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Interview with Shinji Takagi

IEO urges more focus on "what ifs" in IMF handling of financial crises

In the late 1990s, a series of capital account crises rocked the global economy. The IMF found itself at the center of this turmoil and criticized as never before. The experience triggered extensive internal and external reexaminations of IMF policies and practices and intensified the attention paid by the IMF to identifying vulnerabilities and preventing and resolving crises. It also encouraged the organization to add an external perspective to its learning culture.

The resulting Independent Evaluation Office (IEO) initiated, in early 2002, a review of the IMF's handling of capital account crises in Indonesia, Korea, and Brazil. Its report, released on July 28, chronicles vulnerabilities that were in some cases identified but were in others undetected or underappreciated; it also examines weaknesses in IMF-supported programs. Shinji Takagi, Advisor in the IEO and team leader for the capital account crises project, talks with the IMF Survey *about honest efforts and costly missteps. He compliments the IMF for taking measures to enhance the effectiveness of surveillance in recent years but emphasizes that there is still more work to be done.*

Takagi: "In Brazil, IMF surveillance was very effective. In Korea and Indonesia, it wasn't."

IMF SURVEY: The crises of the latter part of the 1990s were notable for their ferocity and the very visible and often highly criticized role of the IMF. That made them likely candidates for an IEO review, but why were only Korea, Indonesia, and Brazil chosen?

TAKAGI: We obviously talked about including Thailand and Russia. We had two overriding considerations in deciding *(Please turn to the following page)*

A decade of reform and progress

Tanzania looks to further boost growth, intensify poverty reduction efforts

Tourism projects have contributed to Tanzania's economic turnaround. Above, hikers climb Mt. Kilimanjaro—one of the world's best-known tourist attractions.

Since the mid-1990s, Tanzania has made major strides in restoring macroeconomic stability and creating an environment conducive to private sector–led growth. These efforts, aided by two successive financing arrangements with the IMF, have positioned the country to make more ambitious structural reforms. On July 28, the IMF approved a new three-year financing arrangement under its Poverty Reduction and Growth Facility (PRGF). Volker Treichel, Senior Economist in the IMF's African Department, describes Tanzania's considerable progress to date and outlines the steps the country is now embarking on to ensure that higher growth also translates into greater employment opportunities and reduced poverty.

During 1996–2002, Tanzania translated several major achievements on the policy *(Please turn to page 222)*

When the authorities won't listen, the only responsible options may be to take the issue to the Executive Board or to make the debate public.
—Shinji Takagi

IEO weighs lessons from capital account crises

(Continued from front page) which crises to cover: our own resource constraints and what we were likely to learn. Russia was obviously special—it's too nuclear to fail and there won't be another Russia. And Thailand was distinctive in that it was the first of these crises and not a product of contagion, and we knew that IMF surveillance had long identified its problems and discussed these vulnerabilities with the authorities. We felt there was less to learn there also.

IMF SURVEY: The three countries have remarkably different stories to tell. But how are they similar?
TAKAGI: They all experienced massive outflows of capital and had IMF-supported programs that involved large amounts of IMF resources. But their crises were distinctive, and the differences are instructive. Brazil's vulnerabilities were largely macroeconomic, and the IMF's management and staff were very aware of them. The initial IMF-supported program tried to support the existing crawling peg exchange rate, and that didn't work. Korea had something very close to a pure liquidity crisis. The macroeconomic impact was severe, but short-lived. Once sufficient money was available, the crisis was resolved. And Indonesia, like Korea, had a balance of payments crisis and a banking crisis. But Indonesia's twin crisis was compounded by a political crisis.

IMF SURVEY: IMF surveillance is meant to alert authorities to impending difficulties. Did it do so in these instances?
TAKAGI: In Brazil, IMF surveillance was very effective. In Korea and Indonesia, it wasn't. In Asia, the IMF and most others saw sound economies that were growing fast. There was complacency, and the IMF missed the buildup of vulnerabilities in areas that were not its traditional focus of analysis. In Indonesia, the IMF identified weaknesses but thought them small compared with the bigger picture.

IMF SURVEY: When the IMF did spot vulnerabilities, was it able to convince the authorities to take action?
TAKAGI: Here, you first have to acknowledge that there can always be differences of view, between the IMF staff, the authorities, and the markets. This was the case with Brazil on the extent of overvaluation. The Brazilians were optimistic, the IMF staff was less so, and some in the markets were pessimistic. Our report argues that the IMF progressively downplayed the overvaluation of the exchange rate in Brazil. The staff argued that there were technical grounds for its view, but from an outsider's perspective, it looks like the IMF downplayed the overvaluation issue because of the authorities' view that the peg should be maintained. I can understand the staff's point of view: the choice of an exchange rate regime is each country's prerogative, a good relationship with the authorities is very important, and the staff can't do its job without it. Exchange rate policy was a big political issue in Brazil, and it's very difficult for the IMF to have real influence in political decision making.

IMF SURVEY: These crises all seemed to have a political component. Did the IMF have sufficient knowledge of, and sensitivity to, these political aspects?
TAKAGI: In Brazil, the staff spoke Portuguese and had worked on the country for quite a long time, but we know now that they still were not fully aware of the political dynamics. In Korea, the IMF's management was aware of the political dimension and asked for a commitment to the IMF-supported program from the presidential candidates ahead of the elections in late 1997. In Indonesia, some on the staff, including the resident representative and some old-timers like Jack Boorman, knew a lot about the country, but the people who worked on the program didn't have the same level of country experience. And, given the political dimensions of capital account crises and the speed with which they move, they didn't have time to acquire those skills on the spot. A lesson for the IMF is that you want some continuity in staff assignments so that sufficient country knowledge is maintained.

IMF SURVEY: In each of these crises, the IMF had a false start and then adjusted.
TAKAGI: It had no choice. In Korea, the United States took the lead. And only sovereign countries could do what it did to twist the arms of the creditor banks. Nevertheless, the IMF played an effective role as a facilitator, doing the necessary technical work. But Korea was unique: almost all of Korea's external debt was held by banks. Brazil was different, too. It didn't want to take any formal steps or do any arm twisting. Even now, it doesn't want to be perceived as a country that would harm investors.
IMF SURVEY: In terms of crisis management, the most difficult case was Indonesia. What went wrong?

Photo credits: Denio Zara, Padraic Hughes, and Michael Spilotro for the IMF, pages 217–18, 225, and 230–31; Str for Reuters, page 217; Kate Newman for Reuters, page 222; George Mulala for Reuters, page 223.

TAKAGI: The principal weakness in the first IMF-supported program was the lack of a comprehensive banking strategy. That was a mistake, in some sense, but why was it made? Two reasons. One, the staff honestly thought that the banking sector was sound, except for a handful of bad apples. And, second, the staff misjudged President Suharto. It closed three banks connected with his family. The president didn't oppose the closure, but then what happened? His family publicly challenged the closures; his half-brother took the minister of finance to court; and his son acquired another bank, transferred all the assets from the closed bank to the new bank, and started business on the same premises. Everyone, of course, saw this as a reopening of the old bank. Public confidence plummeted. The central bank provided liquidity, which skyrocketed while the IMF was advocating a tight monetary policy. In reality, credit just exploded.

The IMF's strategy was clearly not working, but it went on for two more months pushing the reluctant Indonesians to do what they had already proved incapable of doing. The appearance of persisting with a failed program undermined market confidence even more. And then noneconomic factors came into play.

IMF SURVEY: Your report acknowledges that the IMF learned from these crises and has taken corrective steps, but it also suggests there's more to be done. What contribution could the first recommendation—to take a stress-testing approach to surveillance—make to crisis prevention?

TAKAGI: Look at Korea and Indonesia. The IMF recognized weaknesses in the banking sector but thought high growth would take care of these problems. Stress testing asks "What if. . . ?" What if growth slows down? You want to consider a range of possibilities and be better prepared in case you have to deal with them. IMF staff traditionally used a baseline scenario that presented the average view to the Executive Board. We make the case for itemizing risks rather than simply saying, "OK, most likely this will happen." The IMF's new surveillance guidelines already incorporate this concept of stress testing.

