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Interview with George Abed

Middle East's best hope lies in urgently tackling economic and social reforms

Abed: "Open and democratic institutions have been slow to develop."

George T. Abed, a Palestinian and a Jordanian national, took over this summer as Director of the IMF's Middle Eastern Department. In his distinguished 20-year career at the IMF, he has worked on the Middle East and on fiscal policy issues worldwide. Outside the IMF, he taught at the University of California, Berkeley, and managed a development assistance foundation in Geneva, Switzerland. Laura Wallace spoke with him about the region's prospects amid political tensions and difficult economic challenges. Besides modernizing the state and liberalizing the region's economy, he stressed the paramount importance of democracy, human development, and attention to social needs.

IMF Survey: Let's start with some of the hot spots. In light of renewed tensions in the West Bank and Gaza, where do efforts stand to help the Palestinian Authority rebuild its economy? Will relations be facilitated by the recent appointment of Salam Fayyad—the IMF's former senior resident representative in the area—as finance minister?

Abed: Since the Oslo agreement of 1993, the IMF has been assisting the Palestinian Authority in setting up modern economic and financial institutions. With the escalation of conflict in the *(Please turn to the following page)*

Can fiscal policy help oil-producing countries avoid the "resource curse"?

Over the past two decades, the economic performance of the oil-producing countries as a group has lagged behind that of other countries at comparable levels of development. What accounts for this? What role can fiscal policies play in improving the performance of oil-producing countries? In June, the IMF's Fiscal Affairs Department hosted the conference "Fiscal Policy Formulation and Implementation in Oil-Producing Countries" to address these and related questions.

The economic performance of many oil-producing countries has often been poor, despite the seeming advantage of access to substantial natural resources. IMF Managing Director Horst Köhler and Fiscal Affairs Department Director Teresa Ter-Minassian alluded to this in their opening remarks, with Ter-Minassian noting that the many cases of disappointing performance have led to common references to a "resource curse."

What explains the resource curse? Both economic and political factors are at play. Among the economic *(Please turn to page 263)*

Harvard University's Ricardo Hausmann (right) with Teresa Ter-Minassian and Jeffrey Davis of the IMF's Fiscal Affairs Department.

Abed on Middle East challenges

Government expenditures are high by developing countries' standards, and some of that spending—on weapons and on subsidies to inefficient industries, for example—is nonproductive.
—George Abed

(Continued from front page) past two years, our work has been made much more difficult. In June, a reform-minded cabinet of ministers was appointed, which included Salam Fayyad as Minister of Finance—a step welcomed in all quarters. The Palestinian Authority announced a 100-day reform program, which is being monitored by the international community, including the IMF. The reform program is going well, but the physical conditions under which Fayyad and his colleagues work are very difficult and hinder their ability to implement the program. We hope that peaceful conditions can be restored soon so that the new Palestinian cabinet and the donor community can proceed with the urgently needed reconstruction and development.

IMF Survey: Can you clarify the role the IMF plays in monitoring the use of foreign assistance in the Palestinian Authority, from the European Union and elsewhere?

Abed: Because of the IMF's mandate and competence in fiscal and monetary management, donors have relied on us to develop the macro framework for the Palestinian economy, help the Palestinians develop budget priorities, and provide donors with periodic reports on budgetary allocations and major spending categories. The aim is to ensure that the Palestinian Authority allocates development assistance funds to the broad purposes intended. The Palestinians' own domestic revenues generally cover their current requirements—salaries and wages, and other current spending.

With weak institutions and a budget of nearly $1 billion, there has, no doubt, been some abuse; the Palestinian Legislative Council itself has complained about this. However, with the new reform cabinet in place, these problems are being firmly dealt with. Of course, the IMF does not and cannot control downstream spending by the various Palestinian agencies. This matter remains between the Palestinian Authority and the donors.

IMF Survey: What can you say about efforts to rebuild Afghanistan's economy?

Abed: The IMF has been involved principally in rehabilitating economic and monetary institutions—notably to ensure that the ministry of finance and the central bank are able to carry out the functions needed in a postconflict environment. This has mainly entailed an extensive technical assistance program involving the IMF's International Capital Markets, Fiscal Affairs, Legal, and Monetary and Exchange Affairs Departments. We have assisted the authorities in the preparation of a monetary program designed to keep inflation in check while allowing for a substantial recovery of economic activity. We have advised the authorities on the preparation and execution of the budget. The country's capacity to generate domestic revenue is extremely limited. In these circumstances, the actual transfer of funds in relation to original pledges has been slow, and a budget gap remains that we hope can be bridged by the end of the year.

IMF Survey: More generally, why has the region stagnated for nearly two decades, and why is it being sidelined by the forces of globalization?

Abed: The picture is somewhat more complex. Because of oil's importance, depressed oil prices and production from the early 1980s have been reflected not only in low or negative growth rates for this sector but more broadly in the economies of the region. But generally, the other sectors have continued to grow.

Nevertheless, overall growth in the region has been anemic. One reason is that these economies emerged from the 1960s and 1970s with very large public enterprise sectors that grew to be bureaucratic, inefficient, and oriented toward a captive domestic market—an environment that was not particularly conducive to private sector investment, innovation, and risk taking. The pace of economic reform has also been slow. Much needed structural and macroeconomic reforms—privatization; liberalization of prices, trade, and exchange rates; and labor market reforms—didn't even begin until the late 1980s and early 1990s. Many of these reforms remain incomplete and others have yet to begin. Finally, open and democratic institutions—which are conducive to improved governance, better economic performance, and wider interaction with the outside world—have been slow to develop.

IMF Survey: What can be done to turn the situation around?

Abed: To begin with, there is an urgent need to reform the state and its institutions. This means, among other tasks, reducing the size of the public sector to create room for private sector activity, and rationalizing the role of the state within the market economy. Government expenditures are high by developing countries' standards, and some of that spending—on weapons and on subsidies to inefficient industries, for example—is nonproductive. Another set of reforms would bring about greater openness to the outside world. This should be pursued through trade liberalization, flexible exchange rates, sound macroeconomic policies, and regulatory reform to help attract foreign direct investment. Closer regional integration could also spur more rapid economic growth through improved competition, enlarged markets, and more vigorous intraregional trade.

IMF Survey: How far along is the Gulf Cooperation Council [GCC] economic and monetary union?

Abed: In December 2001, the GCC summit decided to create such a union, comprising the six member countries, by 2010. Steps are already under way to prepare for it. A common external tariff will come into effect in 2003, while agreement has been reached to peg the currency to the dollar and to work on convergence criteria for institutional coordination. In the Middle East and North Africa as a whole, the GCC is the most advanced group along these lines. The North African countries have a Maghreb union that remains far short of its announced objectives.

IMF Survey: Are there countries doing a good job that could lead by example?

Abed: There are several. Jordan has managed its economy fairly intelligently in the past several years. It has brought public debt down to manageable levels, promoted macroeconomic stability through lower fiscal deficits, and undertaken a large number of structural reforms, such as privatization, deregulation, and, more recently, pension reform. And Jordan has been well rewarded for its efforts through Paris Club actions and free trade agreements with Europe, the United States, and others.

The Islamic Republic of Iran has also undertaken some important initiatives to improve economic efficiency, including liberalizing trade, unifying the exchange rate, reforming the banking sector, and improving transparency. Over time, if this momentum is sustained, the country will show some positive results. But Iran is in the midst of an internal debate on the course the country should take toward modernization and economic development. This debate is very lively and, in many ways, very healthy, but it is also costly in that it often delays the implementation of economic reform.

