufficiently developed to provide the range of instruments that local institutional investors need. Finally, the report also observes that promoting improved risk management by local institutional investors—including, as appropriate, the imposition of risk-based capital adequacy requirements for insurers—can contribute to deeper and more stable domestic emerging markets. ■

David J. Ordoobadi
IMF International Capital Markets Department

Short-term U.S. interest rates remain at extraordinarily low levels

(percent)



¹Periods in which the United States was in recession, as defined by the National Bureau of Economic Research (NBER).
Data: Bloomberg L.P.; NBER; and IMF staff estimates

Copies of the April 2004 *Global Financial Stability Report* are available for \$49.00 (\$46.00 academic price) from IMF Publication Services. See page 103 for ordering details. The full text of the report is also available on the IMF's website (www.imf.org).

Practitioners in Development series

Botchwey provides an African perspective on new thinking on development strategy

In a March 5 lecture in the World Bank's Practitioners in Development series, Kwesi Botchwey—Executive Chair of the African Development Policy Ownership Initiative and former finance minister for Ghana—drew on his own extensive experience in making and managing policy reform during the 1980s and 1990s to reflect on the new thinking on development strategy for Africa. Botchwey was joined by Michael Chege, an advisor to Kenya's Ministry of Economic Planning, and Jeffrey Herbst, a professor of politics and international affairs at Princeton University, who served as commentators.

The onset of the new millennium has focused the international community's attention on poverty that continues to afflict much of the developing world—especially in South Asia and Africa—despite two decades of policy reform. The current rethinking of development theory and practice has evolved partly, Botchwey said, from a vigorous debate among economists, development practitioners, and others on the merits and weaknesses of the “Washington Consensus”—a set of policy reforms that promoted growth and macroeconomic stability through deregulation, liberalization, privatization, and fiscal discipline.

Within the World Bank—and among academic economists and practitioners generally—African development is now seen as a “more thoroughgoing process of transformation.” This new thinking on development, Botchwey noted, has designated poverty reduction as the overriding goal and made empowerment of poor people and their participation in decisions affecting their lives key elements.

But Botchwey cautioned that the depth and extent of this change can be exaggerated. Several aspects of the emerging paradigm need to be further researched and refined to make the new thinking operational—notably, he said, governance and institutions, empowerment and participation of the poor, national ownership of policy reforms, and the dynamics of aid and private resource flows.

Institutions take time

Botchwey criticized the current focus on governance and institutions in the new development strategy for giving the impression of generalized corruption in Africa without backing this up with sufficient analytical work on the concrete and varied manifestations of bad governance. As a consequence, he said, attention

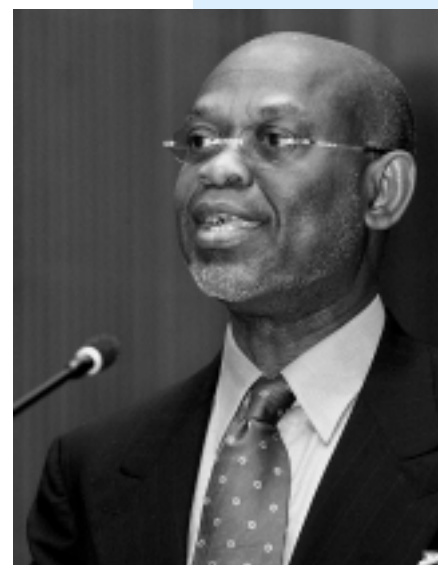
is diverted from an examination of the real causes of market failure and what is needed to improve the efficiency of nonmarket institutions and to rein in the influence of informal layers of power.

Botchwey also noted that the current discussion on development fails to allow countries sufficient leeway to take into account the dynamics of fiscal spending during an election year. These dynamics can temporarily affect economic management in African countries as much as they do in democracies elsewhere. And, arguing that institution building is always a lengthy and complex process, he urged that African institutions be allowed enough time to evolve.

While Botchwey deemed the current emphasis on empowerment valid—especially as it applies to improving the poor's access to education and health—he argued that the present case for participation lacks a full understanding of the operational and political implications. “Much confusion—and I dare say frustration—surrounds the participation of civil society in the poverty reduction strategy process,” he said, referring to the findings of a 1999 World Bank study that showed that the views and perceptions of the poor often diverge dramatically on a number of issues from the positions of governments and international financial institutions. The real challenge, he indicated, is to improve the poor's access to knowledge and information and to establish institutional mechanisms that enable them to build support for policies that promote their interests through elected representatives in national and local legislative bodies. Botchwey also called for setting up accountability institutions at the local level to prevent stronger, corruption-prone factions from subverting the poor's aspirations and interests.

Are national solutions elusive?

As for national ownership and the implementation of reform agendas, Botchwey suggested that the major policy directions of countries' poverty reduction strategy papers are remarkably similar to those pursued under the structural adjustment frame-



Botchwey: “Much confusion—and I dare say frustration—surrounds the participation of civil society in the poverty reduction strategy process.”