IMF SURVEY: You also urge the IMF to be more candid in its surveillance.

TAKAGI: This is really a controversial issue in the IMF. What do we mean by being candid? Well, we assume the staff already holds candid discussions with the authorities. But the staff sometimes fails to convey this candidness to the Executive Board. Brazil's exchange rate policy, for example, was for a long time a taboo subject. The staff hardly discussed policy options in the papers it prepared for the Board.

Staff argue that if it is candid with the Board, authorities may not be candid with staff. Indeed, some of us here in the IEO sympathized with the view that the confidential advisor role of the IMF has to be respected. But it didn't work in Brazil, and we have to ask how surveillance can be made more effective. When the authorities won't listen, the only responsible options may be to take the issue to the Executive Board or to make the debate public.

Critics say this will alarm the markets, but there are different stages of country development and different degrees of transparency. In the United States, nobody says that the government knows more about the U.S. economy than people on Wall Street. Economic issues and policy options are openly debated. And the IMF's views are an input into this public debate. Where transparency and openness are the rule, the IMF should follow suit. In a developing country, where the IMF may be the only source of information, well, the IMF's role may be different.

It is arrogant of the IMF to think that what it says counts more and could therefore alarm the markets
—Shinji Takagi

Staff response

When the IMF's Executive Board discussed the Independent Evaluation Office's (IEO's) report "The Role of the IMF in Recent Capital Account Crises," it also took into account the response of IMF staff. Broadly, the staff welcomed the important lessons that the report drew from Indonesia, Korea, and Brazil. Staff also broadly supported the IEO's recommendations, which go in the direction of strengthening the institution's ability to help countries head off financial crises and deal with crises when they do occur. But the staff also cautioned that the report, in focusing on the early stages of the crises, did not tell the "whole story," as it overlooked later successes in restoring confidence, stemming capital outflows, and putting in place needed structural reforms, as a basis for economic recovery.

The staff also saw the findings confirming its own experience that each crisis is indeed unique in the problems it poses. Anticipating crises, the staff observed, will always require difficult judgments amid great uncertainty, and the capacity to prevent crises will rely on the actions of member countries. In the specific crises that the IEO examined, the authorities and the IMF staff faced enormous analytical and practical challenges. Much of the economic trauma was unavoidable, as many of the underlying problems were, at least in the short run, beyond the countries' and the IMF's control.

Future crises are likely to be no less challenging, but the staff recognized that the organization benefited significantly from incorporating the lessons gained from these experiences. It would also continue efforts to strengthen the effectiveness of surveillance and of IMF-supported programs in light of these lessons.

There has to be some flexibility in the original program, and the public has to understand the logic behind it. If something does go wrong, the public then knows how the program will respond.

IMF Survey: Aren't these situations particularly tricky in emerging markets?

Takagi: Investment houses have billions of dollars invested in these countries and gather a lot of relevant information. It is arrogant of the IMF to think that what it says counts more and could therefore alarm the markets. With Korea, the IMF was telling the market, "we think Korea is sound; don't pull out. But there is some information we can't share with you." You can't deal with markets like that. You have to say, "this is the information we have; we think everything will be fine if you don't pull out." Our report is not suggesting that in all situations the IMF has to say everything it knows. But in a capital account crisis in an emerging market where the information is readily available and the IMF does not necessarily have an information advantage, transparency has to be the rule.

IMF Survey: The report has a number of recommendations on how the IMF designs adjustment programs. Chief among them is greater attention to balance-sheet interaction effects. What's the concern here?

Takagi: Well, it's not a new concern for the IMF. In a standard macroeconomic model, if you devalue the currency, it should be a good thing. Exports are cheaper and the economy is boosted. But if the country has debt denominated in foreign currency, devaluation can be damaging. So don't just look at relative prices; look at the impact working through stocks, especially debt denominated in foreign currency. There has been new appreciation of this interaction since the Asian crisis, and the IMF is already paying more attention to it. There was a degree of learning from Asia that the IMF applied to Brazil. In that instance, the staff did try to figure out what the stock implications would be. But it's difficult to do because you have to gather data on the private sector.

IMF Survey: The report also argues for built-in flexibility in IMF-supported programs.

Takagi: An IMF program is usually based on an assumption that next year's growth is going to be, say, 3 percent. Now, if this goes wrong, the whole program is destroyed and confidence is undermined. There has to be some flexibility in the original program, and the public has to understand the logic behind it. If something does go wrong, the public then knows how the program will respond.

The staff says that the IMF's three- or six-month program reviews are meant to monitor and adjust, but the public and the markets don't perceive this as flexibility. The markets see wimpiness. They see the IMF getting it wrong each time and having to make changes.

IMF Survey: You also encourage the IMF to stay focused in a crisis and avoid the temptation to try to fix problems outside its mandate.

Findings and recommendations

Crises

In *Indonesia*, the IMF identified banking sector vulnerabilities but underestimated their severity and the potential dangers for macroeconomic stability. The financial and economic crisis also quickly became intensely political, which greatly complicated crisis management. Policy reversals, which undermined market confidence, exacerbated the crisis, but the IMF's response was inadequate in some respects.

In *Korea*, the IMF failed to pick up vulnerabilities in the economy before the onset of the crisis and then proceeded with a program that the market strongly suspected was underfinanced. When major industrial country governments, however, took concerted action to address what was, in effect, a liquidity crisis, the chief obstacle to the crisis's resolution was removed. The report credits the IMF with playing a useful role as a crisis coordinator but also notes it underestimated the impact of negative balance-sheet effects and initially advised fiscal tightening that, as the IMF's own evaluation conceded, was unnecessary.

In *Brazil*, IMF surveillance successfully identified the macroeconomic vulnerabilities at the core of the crisis but progressively downplayed the scale of the overvaluation and was unable to persuade the authorities to take early corrective action. In hindsight, the IMF was unduly concerned with the systemic efforts of an early exit from Brazil's crawling peg exchange regime. It did, however, play a useful role in facilitating the transition to an inflation-targeting regime and in helping Brazil develop a more disciplined fiscal policy regime.

Findings

IMF surveillance had varying success in identifying key vulnerabilities that led to these crises. Where it did identify weaknesses, it did not appreciate the full danger (Indonesia) or had little success in persuading the authorities to take timely corrective action (Brazil). It was most effective in anticipating macroeconomic vulnerabilities (Brazil) and had considerably less success in foreseeing financial and corporate sector weaknesses (Indonesia and Korea) that were outside its traditional areas of expertise.

Program design. In all three crises, program projections were sharply out of step with eventual outcomes (too optimistic in Indonesia and Korea; too pessimistic in Brazil), with the result that policy advice and actions were, with hindsight, inappropriate.

TAKAGI: In Indonesia, the major industrial country members of the IMF thought that market confidence couldn't be restored until Indonesia put an end to corruption and cronyism. They had a point, but the detailed structural conditionality that this view engendered didn't work. Also, all this conditionality took on a life of its own and detracted from the more critical issues of banking and corporate debt. And in any case, people didn't believe Suharto would reform, so that undermined confidence in another way.

IMF SURVEY: You also stress the role of communication in the design of a program.

TAKAGI: You need a communications strategy during a crisis. From the very beginning, there should have been an agreement between the IMF and the authorities that whenever program-related information was released, the IMF had to know about it beforehand.

IMF SURVEY: Finally, you see restoring confidence as a key ingredient in resolving these crises. What does the IMF need to do?

TAKAGI: In a capital account crisis, private capital is flowing out. Somehow, the IMF has to help stop that; it has to help the country build up market confidence. In Korea, a number of countries pledged additional money, but no one knew how this would be made available. It was just a number, and the market discounted it. We say that if the IMF is going to play a role in restoring confidence, it must either have large financing of its own or alternative financing on clear, credible terms subject to the same terms as IMF financing.