Among GCC members, several countries are doing well, especially the smaller ones, such as Oman and Bahrain. Saudi Arabia is also undertaking structural and institutional reform that could underpin improved performance. In North Africa, Morocco has successfully undergone a democratic transition, while Tunisia continues to sustain relatively high rates of growth and attract foreign direct investment.

IMF Survey: Besides Iran, what are the prospects for Egypt and Pakistan? More than half of the region's 500 million inhabitants live in these countries.

Abed: In the Arab world, Egypt is a leading country, culturally, politically, and economically. It undertook a number of key macroeconomic reforms in the 1990s that helped reduce inflation, stimulate growth, build up foreign exchange reserves, and attract foreign direct investment. Unfortunately, more recently the pace of economic reform has slowed, and economic performance has weakened somewhat. We hope this is a temporary phenomenon. But Egypt needs to invigorate its reform agenda to get back on a higher growth path—something the authorities are well aware of.

Pakistan has been working closely with the IMF over the past three years and has undertaken important macroeconomic and structural reforms. The economy has stabilized, with lower inflation, higher reserves, and better growth prospects. Exports have been growing vigorously despite the difficult political and strategic environment. The economy has some way to go to achieve the high growth rates needed to create enough employment, and more of the government's spending needs to be allocated to reduce poverty.

IMF Survey: The UNDP's *Arab Human Development Report 2002* [see box, page 260] zeroed in on the need for greater freedom, gender equality, and knowledge acquisition. Are these findings significant, given that the report was prepared by a group of distinguished Arab intellectuals?

Abed: This report is very important because it provides an accurate, comprehensive, and, in many ways, courageous diagnosis of what ails the Arab countries. Its emphasis on human development, democracy, and such issues as poverty, education, gender, the environment, governance, and equity is absolutely on target. The region needs a more open debate on these issues, and this report, I hope, will help invigorate and enrich this debate.

For many in the region, the report was a wake-up call, but for others, it was a welcome articulation of issues that have animated public debate within Arab society. It was welcomed by intellectuals in the region, but official reactions are, of course, more muted. While the report laid out a powerful diagnosis, it unfortunately neither confronted the underlying causes of this malaise nor recommended effective remedies. Many difficult issues are still crying out for solutions. For example, how is the region to bring about a greater commitment to democracy? How will it create institutions that guarantee human and civil rights and an open society? How does it reconcile the need for greater individual liberty with the presence of a powerful state apparatus that constrains such freedoms? How can it overcome some of the deep-

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seated cultural attitudes that stand in the way of modernization? And how does it address the frustrations of young people seeking a better future?

IMF Survey: **Where does the IMF fit in, since most countries in the region aren't borrowers?**

Abed: Given that only four or five countries need or may need financial resources from the IMF, our role has to be defined in terms of how they can develop efficient, modern economies. This requires that the IMF serve as a reliable source of sound policy advice; a partner in the dialogue on economic reform and on how best to interact with a more dynamic global environment; and a provider of technical assistance on institutional and policy reforms. I would like to see the IMF more deeply engaged in the region. I hope to bring this about through open dialogue and by fostering a better understanding of the opportunities and constraints that govern policymaking in the region.

IMF Survey: **Are you troubled by the region's limited interest, so far, in the IMF's transparency initiatives?**

Abed: First, the picture is not as bleak as your question suggests. For example, several countries, including some of the larger ones—Egypt, Iran, Pakistan, Morocco—have already participated in one or more of the IMF's key transparency initiatives (such as the Financial Sector Assessment Program), and several others are planning to do so. But we need to approach the issue with greater nuancing of the concept of transparency and its application in developing regions. There's no doubt that transparency in economic policymaking is highly desirable, and I have little doubt that policymakers in the Middle East and North Africa region believe that. However, there's a perception, one that may be shared in other developing regions, that certain features of the transparency initiatives—for instance, some elements in the standards and codes—come across as one-size-fits-all. Given the region's vast economic, political, and cultural diversity, one can appreciate the relevance of this point.

Another concern is that the manner in which the transparency initiatives have been presented—somewhat forcefully at times—may have given the appearance of an externally imposed agenda. We need to make the extra effort to help countries see that many of the best practices that have been successfully applied elsewhere are useful to them. Finally, we shouldn't forget that, despite the high per capita incomes of the oil-producing countries, the region is composed of developing societies with limited capacity to effectively integrate some of the

Human development is the key to unleashing the Middle East's potential

The real wealth of the Middle East, according to the UNDP's *Arab Human Development Report 2002*, lies not in vast oil and natural gas reserves but in the significant potential of the region's human resources. The report, produced by a team of distinguished Arab scholars, urges the region to secure freedom from fear and freedom from want for its people as a first step toward greater political stability and more participatory governance, improved economic governance, a redressing of gender inequality, expanded educational opportunities, and reduced poverty.

How is the Arab world faring?

In its broad survey of current conditions, the report finds poor performance in terms of civil and political freedoms, gender equality, and human capabilities and knowledge. These deficits, it suggests, are the most important impediments to human development in the region.

The study also candidly assesses the challenges facing the Arab world, citing, among other concerns, weak economic growth and a very worrisome increase in unemployment. It attributes much of the region's joblessness and poverty to insufficiently developed human resources. The report cautions, based on present trends, that unemployment could double to 25 million by the year 2010.

Health, environmental, and education indicators also point to the need for further reforms. While health indicators are close to the average for developing countries, a shift in resources toward preventive programs offers considerable benefits. On the environmental front, the chief concerns are a growing scarcity of water and a shortage of arable land. And despite relatively high expenditures on education, illiteracy rates remain high, especially among women, and there is a significant mismatch between the professional skills being developed and the needs of the labor market. Also of concern, in an age of global communication, is the dearth of websites and Internet users in the region.

In addition, the report notes that the wave of democracy that transformed governance in many developing countries in the late 1980s and early 1990s "barely reached the Arab states." Democracy and human rights may be enshrined in constitutions, but these goals have yet to be fully reflected on the ground.

New social contract needed

How should these challenges be addressed? The most promising avenues, according to the report, lie in mobilizing the private sector to stimulate growth and in developing the full productive capacities of the region's citizens.

more complex and demanding practices into their institutional structures. That said, there is reason to hope that we can accelerate the process in the period ahead.

IMF Survey: Do some of the difficulties with transparency and the prevalence of informal fund transfers exacerbate efforts to combat money laundering and abuse of the financial system?

Abed: Several countries in the region have adopted the standards and codes that apply to combating money laundering and terrorist financing without hesitation. Others are in the process of doing so. In fact, some countries, such as Saudi Arabia, initiated anti-money-laundering efforts in the mid-1990s. Some have also taken measures to limit or eliminate systems of informal money transfer. But we need to recognize two points. First, these standards and codes cannot, in the aggregate, do the detective work needed to track small transactions running through the system that may be used for illicit purposes; in fact, too heavy-handed an approach may end up throwing sand in the wheels of the financial system with only limited benefits. Second, as long as there are developing economies with underdeveloped banking systems, there will always be a market for informal systems of lending and borrowing and money transfer. Indeed, existing informal money transfer procedures seem to be very efficient and are highly favored in certain regions. I have no doubt that much of the informal banking transactions will move toward the formal banking system, making it easier to monitor the transfer of funds and reduce abuse. But this will take time, not only in the Middle East, but in other developing regions as well.

