

Work program

Executive Board to focus on HIPC Initiative, architecture, and surveillance issues

Priorities for the IMF Executive Board's agenda in the period leading up to the April 2000 meeting of the International Monetary and Financial Committee (formerly the Interim Committee) are to finalize decisions on enhancing the HIPC Initiative for heavily indebted poor countries, continue work on strengthening the architecture of the international monetary and financial system, and undertake the biennial review of IMF surveillance of the economic policies of its member countries. Details of the agenda were released October 28 in an IMF News Brief.

HIPC Initiative and poverty reduction

The Board intends to move as rapidly as possible on the initiatives endorsed by the Interim Committee at its last meeting on September 26, including the decision to

transform the Enhanced Structural Adjustment Facility into the Poverty Reduction and Growth Facility (see *IMF Survey*, October 11, page 317). The Board will consider off-market gold transactions and other steps necessary to finance the IMF's participation in the enhanced HIPC Initiative and the IMF's continued concessional lending for poverty reduction and growth in low-income countries. It will also finalize decisions on the new facility and the proposed Poverty Reduction Strategy Papers and review progress in implementing the HIPC Initiative.

International architecture issues

The Executive Board's work on strengthening the international monetary and financial system encompasses several areas: *(Please turn to the following page)*

World Confederation of Labor

Camdessus calls for coordinated approach to tackle global poverty

IMF Managing Director Michel Camdessus addressed the Confederal Board of the World Confederation of Labor on October 26 in Washington, D.C. The full text of his remarks is available on the IMF's website (www.imf.org).

Addressing the topic of strengthening the link between economic and social policies within the framework of a globalized economy, Camdessus said "the most pressing global issue that faces us as we approach the end of the century is poverty." For many years, Camdessus noted, IMF-supported programs "have explicitly incorporated social considerations, but the interrelationship between growth and social development now needs to be more precisely defined." In particular, the IMF is now joining with other multilateral institutions in an effort to reconcile economic



Camdessus: We will not make progress in reducing poverty without a large-scale international effort.

and social policy in the world's poorest countries. We can achieve this, he said, only by continuing our dialogue with the International Labor Organization.

Camdessus spoke of the values behind this effort—values that "seek to humanize a world in search of unity" and on which people can find common ground. Three are closely interrelated: "responsibility, because now every country, no matter what its size, is responsible not

only for its own destiny but for that of other countries of the world; solidarity, because it is clear that we will not make progress in reducing poverty without a large-scale international effort; and citizenship, because it is urgent that it be broadened to cover the new dimensions of problems that have become global." ■

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Executive Board work program

(Continued from front page) • **Standards.** The Board will assess the experience so far with the pilot exercise on the financial sector assessment program and with implementation of the Basel Core Principles of Effective Banking Supervision. It will also review data standards, covering issues related to the IMF's Special Data Dissemination Standard and the General Data Dissemination System.

• **Private sector involvement in crisis prevention and resolution.** In response to the Interim Committee's request that the Board build on the framework reflected in the Group of Seven finance ministers' report to the Cologne summit (see *IMF Survey*, July 5, page 214), the Board will review the experience in securing private sector involvement in recent cases, with a view to establishing general guidelines for the respective roles of the private sector and multilateral and bilateral institutions in a financial crisis.

• **Capital account opening.** In its September 1999 communiqué (see *IMF Survey*, October 11, page 317), the Interim Committee welcomed the IMF's recent work on the pace and sequencing of capital account opening and encouraged further examination of individual countries' use and liberalization of controls, with particular attention to the relationship between capital account liberalization and financial sector stability. Following the April 2000 meeting, the Board will discuss liberalization strategies and the scope and sequencing of financial reforms and prudential policies to safeguard financial stability in the course of capital account opening. The Board will also continue to discuss the issue of exchange rate regimes in an increasingly integrated world economy.

Biennial surveillance review

The biennial review of IMF surveillance will cover the scope and focus of bilateral surveillance and a series of related topics, including a review of recent experience with

IMF policy advice on exchange rates; regional and cross-country issues; standards; coverage of financial sector and capital account issues; and consultation procedures and practices. The biennial review will also consider some of the points raised by this year's external evaluation of IMF surveillance (see *IMF Survey*, September 27, page 303).

Other items

In addition to this heavy agenda of policy items, much of the Board's time will continue to be devoted to the IMF's work on country matters, including discussions of annual member-country consultations and lending to support members' policy programs, as well as global surveillance. Other topics contained in the Board's work program include

- the April 2000 *World Economic Outlook*;
- structural issues in managing foreign exchange reserves and strengthening safeguards on the use of IMF resources and the related issue of misreporting information to the IMF;
- recent initiatives to enhance the IMF's transparency with regard to both its surveillance function and the use of its resources;
- monetary and exchange rate policies of the euro area, in the context of the IMF's regional surveillance;
- IMF technical assistance, including the substance of policy advice and arrangements for its delivery; and
- the IMF's conditionality, particularly in light of recent financial crises.

The summary of the Executive Board's work program is the second to be released to the public as part of the IMF's continuing efforts to increase public awareness of its activities; the first was released in July 1999 (see *IMF Survey*, July 5, page 218). The full text of News Brief 99/73 is available on the IMF's website (www.imf.org). ■



The IMF's Executive Board (shown here with the 24 Executive Directors, their alternates, and staff) represents the organization's 182 member countries.

Staff report welcomes Germany's fiscal measures, sees need for fresh initiatives on labor front

On October 20, the IMF Executive Board concluded the 1999 Article IV consultation discussions with Germany. Germany is participating in the pilot project for release of staff reports, one of a number of current initiatives to increase the transparency of the IMF's operations. This article describes the economic background and key policy issues raised in the report, which was released on November 3. The full text of the staff report, as well as a set of background papers on selected issues, is available on the IMF's website (www.imf.org).

Background and outlook

The staff report notes that as of mid-1998, Germany's economy appeared poised for a long-awaited cyclical upswing: the massive labor market shakeout that followed German unification had finally run its course; the Maastricht fiscal requirements had been met; and external competitiveness was satisfactory. However, the cyclical upswing subsequently stalled as the emerging market crisis took a heavy toll on German exports. The ensuing knock to business confidence was exacerbated by initial uncertainty about the policy direction of the new federal government elected in September 1998. As a result, Germany's real GDP growth came to a halt in late 1998, lagging euro-area performance by some 2 percentage points during the second half of the year, before recovering somewhat in 1999. Unemployment declined in 1998 and has recently been stable at about 9 percent (standardized definition), helped by active labor market programs and slow labor force growth. German inflation has been subdued, remaining below 1 percent as of September 1999, despite higher oil prices and indirect taxes.