IMF SURVEY: Did the report address the oft-cited concern about moral hazard?

TAKAGI: We looked at whether the availability of large-scale financial support from the IMF created moral hazard, and we say it probably did not.

IMF SURVEY: You also suggest that confidence can be restored more quickly if the IMF strengthens its coordination role in crisis resolution.

TAKAGI: That, too, comes from the IMF's experience in Korea. We argued that the IMF should have been more forceful in telling the major industrial countries that the financing was inadequate. We would like to see a more proactive IMF, a more proactive coordinator. If it had been so in Korea, it would have said, "this is an underfinanced program; it's going to damage credibility. You either give us additional money or we aren't going to do this." If that had been the IMF's position, I think the United States and other countries would have had to provide additional money or, as they ultimately did, twist the arms of the banks. ■

The full text of the report, "IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil," related statements, the Board summing up, and the staff response are available on the IEO's website: http://www.imf.org/external/np/ieo/

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—Shinji Takagi

Transparent and adequate financing. Inadequate financing—most specifically unanswered questions about the conditions under which bilateral assistance would be provided—undercut the credibility of the first IMF-supported program in Korea.

Recommendations

Stress-test crisis vulnerabilities. IMF surveillance should build on and systematize the steps it has already taken to incorporate analysis of potential shocks. The report recommends itemizing major potential shocks—including balance-sheet effects—and discussing the authorities' planned responses to such shocks. It also urges greater understanding of the political constraints that will likely shape policy decisions.

Make surveillance assessments more candid and more public. In addition to new surveillance guidelines that call for more systematic assessments of what happened under previous policy advice, the report urges the IMF to escalate signaling procedures when key vulnerabilities are repeatedly unaddressed and suggests it might be useful to seek an outside opinion when the IMF and the authorities are at odds on how best to address an issue. It also recommends publishing country-level analytical work to generate more informed public debate.

Revisit the design of IMF-supported programs to give greater attention to the interaction of balance-sheet weaknesses and key macroeconomic variables and to ensure that restoring confidence is the overriding objective of crisis management. The report suggests that there should be flexibility, particularly in capital account crises, to allow for adjustments if actual outcomes are at variance with expected ones. It asks the IMF to keep an eye on whether conditionality based on financial programming is appropriate for capital account crises and also stresses the importance of communicating the logic of the program to the public and the value of transparency. It also sees adequate financing as a key to restoring confidence. If the IMF does not itself supply adequate financing, it needs to ensure that the terms under which supplementary bilateral assistance would be made available are clear and credible.

Do more as crisis coordinator. The IMF should play a central role in identifying the circumstances in which concerted efforts can help overcome "collective action" constraints that can delay the resolution of crises. This should be based on a meaningful dialogue with the private sector and build on the new mechanisms for such a dialogue that have been developed in recent years.

More progress needed on Tanzania's poverty

Despite considerable achievements on the macroeconomic (including growth) and debt fronts, poverty has remained pervasive.

(Continued from front page) front into impressive economic progress. The country boosted average annual real GDP growth for the period to about 5 percent—roughly doubling the average rate recorded for the preceding five years. From 1999 onward, annual inflation dipped to roughly 5 percent—a sharp decline from the nearly 30 percent a yearinflation experienced during 1990–95 (see table below).

What has accounted for the country's marked turnaround? Clearly, sustained liberalization efforts, in particular in the agricultural sector, helped invigorate the economy, as did the start-up of large-scale gold mining and tourism projects. Also, construction and manufacturing activities picked up in response to the government's efforts to improve the business environment.

On the fiscal side, budgetary restraint was central to achieving macroeconomic stabilization. Tanzania's adjustment and reform program also drew strong donor support, which provided sizable financial assistance that all but eliminated the government's domestic financing needs (a major source of inflationary pressure in the past). In addition, tightened expenditure controls—notably the adoption of a centralized payment system and limiting spending to cash availability—further improved public finances.

In parallel with these reforms, the government undertook a wide range of measures designed to replace remnants of Tanzania's socialist economy with a more market-oriented economy that could help stimulate private sector activity. In this context, the trade regime was liberalized, with the maximum tariff lowered to 25 percent from 40 percent and the number of tariffs reduced from six to three. Tanzania also made substantial progress with privatization. Over the past 10 years, the country has privatized two-thirds of all units slated for divestiture. Most of these companies were small and medium-sized enterprises with limited employment, but some strategic enterprises were also privatized—notably the fixed-line telecommunications company, the national airline, the harbor terminal, and the National Bank of Commerce.

Achieving sustainable debt

In addition to making considerable progress in reestablishing a sound macroeconomic environment, improving fiscal prospects, and fostering a more inviting business climate, Tanzania also benefited from considerable debt relief from bilateral and multilateral donors. In November 2001, it became the fourth country to reach the completion point under the enhanced framework of the Heavily Indebted Poor Countries (HIPC) Initiative sponsored by the IMF and the World Bank. Total external debt-service relief under the initiative is expected to amount to approximately $3 billion. Debt-service payments have been cut substantially—dropping to an average equivalent to 7.7 percent of government revenue from the 19 percent that debt service had absorbed before HIPC assistance took effect. Lower debt-service obligations have also allowed the government to substantially increase its spending on priority sectors. Expenditures on education, health care, and agriculture rose from 8.8 percent of GDP in 2001/02 to 10.2 percent of GDP in 2002/03 and are projected to reach 11.5 percent of GDP in 2003/04.

But does this substantial reduction in the debt-service burden now provide a sustainable level of debt that will allow the country to go forward and tackle poverty more effectively? While there has been considerable

Tanzania's macroeconomic position continues to strengthen

	Preprogram	ESAF/PRGF		Projections
	1990–95[1]	1996–99[2]	2000–02[3]	2003–06[4]
	(percentage change, unless otherwise specified)			
Real GDP growth (percent)	2.7	4.1	5.5	6.1
Gold production (thousand troy oz.)	...	54.4	806.0	1,471.5
CPI (end of period)	29.9	12.3	4.9	4.1
Real effective exchange rate (index: 1990=100)	95.3	135.7	141.8	...
	(million U.S. dollars)			
Exports of goods and services	1,049.0	1,197.0	1,435.0	1,953.0
Imports of goods and services	1,893.0	2,142.0	2,173.0	3,115.0
Receipts from tourism	95.3	135.7	141.8	...
	(percent of GDP)			
Total revenue	12.5	12.1	12.3	14.0
Total expenditure	17.9	16.9	18.6	22.2
Development expenditure	3.5	4.0	3.9	4.8
Overall balance before grants	–5.9	–5.0	–6.3	–8.2
Overall balance after grants	–3.1	–1.2	–1.8	–2.6
Primary balance[5]	–1.3	0.7	–1.6	–3.6
External current account balance[6]	–10.4	–9.9	–8.7	–10.8

Data: Tanzanian authorities; and IMF staff estimates

[1]Total revenue through primary balance, fiscal years 1991/92 through 1995/96.

[2]Total revenue through primary balance, fiscal years 1996/97 through 1999/00.

[3]Total revenue through primary balances, fiscal years 2000/01 through 2002/03.

[4]Projections under new PRGF Arrangement with IMF for total revenue through primary balance; fiscal years 2003/04 through 2006/07.

[5]Calculated as overall balance minus grants and foreign-financed development expenditures; increase reflects increase in program.

[6]Excluding grants.

debate over how debt sustainability is determined and over the role played by fiscal policy, Tanzania's debt-service ratios are projected to remain well below acceptable thresholds over the medium term. Also, an IMF staff analysis demonstrates that Tanzania's projected fiscal stance should be consistent with debt sustainability as long as the government continues to have access to substantial donor financing on concessional terms at the current levels (4–5 percent of GDP). If donors were to gradually withdraw grant support, however, expenditures would have to be cut or revenues increased for the country to pursue a sustainable fiscal policy. This underscores the need for vigilance in the fiscal area, in particular the need to mobilize more revenue. In light of enhanced prospects for donor assistance, though, these risks appear rather remote at the moment.