IMF Survey: Will you be taking your department in any new directions?

Abed: I see the IMF's main role in the region as providing policy advice, assisting in the modernization of institutions, and promoting best practices based on international experience. My first priority is to strengthen the department's capacity to do this with competence and conviction. This will require stepping up our policy research in areas of primary interest to the countries of the region, including the role of the oil sector in the macroeconomy; the reform of the state and its institutions; financial sector reform; trade and exchange rate policy; growth and employment; and regional integration.

My second objective is to continue to improve the quality and diversity of the staff and encourage them

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To do this, it advocates that governments engage their people in a new social contract—one that promotes an efficient public sector, a dynamic private sector, and a powerful civil society.

Mobilizing the private sector will require sound macroeconomic policies and a reliable and responsive institutional framework to ensure an environment conducive to private investment and growth. Revitalizing growth will require efforts to integrate Arab economies regionwide to expand markets; eliminate conflicts and civil wars; promote social cohesion by enhancing political rights and inclusion; and exploit the full potential of existing human resources, particularly women, who remain marginalized and underutilized. Indeed, to enhance human capabilities, the study urges the public sector to supply high-quality education facilities and curricula, provide economic incentives, and tap into expatriate resources, which can provide a dynamic component of external knowledge.

If employment is to be increased and poverty reduced, the region's development strategy should not favor capital over labor and must adopt an appropriate policy package. Such a policy package would need to provide better monitoring of employment and poverty, effective safety nets, and major institutional reforms to increase the poor's share in the power structure of society. Also recommended are an increased focus on education, training, and health care; support for small enterprises and rural infrastructure; market reforms in favor of rural producers; reforms of the labor market, public services, and governance practices; and development of civil society institutions.

Globalization and the rise of supranational political formations suggest an urgent need for Arab countries to deepen cooperation among themselves and better address internal and external challenges. Many regional organizations have been created or proposed for Arab cooperation, but the report makes particular note of the scope to expand investment flows and inter-Arab trade, which accounts for under 10 percent of total Arab trade—a figure unchanged since the 1950s.

Here, too, the report highlights the human dimension. Progress will mean, it observes, going beyond opening trade to building human and technological capabilities; establishing freedom of movement of factors of production, including labor; and forming institutional structures that can secure the popular assent and participation needed to achieve these goals.

Nicole Laframboise
IMF Middle Eastern Department

to become better informed and more intellectually engaged in the cultural, economic, and social life of the region. My third priority will be to raise the profile of the department and, by consequence, that of the IMF in the region. Although the IMF is highly regarded by officials, public attitudes are at best ambivalent. One way to change this would be to strengthen the links between the department and regional organizations and policy research centers, through joint programs and outreach activities, and to broaden our dialogue with civil society, the public, and the media. We have already begun to do so.

IMF SURVEY: How hopeful are you about prospects for the Middle East and its growing number of young people? It seems that many of the problems are at heart political rather than economic.

ABED: I am cautiously hopeful but not euphoric. The region is plagued with debilitating political conflicts; tensions also arise from external interference because of the strategic importance of the region. As a result, heated political debates tend to displace reasoned, economic discourse in public discussions. This is understandable, and in many areas in the region a resolution of political conflicts must precede any meaningful development. Nonetheless, countries that proceed with economic reforms have shown that economic progress does not have to be captive to these circumstances.

The region needs to implement political reform to secure human and civil rights, freedom of the press, the rule of law, an independent judiciary, and an accountable government.
—George Abed

You cited a concern about the region's youth. Indeed, one of the most urgent, and potentially destabilizing, problems in the Middle East is a sense of despair and helplessness that pervades the ranks of the young who are unable to find dignified employment, decent housing, and a sense of ownership in their own society. Moreover, in many countries, a stultifying political and social environment has impeded the younger generation's, especially women's, ability to fully develop its potential and constrained its opportunities. This is leading to social tensions and a massive brain drain.

To reverse these trends and build on the modest progress made to date, the region needs to implement political reform to secure human and civil rights, freedom of the press, the rule of law, an independent judiciary, and an accountable government. It also needs to achieve economic reform to roll back state dominance in the economy and create wider opportunities for individual initiative and for a more dynamic private sector. I have no doubt that unless the deeper political issues are resolved, the potential for economic development will remain severely constrained. Nevertheless, the fact that these issues are now more openly debated gives me hope that progress should and will be made. Otherwise, I am afraid the future will be bleak, and, for those who fail, the global environment is turning increasingly unforgiving. ■

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Stop-go expenditures can trigger "resource curse"

(Continued from front page) factors, Köhler emphasized that volatility in oil revenues has frequently been mirrored in a stop-go pattern of government expenditures that has proved to be economically and socially costly.

Costs of stop-go expenditures

Indeed, a paper at the conference presented by Harvard University's Ricardo Hausmann illustrated how high and volatile government expenditures can bring on the resource curse. In years of high oil revenues, government expenditures increase. Much of this spending goes toward expanding what economists call the "nontradable" sector of the economy—sectors like construction and services whose products are not traded on world markets (and are therefore not a source of foreign exchange revenues).

When oil revenues fall, Hausmann said, the government often has to scale back its spending. But because the country became specialized in nontradables during the boom years, there is not a non-oil export sector to help cushion the fall in domestic demand. So by letting the volatility in oil prices show through in volatility in government expenditures, the government encourages inefficient specialization and lets the country be trapped by the curse.

The World Bank's Alan Gelb argued that political institutions are also important for understanding the economic performance of oil-producing countries. He illustrated the point by grouping these countries according to political systems and then comparing their performance. While the findings were more suggestive than definitive, they did highlight the benefits of creating constituencies for the sound use of oil rents (through public information and education programs), the importance of transparent political processes and financial management, and the value of getting the political debate to span longer time horizons.

Discussing Gelb's work, the IMF's Menachem Katz said that intergovernmental fiscal relationships are another important consideration. Often, these cut across Gelb's suggested political economy classifications, as exemplified by Nigeria, where a strong degree of fiscal federalism has complicated oil revenue management. Andrei Illarionov, Advisor to Russian President Vladimir Putin, stressed the importance of economic diversification and consumption restraint; he also cautioned against excessive investment.

Can oil funds break the stop-go pattern?

Regardless of the relative importance of economic and political factors in explaining the resource curse, there was agreement that breaking the stop-go pattern of government expenditures is a critical element in improving future performance. Are oil funds—institutional mechanisms through which governments can set aside some of their oil revenues for future use—a good way to accomplish this?

Rolando Ossowski of the IMF observed that the limited econometric evidence and country experience raise questions as to the effectiveness of oil funds in improving fiscal management. Such funds may often do little to improve the conduct of fiscal policy and entail risks, including creating a dual budget, fragmenting fiscal policy and asset management, and reducing transparency and accountability. Hausmann and Paul Collier, of the World Bank, also argued against the use of oil funds. Collier noted that funds could sometimes entail an intergenerational transfer from prudent to imprudent governments: prudent governments accumulate wealth that may be subsequently misused by an imprudent government.