With the contractionary impact of the emerging market crisis receding, Germany's short-term growth outlook is now reasonably bright. The improved external environment, easier monetary conditions, and greater policy clarity, in particular in the fiscal area, have already been reflected in a marked strengthening of short-term indicators, including business confidence, orders, and industrial production. Staff projects real GDP growth to pick up from about 1½ percent in 1999 to 2½ percent in 2000. At the same time, however, enduring structural weaknesses in the labor market point to less-than-comforting medium-term prospects.

Policy issues

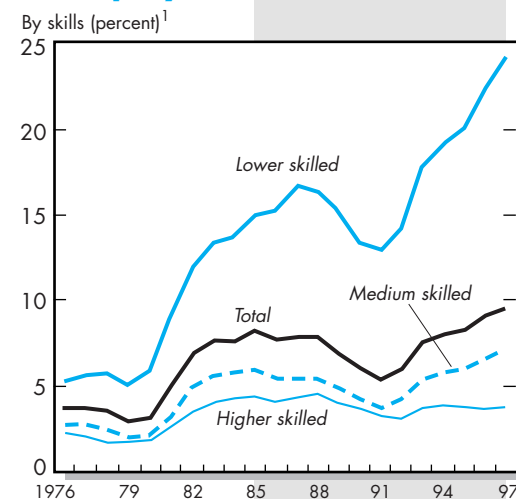
On the macroeconomic policy front, the federal government's June fiscal consolidation and tax reform package has clarified the authorities' medium-term intentions. The staff report welcomes the package's emphasis on

targeted cuts in current spending, which should lend credibility to the fiscal strategy. Moreover, the package reconfirms Germany's commitment to the Stability and Growth Pact (signed in 1997 by European Union members, in which countries aspiring to membership in the European Economic and Monetary Union (EMU) have committed themselves to attaining a medium-term budgetary position close to balance or in surplus). If firmly implemented, the consolidation package would bring the medium-term fiscal position close to balance. At the same time, the staff report notes that the fiscal authorities should craft budgetary policies in cyclically adjusted terms and allow the operation of automatic fiscal stabilizers when growth deviates from budgetary projections—an approach that should foster macroeconomic stability and that has become particularly important in the context of EMU.

The fiscal package's income tax reform proposals envisage substantial cuts in Germany's high statutory business income tax rates, financed through base broadening. The staff report notes that the proposed reforms would lower the overall efficiency cost of the tax system, but would also tilt the playing field toward retention of profits rather than distributions, as the latter would be taxed at significantly higher rates. The report also argues that further steps to lower Germany's tax burden, financed through expenditure restraint, would be desirable.

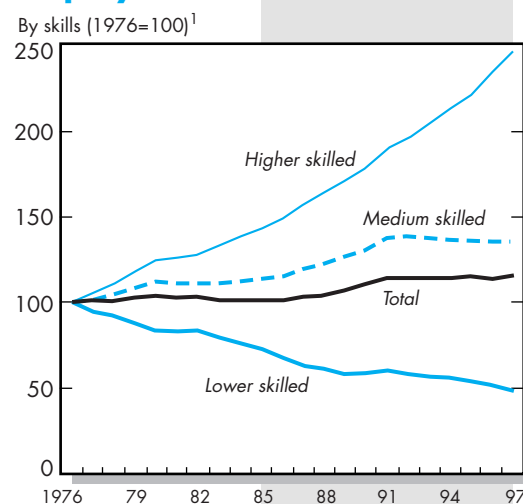
While the staff report thus welcomes the authorities' recent fiscal proposals, it cautions that fresh policy initiatives are needed to address Germany's deep-seated labor market problems—recurrent bouts of labor

Unemployment rates



Data: Reinberg and Rauch (1998), IAB Werkstattbericht, No. 15; and IMF staff estimates
¹Data refer to western Germany only.

Employment levels



Data: Reinberg and Rauch (1998), IAB Werkstattbericht, No. 15; and IMF staff estimates
¹Data refer to western Germany only.

shedding, low job creation, and high structural unemployment. The report also underscores the need, while drawing on other countries' successful experiences, to develop home-grown reform initiatives that are rooted in social consensus and consistent with German society's equity aims.

The report notes that Germany's key labor market institutions—collective bargaining on wages and other work conditions and a large-scale social insurance system—have been premised for many years on two key principles: first, income solidarity—that is, increases in labor compensation and improvements in nonwage benefits should apply at roughly similar rates across different types of workers; and second, social contribution rates should be levied roughly proportionally across the wage distribution, and social insurance benefits should be linked tightly to contributions. Collective bargaining and the social insurance system are complemented by a generous social safety net for the long-term unemployed, based on the principle of a minimum income guarantee that in effect establishes a relatively high wage floor at the lower end of the labor market.

These institutional arrangements worked exceptionally well during the *Wirtschaftswunder* era of rapid catch-up growth in the 1950s and 1960s and were associated with an economic performance that was envied by much of the world. However, as the impetus behind catch-up growth and some of the special circumstances surrounding the *Wirtschaftswunder* era faded away, a large segment of Germany's labor market, mainly comprising the lower-skilled and lower-paid workers, faced increasing difficulties finding gainful employment, as reflected in a striking disparity in disaggregated unemployment and employment trends by skills since the mid-1970s (see charts, page 355).

Labor market

The report suggests that the unfavorable labor market trends for the unskilled reflect the interaction of marked changes in the economic environment with Germany's long-established labor market institutions. On the labor demand side, skill-biased technological progress and globalization shifted labor demand in favor of higher-skilled and better-paid workers (the "highsiders"). On the labor supply side, immigration, new patterns of labor force participation, and, in particular, German unification added to the pool of lower-skilled and lower-paid workers (the "lowsiders"). With collective bargaining wedded to the principle of income solidarity (driven over the medium term by the productivity performance of the highsiders) and with social contributions increasing proportionally across the wage distribution, lowsiders found themselves increasingly uncompetitive. The only available wage-setting option to keep lowsiders' labor cost in line with

their productivity within this institutional framework—across-the-board wage restraint—proved unsustainable during cyclical upturns and was generally followed by episodes of across-the-board wage pushes and further rounds of labor shedding at the low end.