Herbst:
The emergence of more “real champions of economic policy” would be one way to help clarify national economic agendas.

works of the 1980s and 1990s. This raises the possibility that countries’ perceptions of what is acceptable to donors and the international financial institutions take precedence over what the countries themselves believe to be the policies that they own. “Overall, ownership remains largely ephemeral in



concept and rather elusive in practice,” he concluded, partly because the international community has not sufficiently recognized the full implications of the asymmetry in power relations between low-income countries, on the one hand, and their donors and international financial institutions, on the other.

Is there at least scope to resolve differences that emerge on the nature or speed of reforms? One way to reach agreement, according to Botchwey, could be through some form of systematic, independent review mechanism. But in the countries themselves, the culture of aid dependency and associated administrative encumbrances continue to divert policymakers’ attention from the search for truly national solutions.



Chege:
It is imperative that African policymakers identify priorities, since it is impossible to do everything at once and still hope to succeed.

While acknowledging Botchwey’s reservations about whether countries truly own their reform policies, Jeffrey Herbst focused his remarks on a different issue. He described the political dynamics surrounding the economic policy dialogue within African countries as disappointing because of a

general failure on the part of many African leaders to bring economic development issues into the public debate, particularly during national elections. Herbst suggested that the emergence of more “real champions of economic policy,” especially in Africa’s largest economies, would be one way to help clarify national economic agendas and lead by example.

Countering Herbst’s remarks and speaking for the East African Community countries, Michael Chege insisted that many policymakers are generating their own development agendas aided by significant public debate. “There is not a single newspaper in Kenya today that does not have a business and economic supplement every week in which contributions from government, civil society, academia, and even the expatriate community are welcome,” he pointed out.

Noting the ever-broadening list of policy reforms on national development agendas, Chege stressed that it is imperative that African policymakers identify priorities, since it is impossible to do everything at once and still hope to succeed.

Aid partnerships

Turning to the issue of aid and other resource flows, Botchwey remarked that the idea of a mutual compact or partnership—whereby African countries fulfill their end of the bargain while the developed countries reward them for good performance—has become a more or less permanent feature of the political economy of international support to African development reform efforts.

For Africa, there seems to be “no end to diagnostic studies and the quest for solutions,” he observed, citing U.K. Prime Minister Tony Blair’s plan to set up a commission to take a fresh look at spurring African development as the most recent such endeavor. While expressing hope that Blair’s initiative might galvanize the international community to action, Botchwey voiced doubts about whether the world cares enough about Africa to amass the resources required to meet the UN Millennium Development Goals. With official development aid still falling well short of what is needed, trade and knowledge dissemination assume particular significance, Botchwey emphasized in closing. And here, he said, the World Bank has a very important role to play, especially in mobilizing African countries to increase investment in science and education. ■

Jacqueline Irving
IMF External Relations Department

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
March 29	1.58	1.58	2.09
April 5	1.61	1.61	2.13

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members’ remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF’s financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2004).

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

Data: IMF Finance Department

Interview with Robert Shiller

Figuring out financial markets: more psychology than economics?

Robert Shiller is best known for his 2000 book *Irrational Exuberance*, which presciently warned that the U.S. stock market was overvalued and “poorer performance may be in the offing.” Shiller, a professor in the economics department at Yale University, is famous in academic circles for helping launch the field of behavioral finance, which uses insights from psychology and other social sciences to understand the behavior of financial markets. During a visit to the IMF Institute in February, Shiller spoke to Prakash Loungani about prospects for the U.S. stock market and his involvement with behavioral finance.

LOUNGANI: The U.S. stock market crashed in 2001 as you had predicted but has now recovered from those lows. Is the correction over?

SHILLER: People seem to think the correction is largely over. My opinion surveys show many people are quite optimistic. Many seem to be thinking: the recession of 2001 is over, and we only seem to get recessions about once every 10 years now, so there’s no reason why the stock market should not be up. They are not thinking about stock market crashes as a possibility. But I’ve been advising people to diversify and not have too intense an exposure to the U.S. stock market. The market is vulnerable if there is some bad economic news.

LOUNGANI: What kind of news would cause another correction?

SHILLER: One kind of bad news that worries me is about the U.S. labor market. It has done poorly. We are down over two million jobs in the past three years and down nearly one million jobs from the end of the 2001 recession. Since World War II, the only other labor market contraction as protracted as this occurred around the time of the great recessions of 1980 and 1981–82. But back then people knew that the cause of the contraction was the Fed [Federal Reserve Board] policy. This time, the cause is less clear. Labor market fears can weigh on investors, destroying confidence. That’s what happened in the 1930s. We could also get a burst of inflation, as we did in January when the consumer price index went up an annual rate of nearly 6 percent. If the Fed decides the increase is more than a onetime blip, it will react. Interest rates will go higher, and then the stock market won’t look like such a good investment.

LOUNGANI: Could further corporate scandals also take a toll?