There was broad consensus among participants that the justification, if any, for such funds had to be made on political economy grounds. The Norwegian Petroleum Fund, for instance, has proved useful in building public consensus on the judicious use of oil revenues and the need to save. Moreover, this fund works differently from oil funds in other countries. As noted by Martin Skancke, Director General of the Office of the Norwegian Prime Minister, the fund is fully integrated into the country's overall budget: if the country has a fiscal surplus, it is put into the fund; when the country needs to run a fiscal deficit, it is financed out of the fund. Safeguards are in place to ensure transparency and accountability in managing the assets of the fund.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
August 12	2.21	2.21	2.83
August 19	2.21	2.21	2.83
August 26	2.23	2.23	2.85

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?2002).

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

Data: IMF Treasurer's Department

Alan Gelb

Menachem Katz

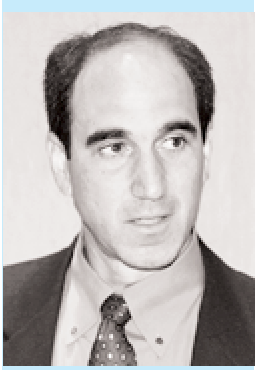
Rolando Ossowski

Paul Collier


Martin Skancke


John Wakeman-Linn


Nasser Al-Jashmi


Steve Barnett

The IMF's John Wakeman-Linn discussed the recently established oil funds in Azerbaijan and Kazakhstan. Both are transition economies with significant development needs and the prospect of substantial growth in oil revenue. The value of oil funds in these countries was largely to meet political economy objectives. Their economic objectives—avoiding excessive real appreciation of the currency and maintaining fiscal discipline—could be accomplished without creating a fund. In Wakeman-Linn's view, the preliminary indications suggest that the funds have contributed to better management of oil wealth and improved transparency.

Nasser Al-Jashmi of the Omani Ministry of Finance discussed the Oman State General Reserve Fund (SGRF) established in 1980. Oman is highly dependent on oil and gas and, in the 1970s, used oil revenue to build infrastructure and extend the provision of basic services to the population. Under current rules, the SGRF is a stabilization fund that allows the government to maintain its planned level of expenditure regardless of oil prices by financing any shortfall in revenue caused by lower-than-budgeted oil prices.

Smoothing oil revenues

While reducing the volatility of government expenditures is key, this would clearly be facilitated by reducing the volatility of oil revenues. The IMF's James Daniel argued that the use of financial instruments for hedging would allow more realistic and certain budgeting, provide insurance against declines in oil prices, and lessen the chances that oil price falls would force costly fiscal adjustments. Supporting this view, Allan Kessler, Vice President at JPMorgan in New York, said that hedging could also improve access to financial markets, particularly during periods of low oil prices, and complement or replace oil stabilization funds.

However, many governments have been hesitant to actively use hedging because of the potential political costs (particularly the failure to benefit from upturns in prices), lack of institutional capacity, financial costs involved in hedging, and the perception that the markets lack depth. Kessler noted that oil markets for shorter maturities are liquid, and the World Bank's Panos Varangis emphasized that there were ways of overcoming some of the concerns about hedging—for instance, by clearly defining the objectives of the hedging strategy and acceptable risk limits. He also stressed the importance of putting in place adequate safeguards and oversight procedures.

Sound fiscal policy

If oil funds are not generally very effective, and use of hedging is likely to remain limited, what other options are available to improve fiscal policy management? The IMF's Steven Barnett laid out some general principles that can help. First, to get a clearer picture of the country's fiscal situation, the non-oil fiscal balance—the balance stripped of oil revenues and any expenditures directly related to oil—should figure prominently in budget analysis. Second, the non-oil balance, and expenditure in particular, should be adjusted gradually. This requires decoupling, to the extent possible, government spending from oil price volatility. Third, the government should strive to accumulate substantial financial assets over the period when it is producing oil; the return on these financial assets can then help keep the fiscal situation healthy even after the oil has run out.

These recommendations were well received by conference participants. Several emphasized the importance of the non-oil fiscal balances, and the lack of public reporting on them was cited as a problem. In this context, oil industry representatives highlighted the usefulness of the IMF's reports on the observance of standards and codes in fiscal transparency both for their assessments of transparency and for the understanding they provide of a country's fiscal institutions and policymaking.

Structural fiscal issues

The conference also covered several structural fiscal issues. There was a lively debate on the quasi-fiscal costs and appropriateness of setting domestic petroleum prices at below-market levels. The IMF's Sanjeev Gupta observed that domestic petroleum prices in oil-producing countries were often substantially below international prices. For a sample of these countries, implicit subsidies in 1999 averaged 3 percent of GDP, equivalent to 15 percent of explicit government expenditure. These subsidies were often seen as inefficient, inequitable, and nontransparent. Moreover, Gupta said that a strong case could be made for taxing petroleum products to reflect possible negative externalities and the relative ease of such taxation. The adverse social impacts of eliminating the subsidies could be mitigated by designing appropriate social safety nets. However, some participants challenged the estimated fiscal costs of these subsidies as too high—citing concerns about the presumed costs of marketing, transport, and taxation. And others wondered if the appropriate reference price for calculating the cost of subsidies should be the long-run marginal cost of extracting oil rather than the international price of oil.

A less controversial topic was the taxation of the oil sector, where the strengths and weaknesses of different regimes were considered. The performance of national oil companies was also critically examined. Participants noted that these companies are often inefficient, engage in noncommercial (quasi-fiscal) activities, and are managed without sufficient transparency and accountability. ■

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Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, pages 257–58, 260, 263–64, 266–67, and 271–72; Leila Gorchev for AFP, page 259; UNDP, page 261; and Joint Brazil Training Center, page 268.

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina[1]	March 10, 2000	March 9, 2003	16,936.80	7,180.49
Brazil[1]	September 14, 2001	December 13, 2002	12,144.40	759.03
Bulgaria	February 27, 2002	February 26, 2004	240.00	182.00
Guatemala	April 1, 2002	March 31, 2003	84.00	84.00
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
Latvia	April 20, 2001	December 19, 2002	33.00	33.00
Lithuania	August 30, 2001	March 29, 2003	86.52	86.52
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Romania	October 31, 2001	April 29, 2003	300.00	248.00
Sri Lanka	April 20, 2001	August 19, 2002	200.00	48.32
Turkey[1]	February 4, 2002	December 31, 2004	12,821.20	3,759.60
Uruguay[1]	April 1, 2002	March 31, 2004	1,752.30	1,243.60
Total			44,938.50	13,954.18
EFF				
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2003	3,638.00	1,651.48
Serbia/Montenegro	May 14, 2002	May 13, 2005	650.00	600.00
Ukraine	September 4, 1998	September 3, 2002	1,919.95	726.95
Total			8,164.95	4,935.43
PRGF				
Albania	June 21, 2002	June 20, 2005	28.00	24.00
Armenia	May 23, 2001	May 22, 2004	69.00	59.00
Azerbaijan	July 6, 2001	July 5, 2004	80.45	64.35
Benin	July 17, 2000	March 31, 2004	27.00	8.08
Burkina Faso	September 10, 1999	December 9, 2002	39.12	5.58
Cambodia	October 22, 1999	February 28, 2003	58.50	8.36
Cameroon	December 21, 2000	December 20, 2003	111.42	63.66
Cape Verde	April 10, 2002	April 9, 2005	8.64	7.41
Chad	January 7, 2000	January 6, 2003	47.60	15.80
Congo, Dem. Republic of	June 12, 2002	June 11, 2005	580.00	160.00
Côte d'Ivoire	March 29, 2002	March 27, 2005	292.68	234.14
Djibouti	October 18, 1999	October 17, 2002	19.08	10.00
Ethiopia	March 22, 2001	March 21, 2004	100.28	41.72
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 3, 1999	November 30, 2002	228.80	52.58
Guinea	May 2, 2001	May 1, 2004	64.26	38.56
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Honduras	March 26, 1999	December 31, 2002	156.75	48.45
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	49.96
Lao People's Dem. Rep.	April 25, 2001	April 24, 2004	31.70	22.64
Lesotho	March 9, 2001	March 8, 2004	24.50	14.00
Madagascar	March 1, 2001	February 29, 2004	79.43	56.74
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2003	51.32	19.65
Mauritania	July 21, 1999	December 20, 2002	42.49	6.07
Moldova	December 21, 2000	December 20, 2003	110.88	83.16
Mongolia	September 28, 2001	September 27, 2004	28.49	24.42
Mozambique	June 28, 1999	June 27, 2003	87.20	16.80
Niger	December 22, 2000	December 21, 2003	59.20	33.82
Pakistan	December 6, 2001	December 5, 2004	1,033.70	775.26
São Tomé & Princípe	April 28, 2000	April 27, 2003	6.66	4.76
Sierra Leone	September 26, 2001	September 25, 2004	130.84	74.67
Tanzania	April 4, 2000	April 3, 2003	135.00	35.00
Vietnam	April 13, 2001	April 12, 2004	290.00	165.80
Zambia	March 25, 1999	March 28, 2003	278.90	124.20
Total			4,752.82	2,628.66
Grand total			57,856.27	21,518.27