The problems at the lower end of the labor market were echoed by financial policy responses that added demand-side strains to an already difficult situation. In particular, fiscal policy at the federal government level, driven by a constitutionally sanctioned urge to "restore order to the public finances" following labor market shakeouts and the associated weakening of the fiscal position, adopted a pronounced procyclical fiscal stance.

The German authorities have recently convened the Alliance for Jobs among the social partners to discuss and initiate reforms to improve the functioning of Germany's labor market. The staff report notes that this forum is a potentially promising framework for developing a cooperative solution in light of successful experiences elsewhere, including among some of Germany's neighbors in Europe. It suggests that a broad-based package is needed both to address the problem of excessive labor cost at the lower end (through lower social contributions and greater flexibility of collective bargaining) and to enhance incentives to take up remunerated work (both through tightening eligibility for noninsurance social benefits and through income safeguards in the form of in-work benefits for the lower-paid workers). In this context, the staff report notes that alternative, narrower approaches to tackling Germany's labor market malaise—for example, trading across-the-board wage moderation for new early retirement schemes—would, at best, have only short-lived benefits. While welcoming Germany's progress in deregulating utilities, the report observes that further product market steps, including liberalizing shopping hours and reducing the massive number of business regulations, would be a valuable complement to labor market reforms.

Conclusion

The report suggests that Germany's financial system appears to have weathered the emerging market crisis. At the same time, EMU and globalization continue to put pressure on financial institutions to become more efficient. However, consolidation is hindered by a variety of ownership structures that make mergers difficult. The report thus encourages measures that would level the playing field across Germany's financial institutions, in particular by clarifying the role of the *Landesbanken*, and increase the transparency of banks' credit risks. ■

Albert Jaeger
IMF European I Department

In oral remarks, Camdessus calls for focus on framework for reducing poverty

IMF Managing Director Michel Camdessus addressed the Joint Ministerial Committee of the Board of Governors of the Bank and the IMF on the Transfer of Real Resources to Developing Countries (Development Committee) during its meeting in Washington, D.C., on September 27. Following are edited excerpts of his spoken remarks.

I am happy to report that the Interim Committee had an excellent swan song before becoming the International Monetary and Financial Committee as it endorsed a funding package for the IMF's contribution to the Heavily Indebted Poor Countries (HIPC) Initiative and for the continuation of the Enhanced Structural Adjustment Facility (ESAF) [see *IMF Survey*, October 11, page 318]. This allows me to say that, at least for the IMF, full funding of the HIPC Initiative has been identified.

This is important. But more important, in my judgment, is the way the package was completed. Of course, the IMF will triple its initial contribution through off-market gold transactions. But, even more important, we have the bilateral support of more than 90 of our 182 members, among them more than 55 developing countries and more than 10 transition economies. Even more relevant, I am happy to count among the contributing countries some of the poorest developing countries, which having benefited from our old ESAF, considered it such a good thing that they wanted countries poorer than themselves to benefit from the new initiatives.

Let me thank you all—these countries you represent—for this outstanding demonstration of such solidarity in our world. I hope, and am certain, that this spirit will spill over to help meet the funding challenges of the World Bank and other multilateral development banks, so that we can begin to implement the enhanced HIPC Initiative soon without compromising their financial integrity.

Let me say a few words about the enhanced HIPC Initiative. Its heart is indeed a strengthened focus on a comprehensive framework for poverty reduction. As has been noted, this is the product of the excellent cooperation of the Bank and the IMF, and I can tell you that I am unable and I suspect even [World Bank President] Jim Wolfensohn is unable to identify the source of these ideas. They come from both sides of the street. They are there, they are good, and we endorse them. We believe that this is an extraordinary new opening for a common fight against poverty. The heart of it is a set of measures supported by our respective Executive Boards, nationally owned, and incorporated in outcome-oriented Poverty Reduction Strategy Papers. I would stress that we talk about a process, not

about bureaucracy. The Poverty Reduction Strategy Papers will be prepared by the countries with the technical support of the Bank and the IMF and will be the central piece of our joint efforts in these countries. In line with the Comprehensive Development Framework, this approach seeks to better focus our work on the critical goal of international development—namely, poverty reduction.

The Interim Committee has also endorsed my proposal to transform our old ESAF into the Poverty Reduction and Growth Facility. At this juncture, I want to thank you for helping us to create the ESAF 12 years ago.

Let me tell you what growth means in this context. Growth means, of course, high-quality growth. It also means growth for poverty reduction, because we all know there is no poverty reduction without growth. But it also means something that sounds possibly a little bit new. It means no sustainable growth if poverty-reduction actions are not at the heart of the growth strategy to ensure its sustainability.

IMF Executive Directors and ECOSOC ambassadors address poverty issues

IMF Executive Directors met with UN Economic and Social Council (ECOSOC) ambassadors in New York on October 28 to discuss cooperative actions the two institutions could take in the fight against poverty. Reducing poverty, UN Deputy Secretary-General Louise Fréchette said, was emerging as one of the greatest challenges of the times and one that should engage all the energies of the international organizations. Although significant progress has been made, there is no time for complacency, and the momentum for reform needs to be maintained, she said.

Noting the significant improvement in global conditions in the past few months, IMF Managing Director Michel Camdessus said he was reasonably optimistic, but not complacent. For countries seeking financial assistance from the IMF, he said the IMF would take social programs aimed at poverty reduction into account when deciding which programs to finance. As for debt reduction, as far as the IMF is concerned, the financing is there. The international community has established the link between debt reduction and human development, which would make a big difference to the world's poorest countries—but only if they are committed to putting in place policy frameworks and structural adjustment programs that would boost their growth rates, Camdessus said.

The full text of Press Release ECOSOC/5877, issued on October 28, is available on the UN website (www.un.org/News/Press/docs/1999/19991028.eco5877.doc.html).



The Poverty Reduction Strategy Papers should be prepared through a process of outreach to civil society in the country concerned. Donors should also be actively involved and use the papers to guide their aid flows. These papers represent an extraordinary opportunity and a major challenge to HIPCs and to all ESAF and IDA [International Development Association] countries to take full charge of their development and poverty-reduction strategy.



Development Committee Chair Tarrin Nimmana-haeminda (left) and Managing Director Michel Camdessus

We in the IMF stand ready to assist country authorities in this process, together with our colleagues from the Bank. But please remember, with a full sense of responsibility, that the Poverty Reduction Strategy Papers represent a daunting challenge for the Bank and the IMF. The process will require a change in the way both institutions work, and to be effective it must be a top priority, with the needed

resources provided for both institutions. In this regard, I am particularly conscious of the burden that it will place on Jim Wolfensohn's staff, where the expertise on poverty reduction lies.