More progress needed on poverty

Despite considerable achievements on the macroeconomic (including growth) and debt fronts, poverty has remained pervasive. As a 2001/02 household budget survey documented, the share of Tanzanians falling below the basic needs poverty line declined only 3 percentage points from 1991/92 to 2000/01 (dropping to 36 percent from 39 percent). And progress was uneven, with poverty rates showing virtually no decline in rural areas but dropping by 10 percentage points (to 18 percent from 28 percent) in Dar es Salaam.

The authorities are aware that if its social and economic goals are to be met, and the benefits of these goals are to be shared more widely, Tanzania must now take steps to further accelerate growth, contain inflation, enhance services, and generate income opportunities for the poor. There is thus a substantial reform agenda still to be taken up.

Increased donor assistance is expected to play a critical part in accomplishing these objectives, which are detailed in the country's Poverty Reduction Strategy Paper (PRSP). But increased aid will require additional reforms, chiefly to improve the country's absorptive capacity and the quality and effectiveness of its institutions (notably in providing reliable services and ensuring the rule of law). In addition, macroeconomic policies will have to be adapted to guard against possible upward pressure on the real exchange rate that will likely result from high aid flows.

Under the newly approved PRGF program with the IMF, the Tanzanian authorities seek to address these issues through a three-pronged strategy designed to mobilize revenues over the medium term, implement ambitious structural reforms, and further liberalize the trade regime.

Increase revenue. If Tanzania is to increase the robustness of its macroeconomic stability and limit the extent to which higher aid inflows increase liquidity, it will have to increase the amount of revenue the government collects. In this regard, the Tanzanian authorities have proposed a number of reforms to their tax system. A key one will be to integrate tax administration along functional lines rather than by type of tax. This should enhance the ability to cross-check taxpayer records and facilitate auditing.

The efficiency of tax administration is also expected to improve with initiatives to increase the threshold for the value-added tax and, in parallel, reform presumptive taxation for taxpayers below the threshold. In addition, self-assessment—one of the reforms included in a new income tax law that is to be submitted to parliament in October—could help free up administrative resources currently devoted to verifying the accuracy of submitted records and strengthen compliance over time.

Implement additional structural reforms. The principal aim of the next round of reforms will be to strengthen the domestic supply response, notably by improving the business environment. Measures will center on improved access to bank lending and financial sector reform, better governance, and streamlined procedures for business licensing. By October, the government intends to submit to parliament amendments to the Land Act aimed at removing obstacles to lending and facilitating access to bank credit for a much wider range of borrowers. The government also intends to adopt an action plan to reform and simplify the system for licensing businesses and take a number of steps to strengthen gov-

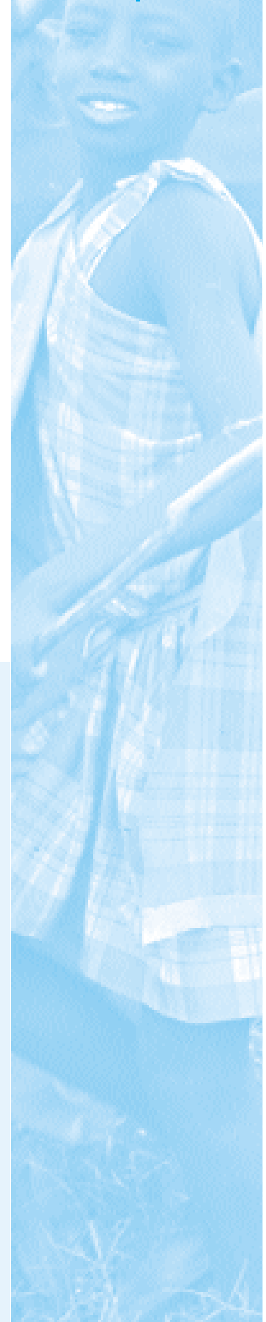
IMF solicits public comment on debt sustainability in low-income countries

To support low-income countries in achieving the Millennium Development Goals and help prevent a recurrence of debt problems that could undermine these objectives, the IMF, in collaboration with the World Bank and in consultation with donors and low-income countries, is working to develop a framework to guide low-income countries' borrowing. This framework would assist countries that have already received permanent debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and other low-income countries where debt is potentially an issue.

As a first step, IMF staff have prepared a paper outlining and assessing some of the key issues that would need to be considered. The paper, "Debt Sustainability in Low-Income Countries—Toward a Forward-Looking Strategy," was discussed by the IMF's Executive Board on July 11 and has been posted on the IMF's website. Comments on the paper should be sent by e-mail to LICDebtSust@imf.org by September 30.

(For the full text of Press Release No. 03/115, see the IMF's website [www.imf.org].)

Tanzania must now take steps to further accelerate growth, contain inflation, enhance services, and generate income opportunities for the poor.



Tanzania's impressive progress over the past decade places it among the best-performing countries in Africa.

ernance and improve transparency, including by publishing the names of individuals, nongovernmental organizations, and companies that are exempt from taxes.

Further liberalize the trade regime. The overall intent of greater trade liberalization is to expand the availability of imports and reduce upward pressure on the exchange rate, but progress will depend, at least in part, on policies adopted by Tanzania's partners in the East African Community (EAC). The EAC's recent adoption of a common external tariff of 25 percent—a level significantly lower than Kenya's previous highest tariff—shows that progress is being made in this area as well. And Tanzania, for its part, is showing its commitment to further liberalization, notably by moving to eliminate or lower import surcharges on a number of imports from the EAC.

Tanzania's impressive progress over the past decade places it among the best-performing countries in Africa. Whether over the coming decade it can make poverty reduction and higher living standards for a broader share of the population a reality will depend importantly on its ability to implement a range of structural reforms. And, given the strong willingness of Tanzania's development partners to provide more aid to support these efforts, reforms will need to be complemented by efforts to improve absorptive capacity and build effective institutions. ■

Available on the web (www.imf.org)

Press Releases

03/106: IMF Completes Third Review and Approves $37 Million Disbursement Under Stand-By Arrangement for Bulgaria, July 8
03/107: Managing Director's Visit to Kenya, July 9
03/108: IMF Executive Board Reviews Noncomplying Disbursement to the Lao People's Democratic Republic, July 9
03/109: Managing Director's Visit to Madagascar, July 10
03/110: Joint Communiqué by the Six Core Agencies of the Integrated Framework—IMF, ITC, UNCTAD, UNDP, World Bank, and WTO, July 10
03/111: IMF Managing Director Horst Köhler Visits Four African Countries and Addresses the African Union Heads of State Meeting in Maputo, July 11
03/112: IMF Completes Uruguay Third Review, Approves Request of Applicability of Performance Criteria, July 11
03/113: IMF Completes First Review of Jordan's Stand-By Arrangement, Approves $30 Million Disbursement, July 11
03/114: IMF Completes Second Review of PRGF Arrangement for Albania, July 15
03/115: IMF Soliciting Public Comment Related to the Design of an Operational Framework for Assessing Debt Sustainability in Low-Income Countries, July 15
03/116: IMF Completes Third Review of the Three-Year PRGF Arrangement and Approves Request for Waivers of Performance Criteria for the Kyrgyz Republic, July 17
03/117: IMF Approves a Three-Year, $8.8 Million PRGF Arrangement for the Islamic Republic of Mauritania, July 18
03/118: IMF Mission Concludes Discussions for the Fifth Review of Turkey's Stand-By Arrangement, July 21
03/119: IMF Completes First Review of the Three-Year Arrangement Under the PRGF and Approves Request for Modification and Waivers of Performance Criteria for the Republic of Tajikistan, July 21
03/120: IMF Completes Fifth Review Under Chad's PRGF Arrangement and Approves $7 Million Disbursement, July 22
03/121: IMF Managing Director's Visit to El Salvador, July 22
03/122: Socialist People's Libyan Arab Jamahiriya Accepts Article VIII Obligations, July 23
03/123: IMF Completes Sixth Review Under Mali's PRGF Arrangement and Approves $8.5 Million Disbursement, July 24
03/124: IMF Completes the Second Review Under the Democratic Republic of the Congo's PRGF Arrangement and Approves $37 Million Disbursement, July 24