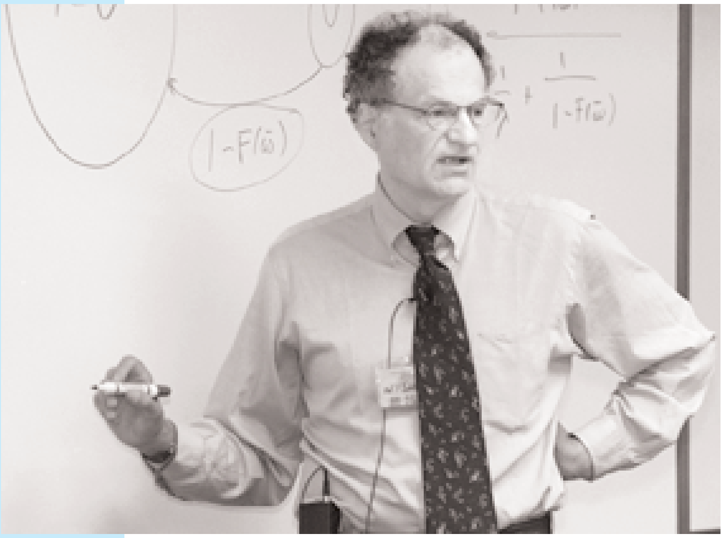
[1] Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

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

Sargent seminar

Reversal of fortunes: understanding the evolution of European and U.S. unemployment



Sargent: Blaming institutions did not fully explain why a system that delivered low unemployment for so long suddenly triggered much higher unemployment rates.

Stanford University's Thomas Sargent, one of the world's leading macroeconomists, has for the past several years focused some of his research on explaining the divergent paths of European and U.S. unemployment. In a recent seminar at the IMF Institute, Sargent said that when he was in graduate school at Harvard in the 1960s, low European unemployment rates "were viewed as a great success and envied" by Americans. The past two decades, however, have seen a reversal of fortunes. Sargent's seminar examined why this has come about.

John Kennedy's May 1961 speech to the U.S. Congress, famous today for its rhetoric about the space race ("this nation should commit itself to . . . launching a man on the moon and returning him safely to earth"), was in fact concerned largely with matters much closer to home. First and foremost on the U.S. president's mind was his country's high unemployment: "Large-scale unemployment during a recession is bad enough, but large-scale unemployment during a period of prosperity would be intolerable."

Europe offered a stark contrast. As one U.S. policymaker, Robert J. Myers, wrote in a 1964 report: "We can surely be excused for looking enviously at our European friends to see how they do it. We have profited much in the past from exchanges of ideas with Europe. It would be shortsighted indeed to ignore Europe's recent success in holding down unemployment." President Kennedy quizzed his economic advisors on the reasons for this difference and even appointed a commission to make sure the difference was not simply a statistical chimera. Alas, it was not.

But before economists could really come up with a satisfactory explanation for the much lower European rates of unemployment, the gap began to vanish. By 1979, France's unemployment rate, for instance, had fully caught up with the U.S. rate and has outstripped it almost every year since. Germany's unemployment rate mirrored U.S. rates over much of the 1980s and was much higher than U.S. rates over the 1990s. Unemployment in many other European nations has followed the French and German trajectory. The U.S. unemployment rate, in contrast, has hovered around its post–World War II average.

What explains this reversal of fortunes? The question has inspired a lot of forensic work by prominent macroeconomists. In addition to Sargent's work, research by MIT's Olivier Blanchard has helped forge some consensus on the causes of high European unemployment (see an interview with Blanchard in the November 20, 2000, issue of the *IMF Survey*, pp. 378–80).

Institutions and shocks

As a preface to his own work on this topic, Sargent reviewed early, and failed, attempts to attribute the high European unemployment rates of the past two decades to a single cause. When Europe's unemployment began to rise in the 1980s, suspicion immediately fell on the role of its institutions, particularly on so-called labor market rigidities. These rigidities encompass a variety of institutional features—such as generous unemployment benefits, higher minimum wage levels, and greater restrictions on firing workers—that tend to make transitions in the labor market more difficult to carry out. Europe's more generous welfare states were said to contribute to a more rigid labor market and hence to higher unemployment. In short, according to Sargent, the explanation offered was that "the Europeans pay for more unemployment, and they get it."

However, European countries had more generous welfare states in the 1960s and 1970s when their unemployment was lower than in the United States. So, blaming institutions did not fully explain why a system that delivered low unemployment for so long suddenly triggered much higher unemployment rates. MIT's Robert Solow caricatured this explanation as "reflecting the naïve belief that unemployment must be a defect in the labor market, as if the hole in a flat tire must always be on the bottom, because that is where the tire is flat."

Another popular line of reasoning was to blame economic "shocks." In the mid-1970s, oil shocks were blamed for rising unemployment, but this explanation fell by the wayside once oil prices fell but unemployment did not. The next shock to take the blame was austerity, or "inadequate aggregate demand," a reference to the push in many European countries toward tight monetary policy and fiscal consolidation to satisfy the Maastricht criteria for European union. However, this explanation also became difficult to sustain as aggregate demand conditions waxed and waned but unemployment continued to rise steadily.

The consensus today is that it is an interaction of institutions and shocks that is critical to understanding the rise of European unemployment. As Blanchard put it, "it could be that the institutions stayed the same, but a change of circumstances made them less appropriate—like winter clothes in the summertime." In explaining the same phenomenon, Sargent reached back to a quote by James Madison: "In forming a system which we wish to last for ages, we should not lose sight of the changes which the ages will produce." Institutions that deliver good performance under one setting may no longer deliver once the setting has changed.