The challenge is magnified by the wish of the international community to accelerate debt reduction and achieve the goal that three-fourths of eligible HIPCs be brought into the process by the year 2000. This is a superb objective. But I will not disguise my concern about the dangers of this timetable.

The process of ownership outreach and participation takes time. There is a tension between these goals and accelerating debt relief, and we must resolve this tension by a formidable effort on all sides to meet this challenge. Hopefully we can successfully marry these ambitious goals. But if we have to choose, we should choose substance over timing.

Our primary aim should be to use debt relief under the HIPC Initiative to help achieve faster, higher-quality growth, combined with effective poverty reduction. We do the HIPC no favor if we put at risk these objectives for the sake of achieving this or any timetable.

A second issue relates to the timing of the completion point. We, along with the Bank and the Paris Club, will be providing significant debt relief during the interim period to the completion point. This, along with the calculation of debt relief at the decision point, has reduced the importance of the completion point. As debt relief is provided irrevocably under the initiative, it is particu-

larly important that by the completion point the process of poverty reduction is well established, the policies elaborated and being implemented, the needed institutions developed, and initial results becoming evident. We must send a clear and coherent message that poverty reduction, and ultimately eradication, is the goal of the international community, and that on this goal we should not, and will not, compromise.

We must also show the world in the future that debt relief was put to effective use and that it was a valuable instrument to achieve what I call the seven pledges to promote human development. [See *IMF Survey*, October 11, page 310.] Central among them are reducing extreme poverty by half by the year 2015, and eliminating gender disparity in primary and secondary education—the most powerful instrument for women's empowerment—by the year 2005.

This effort we have here, with the serious implementation of the new HIPC Initiative, is the instrument for that. Let's do it. ■

For a comprehensive description of the HIPC Initiative, please see IMF Pamphlet No. 51, *Debt Relief for Low-Income Countries and the HIPC Initiative*, by Anthony R. Boote and Kamau Thugge, 1999.

Available on the web (www.imf.org)

News Briefs

99/72: IMF Completes Review and Approves \$10.6 Million Credit Tranche for Malawi, October 25

Public Information Notices (PINs)

99/96: Sri Lanka, October 22
99/97: Netherlands, October 25
99/98: Portugal, October 22
99/99: Costa Rica, October 26
99/100: France, October 28
99/101: Germany, November 3

Letters of Intent

Cambodia, September 29
Djibouti, October 2
Malawi, October 6

Policy Framework Papers

Djibouti, October 2
Cambodia, October 6

Notes: PINs are IMF Executive Board assessments of members' economic prospects and policies. They are issued following Article IV consultations—with the consent of the member—with background on the members' economies and following policy discussions in the Executive Board at the decision of the Board.

Letters of Intent are prepared by a member country and describe the policies that the country intends to implement in the context of its request for financial support from the IMF.

Policy Framework Papers are prepared by the member country in collaboration with the staffs of the IMF and the World Bank. These documents, which are updated annually, describe the authorities' economic objectives and macroeconomic and structural policies for three-year adjustment programs supported by Enhanced Structural Adjustment Facility resources.

Speakers explore reasons for recent expansion, future growth prospects for U.S. economy

The longer the U.S. economic expansion persists, the more it seems to puzzle analysts. Is it an instance of a particularly fortunate virtuous cycle—bred of good policy but extended by extraordinary good luck? Or, as is increasingly asked, does it reflect structural, and permanent, changes that may have enduring implications for the U.S. economy and perhaps others?

A recent IMF Economic Forum, “The U.S. Economy: Where Will It Go from Here?” explored the origins and dimensions of the expansion and looked at what may lie ahead for the economy. John M. Berry of *The Washington Post* served as moderator. Discussants Martin Baily, Chair of the U.S. Council of Economic Advisers; William Dudley, Managing Director and Chief U.S. Economist of Goldman, Sachs & Co.; N. Gregory Mankiw, Professor of Economics at Harvard University; and Steven Dunaway, Assistant Director in the IMF’s Western Hemisphere Department, praised the vitality of the U.S. economy but offered different perspectives on whether there had been fundamental changes in the economy and whether the predicted moderation in the growth rate would be achieved without significant disruptions.

Strength of economy

Martin Baily opened his remarks with a review of the U.S. administration’s forecast: real GDP growth at 3.9 percent in 1999 and 2.4 percent in 2000; a consumer price index at 2.2 percent in 1999 and 2.4 percent in 2000; and unemployment at 4.3 percent in 1999 and 4.5 percent in 2000. Over the near term, the United States is expected to see some slowing of consumption, which has been running well ahead of GDP growth. The administration also foresaw increased budget surpluses over time, and Baily expected continuing fiscal restraint to help move the country to a more sustainable GDP growth rate.

The substantial current account deficit is an obvious area of concern, but Baily emphasized that there is a key difference between the present deficit and the one experienced in the 1980s. Capital inflows to finance the 1980s deficit were essentially used for consumption, particularly to fund the large government deficits of that period. Inflows to finance the present deficit are largely being used for investment, and these investments are expected to generate sufficient returns to service this foreign debt. He also noted that some moderation in the deficit was expected, with renewed overseas demand providing substantial help in this process.

“The surprising or wonderful thing,” Baily observed, “is just how good this economy is.” In the 1970s, the United States saw its unemployment and inflation rates rise simultaneously; now, its unemployment rates have

dropped and its inflation rate has remained low. He noted that the U.S. labor market is performing extraordinarily well, and a strong dollar and capacity utilization slightly below the historical norm have helped keep prices under control. Perhaps the key factor in this environment of low inflation and low unemployment



Martin Baily (left), Steven Dunaway, John M. Berry, N. Gregory Mankiw, and William Dudley review prospects for the U.S. economy.

has been, Baily argued, surprisingly strong productivity growth. And it is this productivity performance that has prompted questions about a “new” U.S. economy.

The productivity boom—now four years old—is old enough to be taken seriously but young enough to still be considered fragile. Baily was generally optimistic, however. Productivity gains had failed to materialize as quickly as expected from the information technology revolution, but there was reason to think the economy might finally be seeing a payoff. Baily cited greater efficiencies in retail distribution—where dramatically improved transportation has accounted for significant changes—and in airline load factors—where technology has allowed U.S. airlines to become about 50 percent more productive, on a labor productivity basis, than their European counterparts.