SHILLER: On that score I’m actually somewhat sanguine. The United States has done enough that U.S. investors at least have got some reassurance from it. [New York State Attorney General] Eliot Spitzer has been going after corporate crime as aggressively as Eliot Ness, the guy who went after the gangster Al Capone. Combine that with people like [Massachusetts Secretary of the Commonwealth] William Galvin and William Donaldson, Chair of the Securities and Exchange Commission [SEC], and it adds up to a lot of people who are really doing their jobs. The budget for the SEC has really been increased; for 2004, it was over \$800 million, more than double what it was five years ago. And people can see what a price Martha Stewart paid for acting on a tip. This is the U.S. solution: the United States has generally handled financial scandals aggressively.

But a lot will depend on how foreign investors in the U.S. stock market react. Foreign holdings of U.S. shares have gone down. It’s a question of whether foreigners continue to invest in this country in the face of more scandals, particularly if we have other events going on at the same time, like an unstable dollar. All that could cause a drop in the U.S. stock market.

LOUNGANI: Are you willing to forecast how big a correction it could be?

SHILLER: The P/E [price-to-earnings] ratio is quite high. It’s about 28 the way I calculate it, which is to divide the stock price by a [moving] average of corporate earnings of the past 10 years. The historical average for the P/E ratio is only 15. So stock prices can come down quite a lot before we hit that point. In fact, the P/E ratio could even go below the historical average if the news is sufficiently bad.

LOUNGANI: Could U.S. housing prices also go through a correction?

SHILLER: I’m not exactly sure what’s going on with housing prices. People still report that a major consideration for their buying houses is that they think



Shiller: “People can see what a price Martha Stewart paid for acting on a tip. This is the U.S. solution: the United States has generally handled financial scandals aggressively.”



Laura Wallace
Editor-in-Chief
Sheila Meehan
Managing Editor

Christine Ebrahim-zadeh
Production Manager

Camilla Andersen
Elisa Diehl
Jacqueline Irving
Assistant Editors

Niccole Braynen-Kimani
Maureen Burke
Editorial Assistants

Philip Torsani
Art Editor

Julio Prego
Graphic Artist

Prakash Loungani
Associate Editor

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 22 times a year, plus an annual *Supplement on the IMF* 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 X2004, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

April 12, 2004

112



Shiller: "We know the role that overconfidence and wishful thinking play in driving financial markets. But psychological theories have still not been completely integrated into economics."

it is a good investment; that is, they expect house prices to appreciate. But fewer people report buying houses just to make a profit from speculation. I think the thought process a lot of homebuyers are going through right now is more like: I know prices are too high, but that's what I thought last year and prices still went up. I better buy now before I'm totally priced out.

Obviously, in both the stock market and the housing market, a lot will depend on how people assess the news that comes in. We know that people can overreact to attention-grabbing news and let some really fundamental piece of news slip by. I don't think economists are at the point yet where we can forecast how investor behavior will play out in response to news.

LOUNGANI: But behavioral finance has been at this for nearly twenty years now . . .

SHILLER: And we've learned and accomplished a great deal. A lot of investor behavior that seemed anomalous from the perspective of purely economic frameworks—rational expectations and efficient markets—is better understood when we bring in psychology. We know the role that overconfidence and wishful thinking play in driving financial markets. But psychological theories have still not been completely integrated into economics. Human behavior is very complex, and economists have been in the mood to simplify it, and simplify it heroically. We will have to change our whole approach to problems—our methodology and our tool kits—if we are serious about grappling with the complexity of human behavior.

LOUNGANI: Are graduate students today more open to different ways of modeling economic problems?

SHILLER: When I talk to our graduate students, I get the feeling that they look at behavioral economics and think: well, if that's what I wanted to do, I chose the wrong department. Shouldn't I capitalize on the methods I have learned in economics? Graduate students are looking out for their own careers and thinking about their own human capital. It just doesn't seem to be as good an investment to them to learn psychological research.

LOUNGANI: How did you turn out to be so rebellious?

SHILLER: I wasn't much of a rebel as a graduate student. My dissertation was on rational expectations. But I was always a bit skeptical about conventional economic theory. An early formative influence was George Katona, who wrote the book *Psychological Economics* in 1975. I never took one of his courses, but I sat in on one of his lectures and was impressed. It seemed fine to me, then, that there were only a few people like Katona who wanted to sit halfway between economics and psychology. It wasn't as clear to me then as now that psychology should be central to economics.

Much later, Stan Fischer [former IMF First Deputy Managing Director] invited me to write a review essay critiquing the rational expectations revolution for a conference he'd organized. Writing that essay awakened further doubts about rational expectations, which I always thought of as a construct that had some interest but was a small part of a big picture.

This became evident to me one day when I was talking to some people at the Federal Reserve Bank of Philadelphia about why long-term interest rates were so volatile. I remember thinking that the theory we had about long-term interest rates—the expectations theory of the term structure—did not get them very far. That led to me to write a paper for them about excess volatility in long-term rates. After the work on the bond market, I thought that the problem had to be even worse with the stock market. That work became better known, and so most people associate me with the theory of excess volatility in the stock market. ■

Photo credits: Denio Zara, Pdraic Hughes, Eugene Salazar, and Michael Spilotro for the IMF, pages 97, 98, 100, and 109–112.