An increase in turbulence

But why did the setting change? Starting in the 1970s, according to Sargent, the economic environment grew more turbulent. Oil prices increased in 1973–74 and again in 1979–80, and exchange rates became more volatile after the breakdown of the Bretton Woods system. In the 1980s came waves of financial market liberalization and product market deregulation. More recently, there has been pervasive technological change, especially as new information technology has appeared, and an acceleration in economic integration among nations. While many of these changes, said Sargent, enhance the long-term efficiency of economies, they also challenge economies and societies to adapt.

More important, these changes generate greater earnings instability for workers and greater risk of having job skills rendered redundant. In the jargon of economists, there is greater risk of a loss of "human capital" in turbulent economic times than in tranquil ones. Indeed, studies by labor economists show such an impact, notably with greater earnings instability for workers, especially in the 1980s, and sizable losses in earnings for workers displaced from their jobs.

In this setting, some labor market institutions, such as high unemployment compensation, can become a trap. Consider a worker who has been displaced from a high-skill (and therefore high-wage) job. In a turbulent economic environment, the odds that the worker has suffered a loss of her human capital are higher, and, correspondingly, the odds of getting a job offer that pays as much as her previous job are lower. If labor market institutions are such that the worker is entitled to a high level of unemployment compensation, she can initially afford to, and will tend to, turn down offers for lower-salaried jobs. If the worker remains unemployed, her human capital deteriorates further. This in turn makes it less likely that she will receive a high wage offer. Again, the option of staying on the dole—if it remains available—continues to be attractive. The bottom line is that that worker spends a long time unemployed. Indeed, the average duration of unemployment in Europe has increased considerably.

Case closed?

So, have macroeconomists cracked the case? Not quite. There is disagreement on the details even though the consensus has moved to recognizing that it takes shocks, institutions, and the interaction between the two to fully explain the pattern of European and U.S. unemployment rates. And developments once again appear to be staying a step ahead of macroeconomists. Just as the mystery of high European unemployment is about to be solved, unemployment has started to fall in European countries such as the United Kingdom and the Netherlands. This has the macroeconomists scrambling again to try to understand what is changing: the shocks, the institutions, or the interaction between them? ■

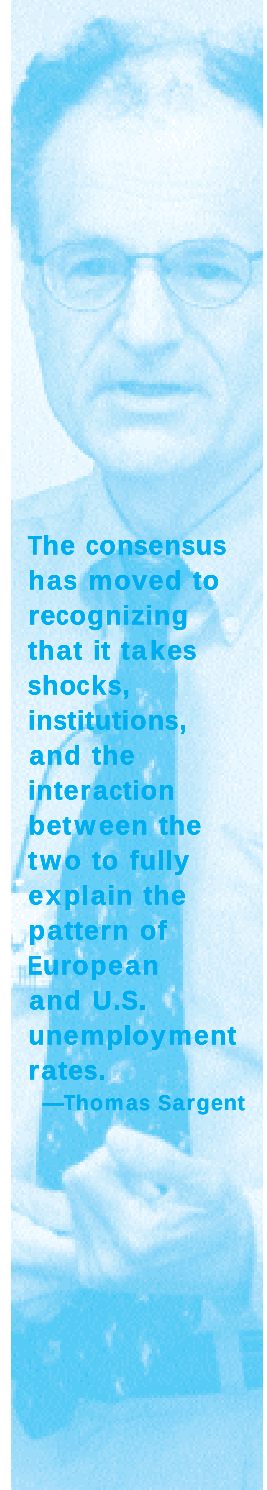
Prakash Loungani
IMF External Relations Department

Members' use of IMF credit
(million SDRs)

	During July 2002	January–July 2002	January–July 2001
General Resources Account	1,038.53	8,947.75	3,640.70
Stand-By	1,038.53	8,672.51	3,581.90
SRF	0.00	0.00	2,349.57
EFF	0.00	275.24	58.80
CFF	0.00	0.00	0.00
PRGF	206.90	323.03	244.16
Total	1,245.43	9,270.78	3,884.86

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

Data: IMF Treasurer's Department



The consensus has moved to recognizing that it takes shocks, institutions, and the interaction between the two to fully explain the pattern of European and U.S. unemployment rates.
—Thomas Sargent

Latin American conference

New fiscal data framework aids policymaking

When the IMF issued its Government Finance Statistics Manual 2001 *in December 2001, policymakers and analysts had questions. What's new here? How are these innovations meant to be implemented? And—bottom line—what does this mean for fiscal policy and analysis? To answer these questions and familiarize economists with the new fiscal data framework that is at the heart of the new manual, the IMF has initiated a series of regional seminars. The first of these, which took place in Brasilia on August 13–15, drew 41 senior officials from 10 Latin American countries.*

Good data are now widely recognized as essential ingredients in effective policymaking. But what constitutes "good" data and what types of data aid policymakers and analysts? The IMF revised its *Government Finance Statistics Manual* in late 2001 to update users on good practices and to propose a new fiscal data framework that would facilitate economic analysis by tracking public finances more accurately and comprehensively. The new system also aims to make the fiscal accounts look more like business accounts—so that the private sector will find it easier to use fiscal data—and allow fiscal accounts to be more easily harmonized with other statistics (notably the national accounts).

To brief users on the innovations of the new framework and to encourage its implementation, the IMF's Statistics, Fiscal Affairs, and Western Hemisphere Departments, in collaboration with the IMF Institute and the Brazilian School of Finance Administration, held a three-day seminar at the Joint Brazil Training Center. Amaury Bier, Executive Secretary of Brazil's Ministry of Finance, encouraged the participants to speak frankly and to examine fully the new system's improvements and the strategies for—and potential obstacles to—its successful implementation. Bier drew particular attention to the manual's concepts and the role they could play in providing a clearer picture of fiscal developments and sustainability in a country like Brazil. It did not take long for the participants to follow his advice to speak frankly.

New fiscal data framework

Paul Cotterell, chief of the IMF's Government Finance Division, enumerated several of the significant changes that the framework would entail. He explained that it would supplement existing data on government flow transactions with public sector balance sheets and would fully reconcile stocks and flows. Further, it would add information based on accrual accounting principles (resource accounting) to existing cash data. One notable innovation is that the new framework permits investment (the acquisition of nonfinancial assets) to be analyzed differently from other types of government outlays: it distinguishes between the government's operating balance (revenue minus noninvestment outlays) and its net lending/borrowing (that is, its financing need, including for net investment).

The goal of the new framework is to increase fiscal transparency and accountability and strengthen fiscal analysis and policy formulation and evaluation. Teresa Ter-Minassian, Director of the IMF's Fiscal Affairs Department, highlighted the additional tools that would be available to fiscal analysts and the usefulness of those tools in enhancing fiscal policies. Also significant, she said, is the shift away from a single measure of fiscal policy to a more nuanced view of

Senior officials from 10 Latin American countries and from three IMF departments gathered at the Joint Brazil Training Center in August to discuss innovations in the *Government Finance Statistics Manual 2001*.

fiscal developments, through multiple analytical balances. Ter-Minassian stressed that implementing the new system would not result in countries' losing information they are currently gathering, although she did say that implementing this new fiscal data framework would take considerable time and that its pace would vary across countries.