Baily hoped to see productivity growth settle in at approximately 2 percent, but it would be crucial to maintain “a highly competitive environment that encourages both innovation and the adoption of innovation,” Baily said, to ensure that the country’s very high rates of investment are sustained.

Truly a mystery

Clearly, there is no debate now over the strength of the U.S. economy, Gregory Mankiw observed. A contrast with 1993 Clinton administration projections of where the country would be with 1999 actual figures points to about 4 percent more output, about 5 percent higher employment, and inflation about 1½ percentage points lower. Analysts have offered a range of explanations for this amazing performance, but he urged his audience to be leery of easy answers.

None of the standard economic interpretations seem to apply, Mankiw said. Keynesians and monetarists, who

believe that aggregate demand changes tend to drive a business cycle, are at a loss to explain why higher inflation is not accompanying higher output and higher employment. And extreme supply-siders are not comfortable either, he noted. They believe higher taxes, particularly higher taxes on the rich, cripple an economy.

But the Clinton administration did just this in 1993, with hardly the effects that supply-siders would have expected. Left-wing supply-siders—those who believed increased spending on infrastructure and worker training was needed to spur the economy—are equally mystified by the economy's current strength.

So, Mankiw asked, do the deficit hawks deserve the credit?

Well, yes, he said, but “even the most optimistic calculations don't give you deficit reduction leading to this great of an economic boom.” A more plausible explanation is that some other factor has produced this tremendously rapid growth, which led to extra revenue, which led to reduced antipoverty programs, which led to a surplus.

The search for another factor, Mankiw said, led him to the Internet and to a theory that the information technology revolution might be responsible for fueling this boom. But while computers have become very cheap and are a major investment item for companies, it is still an open question whether these changes constitute a new paradigm, he said. And it is still not certain that productivity has increased sharply outside the manufacture of computers.

Finally, Mankiw asked, is the stock market experiencing a bubble or a fundamental change? Mankiw professed to be an agnostic on the subject, but was intrigued by arguments that the equity premium—historically thought to be in the area of 6–7 percent—may be shrinking. He would not rule out the possibility of a stock market crash, but thought if one did occur it would be on the order of the 1987 experience. He saw a full-scale financial crisis as far less likely, but if it did happen, he laughed, it would be certain to “catch all of us by surprise, even the economists of the IMF.”

View from Wall Street

Unlike academics, William Dudley remarked, “I work on Wall Street, so I have to pretend I have the answer.” He believed there were three reasons why the economy was so strong: structural changes had made it less cyclical; good policy had contributed (with divided government helping to rein in the more extreme impulses of both parties); and good fortune had played a role.

Structural changes. Most important among the structural changes in the U.S. economy, Dudley argued,

was a transition to just-in-time inventory management. Better information permitted quicker responses and more modest fluctuations in demand.

The U.S. economy is both a lot more open than in the past, allowing the trade sector to serve as a shock absorber for fluctuations in domestic demand, and more flexible, particularly in the labor market. A dramatic reduction in the time taken to meet capital equipment orders has encouraged greater investment. And deregulation has fueled competition.

Good policy. Dudley credited trade liberalization, fiscal discipline, and an apparently better monetary policy regime. In particular, he noted the U.S. Federal Reserve's ability in 1994–95 to tighten monetary policy by 300 basis points without the presence of inflationary pressures. This, he believed, had really prevented inflation from getting entrenched and thus helped sustain the economic expansion.

Good luck. Dudley believed the economy benefited from two crucial instances of good timing. The end of the Cold War provided a useful peace dividend, and the various external shocks—notably the crises in Mexico and Asia—came at opportune moments when the U.S. economy could have overheated.

All of these elements, Dudley remarked, have helped produce a less cyclical economy that has encouraged greater investment, which in turn has led to greater productivity, which has helped restrain inflation and generate more revenue for government. But does this constitute a new era? He was hesitant to jump on the new era bandwagon, but the fact that the United States has had eight months of recession in the past 17 years does give one pause, he said, particularly when before 1983, the U.S. economy was in recession 25 percent of the time. Luck might have been a factor in this performance, but it is highly unlikely, he said, to be the sole explanation.

Dudley hesitated to predict that the good times will continue, but he did note that good policy was no accident. The rising importance of capital markets, he noted, had made bad policy harder to conduct. He also was inclined to view the dramatic revaluation of the equity market as generally appropriate, but he cautioned that it had created two significant imbalances: a spectacular increase in household net worth (and a dramatic decline in the household savings rate that cannot be sustained indefinitely) and a big surge in consumption investment that has been satisfied by very large trade and current account deficits. He also expressed concern that these imbalances may be difficult to redress in a smooth manner.

Dudley also cautioned that if this is indeed a new era, it is one with a dark secret: U.S. real interest rates will need to rise. A smaller pool of savings will need to be apportioned among a larger and wider array of investment projects, and this will mean either keeping mone-



Panelists consider the implications of the continuing U.S. economic expansion for U.S. and other economies.

tary policy too loose or allowing interest rates to go up. U.S. monetary policy remains very accommodative, he argued. The stock market could decline, the dollar appreciate, or interest rates go up, but Dudley found the third option the most likely. The bottom line, he said, is that the U.S. economy “is likely to remain a bit stronger than expected because financial conditions still are more accommodative than people realize,” but there will be growing pressure on the Fed to do more—probably not very quickly but eventually.

Why economic policies matter

Closing out the discussion, Steven Dunaway said he could disagree with little that was said, but he would argue that economic policies have played a key role in determining economic outcomes. The United States, he said, was now seeing the fruits of two decades of good policies, beginning with Paul Volcker’s decision in the 1980s to address rising inflation and bring it down.

During the same decade, deregulation began to provide incentives to change the way businesses conducted their operations. Among the most important steps, Dunaway argued, was the deregulation of transportation, which dramatically lowered costs and made just-in-time inventory management feasible, while simultaneously broadening the scope for competition and making subsequent developments, like e-commerce, possible. Also critically important, he said, was the increased competition prompted by trade liberalization.

One piece of bad policy—the relatively disastrous expansionary fiscal policy of the early 1980s—ended up having some very favorable effects. One consequence was the sharp rise in the U.S. dollar. This forced U.S. business into a corner, he said, but ultimately led it to work “leaner and meaner” to stay competitive. The legacy of that bitter period, he added, is still evident in what appears to be continuous efforts by U.S. companies to reduce business costs and restructure, even though profits have risen.