Public Information Notices

03/83: IMF Concludes 2003 Article IV Consultation with Kenya, July 9
03/84: IMF Concludes 2003 Article IV Consultation with Bangladesh, July 11
03/85: IMF Concludes 2003 Article IV Consultation with Trinidad and Tobago, July 10
03/86: IMF Executive Board Reviews Data Standards Initiatives, July 23
03/87: IMF Concludes 2003 Article IV Consultation with The Bahamas, July 23
03/88: IMF Concludes 2002 Article IV Consultation with Argentina, July 25

Speeches

"The IMF: A Reliable Partner for Africa," Horst Köhler, IMF Managing Director, African Union Heads of State Meeting in Maputo, Mozambique, July 10 (see page 225)
"Life with the IMF: Indonesia's Choices for the Future," Jack Boorman and Andrea Richter Hume, 15th Congress of the Indonesian Economists Association in Malang, Indonesia, July 15
"Reinvigorating Growth in Bolivia," Anoop Singh, Director, IMF Western Hemisphere Department, CAINCO Economic Forum 2003, Santa Cruz de la Sierra, July 17
"Seizing the Opportunities of Globalization in Central America," Horst Köhler, IMF Managing Director, Second Annual Round Table on Central America, San Salvador, July 21

Transcript

Press Briefing, Thomas C. Dawson, Director, IMF External Relations Department, July 17

Köhler in Mozambique

IMF is committed partner in Africa's development

On July 10 in Maputo, Mozambique, IMF Managing Director Horst Köhler addressed the first anniversary meeting of the African Union heads of state. Edited excerpts from his remarks follow; the full text is available on the IMF's website (www.imf.org).

Despite a global economic slowdown, growth in Africa has been relatively resilient. Indeed, since the mid-1990s, economic growth in sub-Saharan Africa has averaged well above 3 percent a year, compared with some 1 percent in the first half of the 1990s. But the gains remain fragile. The sober reality is that maintaining even this relatively good performance will not suffice to halve poverty by 2015, as envisaged in the United Nations Millennium Declaration. Indeed, the New Partnership for Africa's Development (NEPAD) itself aims at raising growth to 7 percent a year. This is an ambitious goal. But Africa has the potential to achieve it if an effort is made on all sides to create the domestic conditions for growth through sound national policies and to ensure that the international environment is supportive of Africa's integration with the global economy.

I congratulate you on NEPAD. With it, Africa assumes responsibility for its own transformation, renewal, and development. NEPAD is also promising because it reflects the broad international consensus reached in Monterrey and Johannesburg last year. Partnership and peer review are integral parts of NEPAD, and I believe that they will foster a critical element of the development process: the ability to learn from each other. There is progress in Africa and even success stories, like Botswana. What is needed now is decisive implementation of proven good practice in national policy agendas and in regional and international cooperation. And, most important, the people of Africa, not just its leaders, must understand, accept, and be involved in NEPAD's implementation. That is why I believe the theme of this meeting—Toward Ensuring the Implementation of NEPAD—is exactly the right one.

Growth and challenges

There is ample evidence that countries with prudent macroeconomic policies attain higher growth rates. We can observe this in Benin, Botswana, Burkina Faso, Cameroon, The Gambia, Mali, Mauritius, Mozambique, Tanzania, Uganda, and others. In most of these cases, the strong performance has been within the context of IMF-supported programs. Good economic performance has also sustained substantial

Adriano Maleiane, Governor of Mozambique's Central Bank (left) and Luisa Diogo, Minister of Planning and Finance, join IMF Managing Director Horst Köhler at the dais.

progress on debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. In the 23 African countries that have reached their decision points, debt service has been halved from about 30 percent of government revenue in 1998 to 15 percent in 2002, while social spending now amounts to four times as much as debt-service outlays.

But in parts of Africa, continued civil strife has taken a heavy toll on development. In the Great Lakes region, in Liberia, and also in Côte d'Ivoire, recent armed conflict has caused significant human losses, and its economic impact has stretched well beyond the countries immediately affected. No effort from international financial institutions can compensate for these economic, social, and humanitarian setbacks. I fully agree with [South African] President Thabo Mbeki's observation at your inaugural meeting in Durban last year: "There can be no sustainable development without peace, without security, and without stability." The African Union must provide critical momentum to end armed conflicts in Africa.

Partners and responsibilities

Sustained economic growth and poverty alleviation in Africa require that all development partners work together to meet their commitments. In the spirit of Monterrey and NEPAD, African countries themselves face—in my view—four main challenges:

• *Greater progress on governance, institutions, and fighting corruption.* While I see much progress in recent years in the efforts to strengthen governance, build sound institutions, and fight corruption, further ambitious work is needed. IMF research has found that growth would be around 2 percentage points higher in sub-Saharan African countries if the quality of their institutions were improved to the average of other regions.

• *Sustained macroeconomic gains.* As demonstrated so convincingly by African countries themselves in recent years, macroeconomic stability is a prerequisite for sustained growth.

• *More investment and a climate in which the private sector can develop and prosper.* As shown by the work of the Investors' Councils that the IMF and the World Bank are supporting in Ghana, Senegal, and Tanzania, there is a lot governments can do to improve the investment climate. Improvements are needed in public administration, in legal and judicial systems, and, more generally, in the enforcement of the rule of law. The legal definition and use of land title would boost private sector activity and job creation in many African countries. Land title can play a crucial role, at the very least, as collateral for the financing of investment. Government also plays an important direct investment role as well, especially in providing the necessary infrastructure for private investment and development. In this vein,
I very much hope that NEPAD, in cooperation with the World Bank and the other regional development banks, will stimulate needed infrastructure investments.

• *Growth through regional cooperation.* There are also considerable unexploited opportunities in Africa to promote growth through regional cooperation. Creating larger and more integrated markets, facilitating cross-border investment, and allowing the free movement of people and exchange of ideas carry economic as well as political benefits. From ECOWAS [the Economic Community of West African States] in the west to COMESA [the Common Market for Eastern and Southern Africa] in the east and south, institutional frameworks exist. I urge you to make better use of these regional arrangements, including by aggressively reducing significant tariff and nontariff trade barriers between countries. Boosting South-South trade carries a dual benefit: it strengthens your local basis for generating growth and jobs, and it also gives you a stronger edge when urging advanced economies to reform their trade practices.

At the same time, as the second pillar of the development partnership, the international community must also live up fully to its commitments:

• *Fulfill official development assistance goals.* While there has been some progress in raising official development assistance levels since Monterrey, total aid commitments are still well below what are needed to reach the Millennium Development Goals. I continue to urge the developed countries to live up to their pledges and their long-standing target of 0.7 percent of GNP for development assistance. And this assistance should be given, as far as possible, on grant terms. I also support U.K. Chancellor Gordon Brown's proposal of an international financing facility to accelerate progress toward meeting the Millennium Development Goals. But current aid flows are not only insufficient, they are also unpredictable and often uncoordinated among donors. Better aid coordination and multiyear commitments are key steps in making development assistance more effective. The IMF is fully committed to participating in the donor harmonization process defined in Rome earlier this year.