Country developments

Senior delegates from Brazil, Chile, and Mexico briefed participants on initiatives in their own countries, notably the use of structural balances in Chile, development of various analytical measures in Mexico, and efforts to strengthen fiscal cooperation and data systems within Brazil's decentralized system. Following these presentations, Ana Maria Jul, Associate Director of the IMF's Western Hemisphere Department, reviewed the fiscal variables that have been developed in the context of IMF discussions with member countries in the region. She called particular attention to Ecuador's innovative development of a balance sheet that, among other things, incorporated the value of oil and gas reserves and enriched the available information for fiscal policy formulation. A major theme across all of the presentations was fiscal sustainability and how it could be assessed. The extension of fiscal statistics and analysis to government balance sheets should significantly improve countries' capacity to do such assessments.

Broader coverage matters

Latin America's coverage of fiscal statistics is broader than anywhere else in the world, and that, argued Adrienne Cheasty, chief of the IMF's Fiscal Operations I Division, provides clear and important advantages. Narrow coverage, she observed, tends to provide incentives to shift fiscal policies to institutions outside monitored government agencies. This can yield unpleasant

Available on the web (www.imf.org)

News Briefs

02/81: IMF Managing Director Köhler and World Bank President Wolfensohn Urge Donor Nations to Commit Critically Needed Food Aid to Southern Africa, August 1
02/82: Joint Statement by IMF, World Bank, and Inter-American Development Bank on Uruguay, August 4
02/83: IMF Managing Director Köhler Prepared to Recommend $500 Million Increase in Stand-By Credit to Uruguay, August 4
02/84: IMF Gives Final Approval of First Review of Guinea's PRGF Loan, August 5
02/85: IMF Completes Third Review of Turkey's Stand-By Arrangement, August 7
02/86: IMF Managing Director Köhler Confirms Agreement with Brazil, August 7
02/87: IMF Completes First Review and Approves New Increase on Uruguay Stand-By, August 8
02/88: IMF Management Recommends $200 Million Stand-By Arrangement for Paraguay, August 13

Press Releases

02/35: IMF Approves $89 Million Stand-By Arrangement for Bosnia and Herzegovina, August 2
02/36: IMF Approves a Three-Year, $5 Million PRGF Arrangement for Rwanda, August 12

Public Information Notices

02/78: IMF Concludes 2002 Article IV Consultation with Chile, July 31
02/79: IMF Concludes 2002 Article IV Consultation with Benin, August 5
02/80: IMF Concludes 2002 Article IV Consultation with the United States, August 5
02/81: IMF Concludes 2002 Article IV Consultation with Bulgaria, August 5
02/82: IMF Concludes 2002 Article IV Consultation with Sweden, August 7
02/83: IMF Concludes 2002 Article IV Consultation with Ireland, August 7
02/84: IMF Concludes 2002 Article IV Consultation with the Czech Republic, August 7
02/85: IMF Concludes 2002 Article IV Consultation with Japan, August 8
02/86: IMF Concludes 2002 Article IV Consultation with the Republic of Croatia, August 8
02/87: IMF Advances Efforts to Combat Money Laundering and Terrorist Financing, August 8
02/88: IMF Concludes 2002 Article IV Consultation with the Republic of Yemen, August 12
02/89: IMF Concludes 2002 Article IV Consultation with the Slovak Republic, August 13
02/90: IMF Concludes 2002 Article IV Consultation with Austria, August 14
02/91: IMF Concludes 2002 Article IV Consultation with Finland, August 15
02/92: IMF Concludes 2002 Article IV Consultation with Malawi, August 16

Speeches

Opening Remarks by Anne Krueger, IMF First Deputy Managing Director, at the IMF Institute Seminar "Globalization in Historical Perspective," August 12

Transcripts

Press Briefing by Thomas C. Dawson, Director, IMF External Relations Department, August 2
Conference Call on Turkey by Michael Deppler, Director, IMF European I Department, August 7

surprises, such as higher debt, and lead to suboptimal fiscal policies and inappropriate adjustments. Cheasty also added that analysts need to know the size of public sector activity and its effects on economic growth.

Implementation strategies

Participants agreed that the new manual and its fiscal data framework represent a useful advance, but how were they to move from proposals on paper to enhancements on the ground? Betty Gruber and Ethan Weisman summarized other countries' experiences. They highlighted, in particular, the adoption of accrual accounting by Australia and Iceland, the efforts by the IMF's Statistics Department and European Union authorities to take existing accrual data from the national accounts and present them using the new framework, and a preliminary exercise in Mauritius to shift cash data into the framework. Cheasty also illustrated some new analytical variables that could be derived from fiscal data based on the new manual and described the relevance of these variables for analyzing liquidity constraints and fiscal sustainability and vulnerability.

Experiences elsewhere prompted a vigorous discussion of possible implementation strategies in the region. The seminar's participants quickly realized that different migration paths would need to be formulated based on individual country circumstances, underlying policy frameworks, and accounting and statistical systems. The shift to the new fiscal data framework will take time and will need to be implemented in parallel with ongoing fiscal data work. And central to this process will be the need to train policy officials and fiscal data compilers within each country.

While enthusiastic about the benefits afforded by the manual's innovations, the participants also realized that these discussions were just the first step toward implementing the new process. Many challenges remain, but the seminar did deepen understanding of the new framework's potential benefits and provided participants with the opportunity to build a network of experts to bring these potential improvements to fruition. ■

Ethan Weisman
IMF Statistics Department

Interview with Bayoumi and Haacker

IT's benefits are widespread, but users gain more than producers

Is the much-hyped "new economy," based on the information technology (IT) sector, a real phenomenon? Reactions to this sector have gone from "unbridled optimism through much of 2000 to skepticism after the crash in IT equity prices later that year." But Tamim Bayoumi and Markus Haacker, authors of a recent IMF working paper, are convinced not only that the IT revolution is real but that it will produce big benefits over the long run. They spoke to the IMF Survey *about who will benefit from the IT revolution and how.*

IMF Survey: There's already an enormous literature on the "new economy." What's different about your study?

Bayoumi: Quite a lot. The academic literature has focused on the real GDP benefits of the IT revolution because macroeconomists often equate real GDP with welfare. With the large change in the relative prices of IT goods that we've seen over the past few years, however, the question of who actually benefits is more complex.

So we went one step further and asked how much IT has increased welfare, measured in various ways. In particular, we asked whether the main producers of IT goods are also the main beneficiaries. The main producers include the east Asians, particularly countries like Singapore and Malaysia, and the Irish. The major users include the United States but also such countries as Australia, which produces almost no IT goods. Our conclusion is that the major benefits go to the main users of IT goods.

IMF Survey: Why do the benefits accrue chiefly to the users? Won't the producers benefit in the long run?

Bayoumi: There are a couple of important points here. First, IT is a highly competitive industry, and hence it's difficult to make money. That means people are selling the goods for what they're worth in the marketplace. Producers could make money if they had some monopolistic ability to seize the profits they were getting. But competition means that productivity gains translate into lower prices, and this is how consumers benefit. It's not that producers—such as countries in east Asia—haven't benefited. One of the results of our study is that the producers, given their level of income, generally also use IT more than equivalent countries. It's just that the benefits go to the users of IT products.

Haacker: In the long run, there's an important point, which is that currently there is a technology gap—with the rich exploiting IT more effectively than the poor—that will probably continue for some time. But it's not at all clear who will benefit the most. If you look at the railroads, the biggest benefit appears, in the very long run, to have gone to Mexico. The reason is that they didn't have waterways for transport, and the railways took over for inefficient transportation by carts. A more current example is the emergence of cellular phone networks in countries with few land lines. So it's difficult to say right now whether the rich countries or the poor countries will benefit the most in the long run.