The last key piece of the economic puzzle was the 1993 tax increase and other measures included in the 1993 Omnibus Budget Reconciliation Act. That legislation, Dunaway said, set the foundation for the fiscal surpluses today. IMF analysis suggested that most of the improvement in the U.S. fiscal balance—which swung from a 4.7 percent of GDP deficit to what is likely to be a more than 1 percent budget surplus this year—“is attributable to policy actions, including tax increases and spending cuts, particularly discretionary spending reductions.”

With this sound policy foundation in place, the question, Dunaway said, is what the future holds. Basically, he argued, if the United States continues to follow sound macroeconomic policies, the economy should continue to “cruise along,” albeit, it was hoped, at a somewhat reduced speed. Dunaway acknowledged the risks that other panelists had cited—notably a potential overvalu-

ation of the stock market, the decline in household savings, and the current account deficit. But he was more sanguine about the impact of both the savings decline and the current account deficit. The decline in savings, he believed, could be explained by a need to save less in a low-inflation environment; by increased per capita transfers from Social Security and Medicare; by a substantial expansion of credit to the household sector; by an improved fiscal position, which is perceived to mean reduced future tax burdens; and, of course, by the sharp rise in equity wealth. Of these factors, only the last one could be seen as potentially subject to a sharp reversal, which could prompt a reduction in consumption and a significant slowdown in GDP growth.

The current account deficit has grown, Dunaway observed, for several reasons, among them that the United States has grown substantially faster than most of its major trading partners (thus suggesting that cyclical differences have been a major contributor to the deficit). But it has also reflected the inflow of capital, partly seeking higher returns on investment in the United States and partly fleeing less stable conditions in other markets, particularly in the wake of the Asian financial crisis.

The U.S. current account deficit should correct itself—as conditions elsewhere stabilize and as some capital flows back—and the dollar will probably depreciate over the medium term. A redressing of this imbalance has been widely anticipated, but debate rages over whether this can be achieved smoothly. Dunaway emphasized that as long as U.S. fiscal and monetary policy remained strong—and confidence in the economy remained high—a sustained run on the U.S. dollar would be unlikely. Sharp movements in the currency might at times occur, he said, but it is not clear that these would be translated into sharp swings in the real economy.

Dunaway regarded the stock market as more of a puzzle. He admitted to being uncertain as to whether the market was overvalued, but he argued there were good reasons to suspect that some of the run-up in prices was permanent, reflecting diversification of portfolios by aging baby boomers who are looking to raise the returns on their stock of wealth. Innovations in financial markets have made it easier and cheaper for them to do this. Also, technological changes may have increased the profitability of firms on a sustained basis, justifying higher stock prices. He suggested that even if the market were to decline by 25 percent, it would not be likely to have a major impact on economic activity. The real risk, in Dunaway’s eyes, is bad policy, particularly on the fiscal side. An expansionary fiscal policy at this point, he concluded, “would be absolutely disastrous.” ■

The U.S. economy is likely to remain stronger than expected, but there will be growing pressure on the Fed to do more.

—Dudley

The full transcript of this Economic Forum is available on the IMF’s website (www.imf.org).

Liberalization of exchange and capital controls has fueled rise of global trade and investment

During the past decade, most economies have become considerably more open to trade and capital flows. A principal force driving the growth of international trade and investment has been the liberalization of global financial transactions, and exchange and capital controls. A recent IMF publication, *Exchange Rate Arrangements and Currency Convertibility: Developments and Issues*, looks at the evolution of countries' exchange and capital control regimes and how these developments have affected exchange rate regimes. Highlights from the new publication, which is part of the IMF's *World Economic and Financial Surveys*, follow.

Currency convertibility

In spite of recent currency crises, the trend toward currency convertibility has continued. During the 1990s, most IMF member countries continued to liberalize their exchange and capital controls. Although some exchange and capital controls were reintroduced in the aftermath of the Asian and Russian financial crises, they were limited to a few countries and were mostly short-lived.

An indicator of the trend toward currency convertibility for current international transactions is the number of countries that have accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement. A member normally accepts these obligations only after eliminating all exchange restrictions on payments and transfers for current international transactions as defined by the IMF's Articles. Between 1990 and October 1999, this number more than doubled, to 151. Overall, significant progress has been made in establishing a multilateral exchange and payments system consistent with the purposes of the IMF.

Countries' use of capital controls has also declined significantly over the 1990s as measured by the larger number of liberalizations than tightenings. In response to the much greater attention to capital account issues, beginning in 1996 the IMF expanded considerably the information that it collects and publishes on members' capital controls. This information has allowed, for the first time, a comprehensive assessment of members' capital control regimes, distinguishing between different types of underlying financial transactions and between controls on capital inflows and outflows. This information shows that, apart from the industrial countries, when portfolio capital transactions have been substantially liberalized, most countries maintain moderate to high degrees of control over capital movements. Controls on outflows are somewhat more prevalent than those on inflows.

Technological and financial innovation has created a demand for more sophisticated international exchange and payment systems and required that greater emphasis be given to fostering the development of sound financial systems and to promoting transparency and sound macroeconomic policies, rather than relying on administrative controls to regulate international exchange and payments and capital transactions. The experiences of countries with sequencing capital account liberalizations reveal that such liberalizations should be an integrated part of more comprehensive programs of economic reform involving the development of domestic financial markets and institutions and the adoption of consistent macroeconomic policies. The Asian currency crisis provided lessons on the importance of the supporting policies, as well as on the role of regulatory and policy biases, in explaining the volatile capital flows.

Adapting exchange rate arrangements

The trend toward currency convertibility has required greater coordination by countries of their monetary and exchange rate policies. In many cases, the response to increasing capital flows has been to adopt more flexible exchange rate arrangements; some countries have adopted more rigid forms of pegged arrangements (such as currency boards) that have been resilient in the face of large capital flows. Consistent with the liberalization of economies more generally and the much larger volume of private international capital flows, there has been much greater reliance than previously on interbank markets to coordinate the supply of and demand for foreign exchange; and following the development of such markets earlier in the industrial countries, developing countries have made significant progress in developing forward exchange markets for hedging foreign exchange risks and have reduced reliance on complex multiple exchange rate systems.