Total aid commitments are still well below what are needed to reach the Millennium Development Goals.
—Horst Köhler

• *Trade holds the key.* As Ugandan President Yoweri Museveni noted recently during a visit to Washington, "We have a long way to go as we seek to integrate ourselves into the global supply chain, but it is a road we have no choice but to travel. Our salvation lies through trade, not aid." I completely agree. It is critically important to reverse the declining trend of sub-Saharan Africa's share in world trade, which has fallen to below 1 percent, when we subtract out South Africa and Nigeria (otherwise at 2 percent). The first priority must be for developed economies to significantly reduce trade-distorting subsidies and improve market access for developing country exports. President Museveni is again right when he asks, in particular, to reduce the hurdles African countries face to develop value-adding processing industries as part of their export base. It is encouraging that the leaders of the Group of Eight have personally pledged to make the Doha Trade Round a success. Agriculture is the key to ensure that it truly becomes a development round. I hope that the recent agreement within the European Union to begin to reform its Common Agricultural Policy will serve as a useful impetus to restart negotiations in this area. In September, the World Trade Organization will hold its ministerial meeting in Cancún. This will be the occasion for the advanced economies to match rhetoric with action. It is also the occasion for Africa to seize the initiative and articulate a common position, united with a well-prepared negotiating strategy.

IMF can help

The IMF remains fully engaged in Africa and is committed to helping its African members raise growth. The country-driven and participatory PRSP [Poverty Reduction Strategy Paper] approach has become widely accepted as the operational framework at the country level. From my discussions over the past week, I sense that there is a need to better define the prioritization of policy measures proposed in PRSPs. In particular, priority needs to be put on rural development to raise productivity and income in rural areas. This needs to be coupled with efforts to modernize and diversify urban economies. The World Bank and the

IMF are your partners in implementing PRSPs.

For its part, the IMF will continue to concentrate on its areas of competence—helping to establish a framework for sound macroeconomic policies and institutions. To this end, we have reduced our conditionality by focusing it on those areas that are central to achieving the macroeconomic objectives of the program. And we are working hard to ensure a better alignment between the PRSP, the national budget framework, and our own concessional lending facility, the PRGF [Poverty Reduction and Growth Facility]. And the IMF and the World Bank will continue to review the debt sustainability of our African member countries. We know that more "topping up" of debt relief may be needed. I am prepared to recommend this to the IMF's Executive Board based on a careful country-by-country analysis. Moreover, in our current work program, we are considering ways to help low-income countries better manage the impact of economic shocks.

Over the long term, the IMF will further tailor its assistance to the evolving challenges facing African countries. I fully agree with the objective of the African Union to establish the necessary conditions to enable the continent to play its rightful role in the global economy. In the economic and financial area, realizing this objective requires developing a long-term road map for increasing access to private sources of investment and finance. The IMF is committed to helping Africa proceed down this road.

We are working with countries to build stronger and diversified financial sectors to mobilize domestic investment, attract foreign direct investment, and pave the way for eventual access to foreign capital markets.

I know that the lack of capacity to implement reforms constrains progress in the fight against poverty. Africa is already the largest recipient of technical assistance from the IMF, but we will further increase our efforts. Our recently established regional capacity-building centers—the East and West AFRITACs in Dar es Salaam and Bamako—have had a good start. We will evaluate their performance after 18 months, with a view to opening three more such centers in sub-Saharan Africa.

Overall, the IMF has given its African members significant attention in recent years in its policies and decisions. I will stay this course.

The vision of the African Union—of economic integration across the continent—must inspire us all. I am optimistic that, with persistence, the challenges facing Africa, great as they are, can be overcome. And you may rest assured that, on your road, the IMF will be a reliable partner. We will stand by you, with our expertise and financial resources, to help you realize your aspirations. ■

We are considering ways to help low-income countries better manage the impact of economic shocks.
—Horst Köhler

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03/130: "Exchange Rate Pass-Through in Romania," Nikolay Gueorguiev

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03/207: Norway: Report on the Observance of Standards and Codes

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03/209: Chad: Poverty Reduction Strategy Paper

03/210: Republic of Kazakhstan

03/211: Republic of Kazakhstan: Selected Issues and Statistical Appendix

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Stand-By, EFF, and PRGF arrangements as of June 30

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By arrangements				
Argentina[1]	January 24, 2003	August 31, 2003	2,174.50	9,751.00
Bolivia	April 2, 2003	April 1, 2004	85.75	42.87
Bosnia and Herzegovina	August 2, 2002	November 1, 2003	67.60	12.00
Brazil	September 6, 2002	December 31, 2003	22,821.12	8,664.30
Bulgaria	February 27, 2002	February 26, 2004	240.00	104.00
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Croatia, Rep.	February 3, 2003	April 2, 2004	105.88	105.88
Dominica	August 28, 2002	August 27, 2003	3.28	1.23
Ecuador	March 21, 2003	April 20, 2004	151.00	120.80
Guatemala	June 18, 2003	March 15, 2004	84.00	84.00
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
FYR Macedonia	April 30, 2003	June 15, 2004	20.00	16.00
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Romania	October 31, 2001	October 15, 2003	300.00	110.22
Turkey	February 4, 2002	December 31, 2004	12,821.20	2,381.40
Uruguay	April 1, 2002	March 31, 2005	2,128.30	798.10
Total			42,890.91	15,293.52
EFF				
Indonesia	February 4, 2000	December 31, 2003	3,638.00	688.12
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	450.00
Total			4,432.40	1,261.85
PRGF				
Albania	June 21, 2002	June 20, 2005	28.00	20.00
Armenia	May 23, 2001	May 22, 2004	69.00	29.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	51.48
Bangladesh	June 20, 2003	June 19, 2006	347.00	297.50
Benin	July 17, 2000	March 31, 2004	27.00	4.04
Burkina Faso	June 11, 2003	June 10, 2006	24.08	20.64
Cameroon	December 21, 2000	December 20, 2003	111.42	47.74
Cape Verde	April 10, 2002	April 9, 2005	8.64	6.18
Chad	January 7, 2000	December 6, 2003	47.60	10.40
Congo, Dem. Rep. of the	June 12, 2002	June 11, 2005	580.00	133.33
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Ethiopia	March 22, 2001	March 21, 2004	100.28	31.29
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	January 12, 2001	January 11, 2004	108.00	58.50
Ghana	May 9, 2003	May 8, 2006	184.50	158.15
Guinea	May 2, 2001	May 1, 2004	64.26	38.56
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Guyana	September 20, 2002	September 19, 2005	54.55	49.00
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Rep.	December 6, 2001	December 5, 2004	73.40	38.24
Lao PDR	April 25, 2001	April 24, 2004	31.70	18.11
Lesotho	March 9, 2001	March 8, 2004	24.50	7.00
Madagascar	March 1, 2001	November 30, 2004	79.43	45.39
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2003	51.32	6.15
Moldova	December 21, 2000	December 20, 2003	110.88	83.16
Mongolia	September 28, 2001	September 27, 2004	28.49	24.42
Nicaragua	December 13, 2002	December 12, 2005	97.50	76.61
Niger	December 22, 2000	December 21, 2003	59.20	13.52
Pakistan	December 6, 2001	December 5, 2004	1,033.70	516.84
Rwanda	August 12, 2002	August 11, 2005	4.00	2.86
Senegal	April 28, 2003	April 27, 2006	24.27	20.80
Sierra Leone	September 26, 2001	September 25, 2004	130.84	42.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	57.00
Tanzania	April 4, 2000	August 15, 2003	135.00	15.00
Uganda	September 13, 2002	September 12, 2005	13.50	12.00
Vietnam	April 13, 2001	April 12, 2004	290.00	165.80
Total			4,918.71	2,786.97

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

Data: IMF Finance Department

Can Sweden's welfare state rise to the challenges of the twenty-first century?

What should be the role of the state in economic affairs? This long-standing question has assumed greater prominence as countries have tried to adjust to the forces of globalization and aging populations. The experience of Sweden, which for many years has maintained one of the most extensive welfare states, is of particular interest not only to other industrial countries but also to emerging market and developing countries. The authors of Sweden's Welfare State: Can the Bumblebee Keep Flying? *Michael Keen, Subhash Thakur, Valerie Cerra, and Balázs Horváth, met with the* IMF Survey *to discuss how Sweden has managed to sustain a welfare state for so long and the challenges it now faces.*

IMF Survey: What was your motivation for studying Sweden's welfare state at this juncture?