IMF Survey: Does the IT revolution differ dramatically from earlier technological innovations—electricity, the railways, the telephone?

Bayoumi: The IT revolution has a lot in common with previous revolutions but is also somewhat different. We discussed this in greater detail in the October 2001 *World Economic Outlook*. The similarities are that almost all of the earlier revolutions—electricity, railways, and cotton textiles—also had the stock market mania where people expected to make huge amounts of money forever. And they didn't. So you had a big rise in stock prices and then a big fall.

Haacker: Another important difference between the IT revolution and earlier technological revolutions is that IT goods are highly tradable, and production is diversified. East Asia makes a lot of components that then go into U.S. computers. With the railways and electricity, that diversification wasn't there. The only real parallel is cotton textiles, whose production was concentrated in Britain, but about half the goods were exported. Falling prices transferred that half of the benefits to consumers abroad. We find the same result for the IT revolution—if you export IT goods, you lose most of the benefits—that was found in studies of cotton textiles during the Industrial Revolution.

IMF Survey: You used two different methods to quantify the welfare gains—one looking at the impact of falling IT prices on real GDP and domestic demand across countries and one calculating "social savings." Can you briefly discuss what you did and your results?

Bayoumi: Most of the previous studies used a gross accounting framework to assess the impact of the IT revolution on GDP. We calculated how much benefit derives from falling prices. The first method looks at how falling prices have increased the amount produced and, correspondingly, the amount consumed. As prices fall, if you buy a computer and it's half as expensive as it was the previous year and it's the same computer, then if you spend the same amount of money you get much more for it. The first part of the study thus asks how much more real investment or real consumption we have as a result of falling prices.

The second part of the study explores a more direct measure of what economists call welfare. If I buy a computer for $50 that cost $100 last year, how much have I gained? Economists call this concept "consumer surplus." I've gained $50 because of the fall in prices. That's the basic difference between the two approaches. But the objective of both is to measure how much more people consume, because consumption is the ultimate goal of economic activity. We want to consume; we don't want to produce.

Haacker: Studies inspired by the neoclassical growth model look at the impact of the IT revolution on productivity and on the change in real IT investment as measured by the fall in relative prices of IT goods. We take a broader measure of the overall impact, looking at the impact on productivity—in that sense our study is comparable with earlier studies—and also at the impact on domestic demand, including both investment and the gains to consumers from the fall in relative prices.

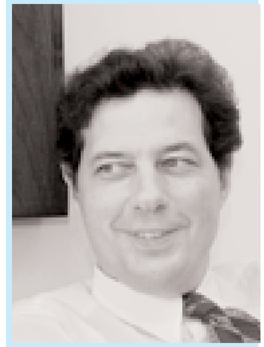
IMF Survey: How did you handle differences in the availability and quality of data?

Haacker: The data on use of IT goods in national accounts differ very much across countries, and so do the price indices used to deflate them. To extend our study to a broad sample of countries, we had to obtain measures of IT sales and prices that are comparable across countries. We used U.S. price indices adjusted for exchange rates, and we used two private databases on IT production and IT sales across countries, which may not be as comprehensive as the available national accounts data but enabled us to extend our study to include the major producers—and the major OECD countries—as well as countries that are not typically covered by this type of study.

Bayoumi: There is a problem of consistency across data. Our solution was to use private sector sources, and these have the same methodology across countries. It's as good as you're going to get. We worked very hard on that, and we're very pleased with the results.

IMF Survey: What, then, do you make of the dramatic drop in fortunes of the IT sector in the past couple of years?

Bayoumi: It's pretty much true to form. We have these financial excesses, and then everything falls down. By the way, the equity prices that fall never come all the way back—don't expect the NASDAQ



Bayoumi: "Almost all of the earlier revolutions—electricity, railways, and cotton textiles—also had the stock market mania where people expected to make huge amounts of money forever. And they didn't."

Haacker: "Currently there is a technology gap—with the rich exploiting IT more effectively than the poor—that will probably continue for some time."

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to go up another 200 percent. That's the finding from history. These industries then become more normal. Initially, financial markets realize that producers will make a lot more of this stuff, but they apparently think they'll produce it at the same prices. They don't. They produce it at lower prices and don't make much money. This comes back to the competition point.

If you look at the historical parallels, we're pretty much exactly where I expected we would be in terms of the IT revolution. The productivity side is real, it's going to be big, and it's continuing, but it's not making money for the producers.

IMF Survey: What should policymakers in advanced, emerging, and developing countries make of your findings?

Bayoumi: We discuss the nature of technological revolutions, which basically have two stages. First comes the initial technological breakthrough that results in falling prices in a whole series of goods. This is essentially the stage we're in now. And that produces significant gains. The second stage is the reorientation of production, which yields considerable long-term gains. For example, electricity made it possible to take a factory's power source away from the middle of the factory and put it somewhere else. As a result, production lines could be made more efficient. Reorientation is a long process and implies that the benefits will carry on for a long time.

So one thing to take from our study is that the benefits of the IT revolution are very real and are going to last for a long time. Another thing to take from it, however, is that the financial excesses of the IT revolution *were* financial excesses; people consistently overestimated the profitability of the sector itself until the bubble burst.

A point we make only peripherally, but one that is worth making, is that very often these technological revolutions and the equity bubbles they create result in significant regulatory changes. For example, the railroads in the United States were clearly instrumental in the rise of antitrust laws. In the same way, we're seeing big regulatory changes now, partly as a result of the financial excesses of the IT revolution.

In terms of emerging markets, we have an interesting result. Making IT products is a good thing to do, but IT goods have many of the characteristics of commodities, and the major IT producers have to accept that their prices will go up and down very much like the prices of other commodities. As far as the poorest countries are concerned, the very long term result is also a positive one: we know that technologies, once they disperse more widely, can bring big benefits to everybody (as Mexico benefited from the railroads).

Haacker: "Whereas a small number of the main producers generate major benefits in terms of GDP growth, those dissipate through a fall in the terms of trade."

IMF Survey: Did any of your results surprise you?

Haacker: What we find is that, unlike in the studies focusing on the impact of the IT revolution on GDP, the benefits are much more widespread. Whereas a small number of the main producers generate major benefits in terms of GDP growth, those dissipate through a fall in the terms of trade. Thus, among the main beneficiaries of the IT revolution are countries that have a very small IT-producing sector—like Australia and New Zealand—whereas some of the main producers are not some of the main beneficiaries.

Bayoumi: Two results struck me. First, the difference across industrial, relatively rich countries is greater than you might think. Not only the United States, but also Australia, New Zealand, the United Kingdom, Sweden, and Canada are exploiting IT quite well. Very strikingly, the continental Europeans are much further behind, particularly the southern continental Europeans—Greece, Italy, and Spain. I was surprised by the size of the differences across these countries.

The other thing that surprised me is that this tech revolution is either faster or bigger than earlier, similar revolutions. I suspect it's faster because the world has sped up in many ways. You can communicate more easily. I went into this study wondering if IT really was a big deal, given all the limitations, and found evidence that it really is. ■

Copies of IMF Working Paper No. 02/117, *It's Not What You Make, It's How You Use IT: Measuring the Welfare Benefits of the IT Revolution Across Countries*, by Tamim Bayoumi and Markus Haacker, are available for $10.00 from IMF Publication Services. Please see page 262 for ordering information.