The trend toward adopting more flexible market-based exchange rate arrangements has, in part, reflected moves toward currency convertibility; as countries eliminated exchange restrictions for current international transactions and liberalized capital movements, they created conditions conducive to the development of domestic foreign exchange markets where exchange rates could be determined more flexibly. The increase in capital flows has placed a premium on countries following consistent monetary and exchange rate policies; in most cases, the policy response to capital inflows has involved allowing more flexibility in exchange rate arrangements. Countries attempting to maintain fixed or tightly managed



exchange rates have a limited capacity to set their interest rates independent of the foreign interest rate without risking significant capital flows. Nevertheless, some countries have subordinated monetary policies to the maintenance of exchange rate pegs as part of their stabilization and structural reforms, or in the context of regional integration initiatives.

Reflecting the need to focus on the coordination of monetary and exchange rate policies in the surveillance of exchange rate arrangements, the IMF revised the official classification scheme it had used since mid-1975 to summarize members' exchange rate arrangements. The new classification scheme was published in the IMF's *International Financial Statistics* beginning in April 1999. Unlike the old scheme, which grouped members' exchange rate arrangements according to the announced degree of flexibility of the arrangements, the new scheme classifies members' arrangements by their actual degree of flexibility and also presents members' exchange rate regimes against alternative monetary policy frameworks. Bringing together information both on exchange rate arrangements and on nominal anchors of monetary policy helps to make potential sources of inconsistency in the monetary and exchange rate policy mix more transparent and illustrates that different forms of exchange rate regimes could be consistent with similar monetary frameworks. Additional classification categories have also been added to account for countries

in which the currency of another country circulates as the sole legal tender and for countries that manage their exchange rates within currency bands. The new classification scheme, therefore, better captures the complexity of IMF members' exchange rate arrangements. While declining in importance, exchange rate peg arrangements remain the most prevalent type of exchange rate arrangement under the new classification scheme.

The IMF's latest survey of exchange rate arrangements and currency convertibility contains several background studies dealing with current topics and reviews the IMF's recent technical assistance on exchange systems and capital account liberalizations. The topics covered include sequencing of the liberalization of the exchange system with the liberalization of international trade, sequencing of capital account liberalization in the Asian currency crisis economies, development of a new index to measure the degree of regulation of the exchange system and the capital account, and the operation of the foreign exchange market. ■

R. Barry Johnston

IMF Monetary and Exchange Affairs Department

Copies of *Exchange Rate Arrangements and Currency Convertibility: Developments and Issues*, by an IMF staff team led by R. Barry Johnston, are available for \$25.00 each (academic rate: \$20.00) from IMF Publication Services. See below for ordering information.

Recent publications

Books

Current Developments in Monetary and Financial Law, volume I, IMF Legal Department (\$65.00) (see page 365)

Working Papers (\$7.00)

- 99/118: *Inflation and Growth in Transition: Are the Asian Economies Different?* Sanjay Kalra and Torsten Sløk
 99/119: *Modeling and Forecasting Inflation in India*, Tim Callen and Dongkoo Chang
 99/120: *Measuring Misalignment: Purchasing Power Parity and East Asian Currencies in the 1990s*, Menzie D. Chinn
 99/121: *Determinants of Argentina's External Trade*, Luis Catão and Elisabetta Falcetti
 99/122: *Inflation, Money Demand, and Purchasing Power Parity in South Africa*, Gunnar Jonsson
 99/123: *Regional Income Redistribution and Risk Sharing: How Does Italy Compare in Europe?* Jörg Decressin
 99/124: *Three Million Foreigners, Three Million Unemployed? Immigration and the French Labor Market*, Dominique M. Gross
 99/125: *Technology and Epidemics*, Alberto Chong and Luisa Zanforlin

- 99/126: *Long-Term International Capital Movements and Technology: A Review*, Harm Zebregs
 99/127: *The Enforcement of Property Rights and Underdevelopment*, Era Dabla-Norris and Scott Freeman
 99/128: *Neglected Heterogeneity and Dynamics in Cross-Country Savings Regressions*, Nadeem Ul Haque, M. Hashem Pesaran, and Sunil Sharma
 99/129: *Emerging Markets Crisis: An Asset Markets Perspective*, Ricardo J. Caballero and Arvind Krishnamurthy
 99/130: *Skill Acquisition and Firm Creation in Transition Economies*, Zuzana Brixiova, Wenli Li, and Tarik Yousef
IMF Staff Country Reports (\$15.00)
 99/121: Finland: Staff Report for the 1999 Article IV Consultation (Pilot Project)
 99/122 Finland: Selected Issues
 99/126: Kingdom of the Netherlands: Staff Report for the 1999 Article IV Consultation (Pilot Project)
 99/127: France: Staff Report for the 1999 Article IV Consultation (Pilot Project)

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

Following is an excerpt of a recent IMF press release. The full text is available on the IMF's website (www.imf.org) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Cambodia: ESAF

The IMF approved a three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF) for Cambodia in an amount equivalent to SDR 58.5 million (about \$81.6 million) to support the government's economic program for 1999–2002. There will be seven disbursements, each in an amount equivalent to SDR 8.4 million (about \$11.7 million). The first disbursement is available immediately; the next disbursement will become available after Cambodia meets the performance criteria for March 2000 and the conditions for

the first review. Disbursements during the second and third years of this arrangement shall be subject to phasing and conditions to be determined following future reviews.

Following are extracts of a statement by IMF First Deputy Managing Director Stanley Fischer following the Executive Board's discussion.

"The main goals of the ESAF-supported program with Cambodia are to protect macroeconomic stability, rebuild the Cambodian economy, and reduce poverty. Directors considered that decisive fiscal reform is the central element in the ESAF reform agenda and urged the authorities to formulate the 2000 budget in line with the agreed fiscal framework.

"Directors attached great importance to improving transparency and accountability as well as to adherence to the rule of law and urged the authorities to implement strictly the recently approved Financial Institutions Law. Directors agreed that, over the medium term, external viability will depend on the sustained implementation of policies, continued donor support, and debt relief on favorable terms.

"Directors concluded that continued improvements in governance and determined implementation of the ESAF program would contribute greatly to rebuilding the economy and reducing widespread poverty."

Medium-term strategy

Objectives of the ESAF-supported program are to raise economic growth and per capita income and reduce poverty. The main challenges are to rebuild the economic infrastructure and strengthen the business environment, while addressing governance problems that impede sustainable development.