Thakur: IMF surveillance in advanced European economies, as elsewhere, has increasingly extended beyond its traditional macroeconomic focus. During the Swedish consultation, we set out to look at the broader picture of Sweden's welfare state and to assess its achievements and prospects. Sweden's experience has been extensively studied as a model of the social democratic welfare state, and so, to draw on as broad a spectrum of views as possible, we widened our discussions beyond the official and semiofficial circles to include a range of observers—for example, academics at the Stockholm School of Economics and Uppsala University, and various research institutions.

You could say that our study, which has evolved over a period of almost two years, is, in a sense, the IMF's attempt to understand what is so special about the Swedish model, why many have regarded it as successful, what its costs are, and what challenges it is likely to face in the future. In our view, the two key forces that the Swedish model will need to confront if it is to remain viable are globalization, which potentially undermines the welfare state's fiscal basis, and the demographic transition.

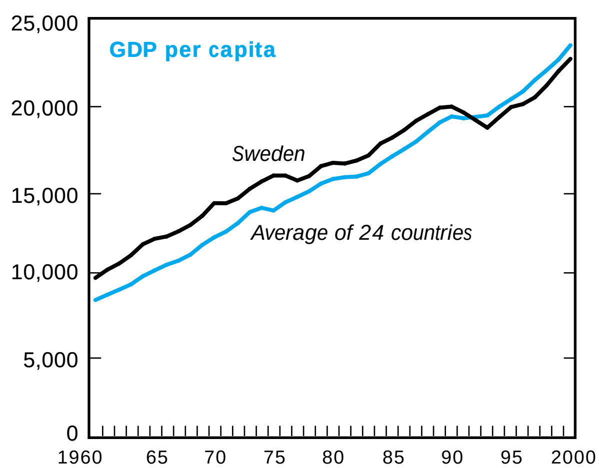
IMF Survey: There has been considerable debate about the benefit of a welfare state like Sweden's, with its critics saying it hampers growth and its advocates saying it ensures high living standards for all Swedish citizens. Hasn't the welfare state begun to have a negative effect on economic growth?

Cerra: Indeed, Swedish scholar Assar Lindbeck observed that Sweden slipped from having the third-highest per capita income among OECD countries in 1970 to ranking fourteenth in 1991. But a careful study of the trends in relative incomes shows that Sweden managed to maintain its per capita income at a roughly constant margin above the OECD average until its banking crisis in the early 1990s. The recession that began in 1991 led to an abrupt and permanent decline in output and per capita income.

In short, Sweden lost its high ranking very suddenly at the onset of the banking crisis and has not been able to regain it. Looking at other measures —such as GNP rather than GDP, per capita income of the working-age population rather than the total population, or ones based on different exchange rates for international comparisons—leads to the same conclusion. Thus, it can be argued that the slippage in Sweden's living standards measured by per capita income was not a gradual sclerosis necessarily caused by the welfare state but rather a sharp onetime drop in income triggered by avoidable macroeconomic policy mistakes that was not recouped later. But Sweden ranks high on many other measures of living standards, such as educational attainment, health care, and environmental quality.

Despite recent slippage in its ranking, Sweden continues to enjoy high per capita income

(1995 purchasing power parity)



Data: OECD; IMF, *World Economic Outlook*, and IMF staff calculations.

The literature on how the welfare state affects growth is also relevant. A lot of academic studies sug-

The two key forces that the Swedish model will need to confront if it is to remain viable are globalization, which potentially undermines the welfare state's fiscal basis, and the demographic transition.
—Subhash Thakur

Keen: "We do express some concern in the book about the generosity of unemployment and, perhaps even more, sickness benefits."

Horváth: "National savings have significantly improved partly because of fiscal consolidation that moved the budget from a large deficit position to a sizable surplus."

gest that a number of different taxes distort labor supply decisions, the incentive to save, and so forth. The extent of that depends on the type of tax, how distorting it is, and whether the revenue is put to productive use, such as for education or programs that enable the labor market to adjust to changing circumstances, or whether it is used to finance unproductive public expenditure.

IMF Survey: Sweden was one of the stars of the high-tech sector before the bursting of that bubble. Assuming that high growth in this sector helped offset some of the economic difficulties caused by welfare policies, what is the prognosis for growth in Sweden?

Cerra: The explosive demand projections for the high-tech sector must now be revised down with the bursting of the bubble. Yet Sweden's long-term prospects in this sector are still promising, especially if labor market incentives are improved, particularly for highly skilled workers. Sweden has a highly educated workforce and productive labor relationships. Its openness to international trade, significant investment in research and development, political stability, and high quality of institutions and transparency in economic policy, as well as its links to both continental Europe and the Anglo-Saxon countries, enhance its competitive position.

IMF Survey: Has the quality of the government intervention in Sweden helped offset some of the downsides of a welfare system?

Horváth: It certainly has. The quality of government intervention has been very high in several respects. The public sector has been transparent. There is also a strong regulatory framework in Sweden, which helped create an environment conducive to private sector activity despite the large role of the public sector, a necessary component of any developed welfare state. Sweden's very strong social safety net has encouraged risk taking; it has been argued that this was one of the reasons the information technology sector thrived in Sweden.

Thakur: Transparent and effective governance in the public sector has been a key element in the Swedish story because such governance has helped sustain the social consensus for the high level of taxation and public spending. Without it, the viability of the welfare state would have come under question.

IMF Survey: What, specifically, has been the impact of Sweden's labor market interventions?

Horváth: First, centralized wage bargaining was a pivotal element of the welfare state. It helped maintain social peace and delivered very high rates of participation and employment. These, in turn, ensured the high tax revenues needed to sustain a welfare state. But there are significant drawbacks to the centralized wage bargaining setup, including a compressed wage scale, which leads to relative overpayment of low-skilled labor and relative underpayment of high-skilled labor. This can create disincentives because the reward for accumulating human capital is lower than in other countries. It could also imply some net human capital loss through net migration.

Various measures have been taken to offset some of the problems of centralized wage bargaining. For example, a significant portion of wage determination was shifted from the central level down to the factory level, leading to increased wage flexibility and some wage decompression. There was also a rise in part-time and temporary employment, helping to maintain very high participation rates. For example, the participation rates of women and people over 55 are higher in Sweden than in almost any other country.

Keen: On the tax-benefit side, it's true that the combined effect of taxes and transfers is to produce, for some groups, quite high effective marginal tax rates on labor income. But the same is true in many other European countries and is to some degree inescapable if one wants to ensure high basic living standards for all. We do, though, express some concern in the book about the generosity of unemployment and, perhaps even more, sickness benefits.

IMF Survey: Sweden's tax regime has been successful in attracting foreign investment. Can it sustain this?

Keen: For many years, Sweden's tax treatment of companies has made it pretty attractive to investors. Historically, it did this by combining quite high corporate tax rates with a fairly narrow tax base. Since a major tax reform in 1991, it has changed strategies and now has a fairly broad base but relatively low rates. The issue for the future is what happens to corporate tax revenues. If other countries lower their tax rates and make their tax regimes more attractive, Sweden will come under pressure to respond, thereby diluting its revenues. Further pressure on corporate taxation can certainly be expected. When Sweden adopted the 28 percent corporate tax rate in 1991, it seemed remarkably low, but now it seems on the high side compared with, say, Ireland, where the rate is 12½ percent.

IMF Survey: But Sweden's tax regime has not favored saving. Is there any discussion of changing the tax structure to improve the saving rate?

Keen: The tax treatment of capital income has certainly been a recurring issue in Sweden. In fact, in the 1991 tax reform, Sweden moved away from taxing capital income and wage income at the same rate—a radically new approach. Essentially, it decided it had failed to tax capital income effectively— revenues from capital income taxes were actually negative because people claimed more deductions for interest payments than they declared as taxable income.

So Sweden moved to a moderate, low, and uniform flat tax on capital income of various kinds. Sweden has not adopted special savings incentive schemes, like the IRAs or the 401(k)s in the United States, to encourage household savings. Rather, it has tried to have a simple, moderate tax on capital income. There may be scope for reducing effective tax rates on savings, but we think a lot can be said for this strategy.

HORVÁTH: I'd like to add that, overall, national savings have significantly improved partly because of fiscal consolidation that moved the budget from a large deficit position to a sizable surplus.

IMF SURVEY: In the absence of policy interventions, how serious would poverty and income inequality be in Sweden? Harking back to the quality of government intervention—the amounts spent on education in particular—doesn't this reduce the need over time for transfers to equalize income distribution?

KEEN: Those are tough questions. It's essentially impossible to say what poverty and inequality would be in any industrial country without government intervention. Typically, to assess how intervention affects inequality and poverty, we compare people's incomes before and after taxes and transfers. Of course, that pretax income reflects people's perceptions of how much they'll receive in transfers from the government. If there were no income support, we would typically expect pretax incomes of the poor to be higher than they actually are, because the onus would be on people to look after themselves.

Whether the need for activist distributional policy declines over time depends in part on the dynamics of inequality over people's lifetimes. We are all endowed with different skills and have different luck; some of us have good ideas, some bad ideas; some of us are healthy and some not. By the end of our lifetimes, some inequality would emerge even if we all started off equal, and this inequality can transfer itself to the next generation through bequests of various kinds. Some people would say that's fine. But Sweden has a stronger egalitarian consensus than that.

HORVÁTH: A lot of different aspects have to work together for a large welfare state to be sustainable. Other countries have tried a welfare state without having a critical mass of supporting institutions in place. Hungary's attempt to create a welfare state, for example, was considered premature because it tried the transfers and large spending without having the revenue base.

THAKUR: The Swedish experience is interesting in the context of the debate around the world, particularly in developing countries, on whether rapid growth is compatible with a reduction of inequality. We all know that some of the economies in east Asia have grown rapidly and also reduced poverty and inequality. That's certainly true of Sweden. If we look at a time span of more than a century, Sweden moved from being one of the poorest countries in Europe to one of the richest. At the same time, the degree of inequality was dramatically reduced, and that has something to do with the points made earlier about the quality of public intervention and how public spending has been used to assist people at the bottom of the income distribution.

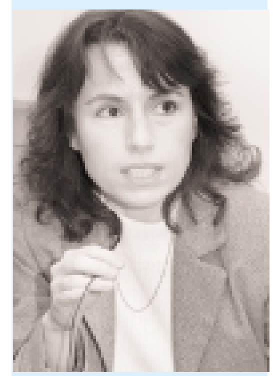
IMF SURVEY: However one interprets its past performance under the welfare state, Sweden will face challenges in the years ahead. What do you think are the most significant of these, and how do you think they will affect public support for the welfare state?

CERRA: The change in the composition of the population and the workforce may present the most significant challenges. For example, the aging of the population will entail fiscal costs not only for public pensions. There will be an increasing strain on the health care system, and we've already seen an increased use of sick leave, which is generously compensated in Sweden. The local government workforces are particularly susceptible to these problems, even in the near term, because they tend to be older. In addition, many of the health care services are provided by local government, and there will be increasing pressure for tax increases at this level to fund an expansion of services so as to increase both the number of health care service providers and the wages to attract people to this sector.

Immigration associated with European integration and the expansion of the European Union may help reduce some of these pressures—for example, if they can help increase the number of young workers. But immigration, if poorly managed, could also undermine the social consensus behind social insurance programs.

THAKUR: Globalization is as important a force as demographic transition for the prospects of a large welfare state. Although it has been much debated whether globalization is a new force or has been around for a long time, the degree of integration

Thakur: "An important lesson to keep in mind is that Sweden has always viewed itself as a small open economy—open to trade, investment, and competition from abroad."



Cerra: "But immigration, if poorly managed, could also undermine the social consensus behind social insurance programs."

IMF SURVEY

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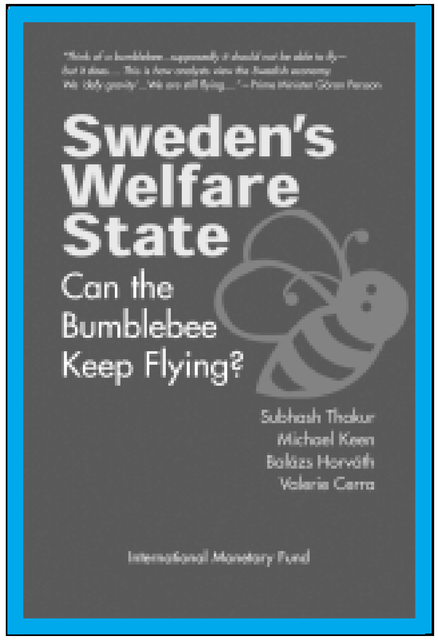
around the world has clearly been rising rapidly. The older notions of solidarity that have been very important to the success of the Swedish model are under stress from the forces of global integration.

Globalization also tends to reduce governments' autonomy to put in place market-correcting measures to preserve their own model of the social contract. That's where the interaction of demographics and globalization creates powerful pressures, which are most obvious on the fiscal side. Our central message is that Sweden will need to streamline its welfare state to preserve its key elements and sustain its success.



IMF SURVEY: What lessons can you draw for other industrial countries from Sweden's experience?

HORVÁTH: The lessons can be divided into three groups: design, sustainability, and the way a developed welfare state reacts to shocks. On design, there has not been a successful welfare state where incomes are low. So high per capita incomes appear to be a prerequisite.

There also needs to be a critical mass of institutions in place that reinforce each other and sustain the welfare state. We've talked about the labor market institutions, such as wage bargaining, but there is also a need for a transparent and efficient tax and transfer system that maintains incentives and achieves some of the main objectives of a welfare state, which are lower income inequality and giving everyone equal opportunities in life. A strong safety net is essential. There's also a critical need for a sound policy framework. For example, Sweden has a well-implemented inflation targeting regime and a fiscal framework that ensures fiscal prudence. Finally, there is a need for a strong and broad social consensus in support of a welfare state because building all the institutions necessary to sustain one takes several political cycles.

As for reactions to shocks, the large public sector makes the system more rigid, and centralized wage bargaining makes the labor market more rigid. It is thus important to prepare for exogenous shocks, and it's important not to compound the shocks with policy mistakes. If the adjustment is not fast enough, there might be permanent losses in income. That has been the Swedish experience.

THAKUR: The Swedish experience has attracted policymakers in several developing countries. In this context, an important lesson to keep in mind is that Sweden has always viewed itself as a small open economy—open to trade, investment, and competition from abroad. It is no accident that Swedish economists such as Eli Heckscher and Bertil Ohlin were pioneers in the study of international trade. That's why globalization, although an intensifying force, is not a new phenomenon for Sweden.

IMF SURVEY: You take your book title from a remark by Swedish Prime Minister Göran Persson. He compares Sweden's welfare state to a bumblebee that should not, in principle, be able to fly but does. Can the Swedish bumblebee continue flying?

THAKUR: Sweden's welfare state has sustained itself for a long time. Our book attempts to explain the forces that have shaped it to see whether the bumblebee will need to adapt a bit.

HORVÁTH: If it manages to adapt to changing circumstances, there is no reason it cannot continue to fly. ■

Copies of Sweden's Welfare State: Can the Bumblebee Keep Flying? *by Subhash Thakur, Michael Keen, Balázs Horváth, and Valerie Cerra, are available for $23.50 each from IMF Publication Services. For information about ordering, please* *see page 227.*

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
July 14	1.49	1.49	1.97
July 21	1.49	1.49	1.97
July 28	1.51	1.51	1.99

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?2003).

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Data: IMF Finance Department