Cambodia's medium-term macroeconomic framework for 1999–2002 is aimed at raising economic growth to 6 percent, lowering inflation to 4 percent, containing the external current account deficit to 13 percent of GDP, and increasing gross official reserves to about four months of import coverage.

Cambodia joined the IMF on December 31, 1969; its quota is SDR 87.5 million (about \$122.1 million). Its outstanding use of IMF financing currently totals SDR 46.2 million (about \$64.4 million).

Press Release No. 99/51, October 22

Cambodia: selected economic indicators

	1995	1996	1997	1998	1999 ¹
	(percent change)				
Real GDP	7.6	7.0	1.0	1.0	4.0
	(percent of GDP)				
Consumer prices (final-quarter basis)	3.5	9.0	9.1	12.6	5.0
Overall budget balance (cash basis)	-7.8	-8.4	-4.3	-5.8	-3.3
Current account (excluding official transfers)	-17.4	-15.7	-8.2	-9.1	-12.3
	(months of goods and services)				
Gross official reserves	1.5	2.1	2.4	3.6	3.5

¹Projections.

Data: Cambodian authorities and IMF staff estimates and projections

De Larosière to chair Per Jacobsson Foundation

Jacques de Larosière has been named chairman of the Per Jacobsson Foundation as of November 1, succeeding Sir Jeremy Morse. In the course of a long and distinguished career, de Larosière served as Managing Director of the IMF from 1978 to 1987 and served thereafter successively as Governor of the Bank of France and President of the European Bank for Reconstruction and Development. He succeeds Sir Jeremy Morse, who served from 1972 to 1974 as chairman of the deputies of the Committee of the IMF's Board of Governors on the Reform of the International Monetary System, known as the Committee of Twenty, and subsequently was chairman of Lloyds Bank. Leo Van Houtven, former Secretary and Counsellor of the IMF, continues as president of the foundation.

Established in 1964 in honor of the third managing director of the IMF, the Per Jacobsson Foundation sponsors annual lectures designed to promote informed international discussion of current issues in monetary affairs. The 1999 Per Jacobsson lecture was given by Wim Duisenberg, President of the European Central Bank (see *IMF Survey*, October 25, page 345). The full text is available on the IMF's website (www.imf.org).

Next year, Per Jacobsson lectures will be held in Lucerne in connection with the General Meeting of the Bank for International Settlements in June 2000, and in Prague on the occasion of the Annual Meetings of the IMF and the World Bank in September 2000.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
October 25	3.69	3.67	4.20
November 1	3.72	3.72	4.23

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 (as of January 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 113.7 percent) 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/external/np/tr/sdr/sdr.htm).

Data: IMF Treasurer's Department

Volume provides perspective on legal issues, broader financial sector developments

Current *Developments in Monetary and Financial Law*, Volume I, prepared in the IMF's Legal Department, is the most recent addition to its series of books, previously entitled *Current Legal Issues Affecting Central Banks*. The new series title reflects an expansion of the topics under review. As part of the IMF's ongoing efforts to increase transparency, the book explains how the organization makes decisions. It analyzes international financial crises, financial sector developments, governance of central and commercial banks, and payment systems developments, as well as criminal activities that affect the financial world. The book—a valuable annotated reference source—presents international perspectives from almost fifty authors, including officials of international financial organizations, central bankers, attorneys, academicians, and economists.

Decision making and IMF operations

The volume opens with an analysis of how legal decisions are made in the IMF. The IMF's General Counsel, François Gianviti, describes the IMF's legal system and explains that the IMF's Articles of Agreement—an international treaty comparable to a national constitution—form its basis. He then analyzes the IMF's structure by discussing the selection, powers, and status of the three decision-making entities—the Board of Governors, the Executive Board, and the Managing Director. Gianviti notes that, in contrast to a political organization like the United Nations, which operates on the “one country—one vote” principle, the IMF might be more accurately compared to a private corporation but with some features of an international agency.

IMF Assistant General Counsel Hector Elizalde provides another inside view of the IMF's operations. He clarifies the status of countries that participate in the European Economic and Monetary Union with respect to IMF membership, quotas, and participation in the Board of Governors and the Executive Board.

Financial crises

Several authors provide insight into the response of international financial institutions to crises in Latin America and Asia. Claudio Loser, Director of the IMF's Western Hemisphere Department, analyzes the causes of Latin America's 1980s debt crisis and the 1994–95 “tequila” crisis and draws lessons for governance, labor market reform, and human capital. He notes that the 1994–95 crisis was the first financial crisis to develop against the backdrop of truly global financial markets and that international financial support to Mexico in 1995 reached unprecedented levels.

In the context of crisis intervention, Charles Enoch, Assistant Director in the IMF's Monetary and Exchange Affairs Department, asks “why give independence to central bankers if they have shown that they cannot use it?” He responds by explaining that, when a central bank's framework is unable to change its management to deal with a crisis effectively, a currency board may be a viable alternative. He expands on the causes and consequences of establishing a currency board, the prerequisites for its establishment, and the circumstances in which such an arrangement is not appropriate.

Central banks—governance issues

Governance issues continue to be of vital concern in the commercial as well as the central banking world. The seminar on which *Current Developments in Monetary and Financial Law* was based attracted about forty central bank legal advisers from around the world. In this volume, authors examine systems set up to ensure accountability of central banks for monetary policy and for external review of their decisions.

Stephen Cecchetti, Director of Research for the Federal Reserve Bank of New York, discusses the system of accountability for the 85-year-old U.S. Federal Reserve System. This system, he explains, influences monetary policy by setting reserve requirements for banks, setting the lending rate and making loans to commercial banks, and buying and selling government-guaranteed instruments. Having raised some practical issues regarding central bank activities, Cecchetti analyzes why central banks should adopt and follow policy rules rather than use pure discretion in responding to external events. His analysis discusses accountability and how independence is assessed under the Federal Reserve System.

Geoffrey Miller, a professor at New York University Law School, explains a basic framework for external review of central bank decisions and then applies it under the criteria of timing and stringency. He discusses exceptions to the U.S. rule for judicial review after administrative procedures are final, and sets out a menu of stringency options ranging from no review at all to plenary review with no deference to the initial decision maker. ■

Rachel Ray
IMF Legal Department



Copies of *Current Developments in Monetary and Financial Law*, volume I (644 pages), are available for \$65 each from IMF Publication Services. See ordering information on page 363.

Albania's experience with fraudulent investment schemes offers lessons for other countries

In 1996–97, the rapid growth and spectacular collapse of pyramid investment schemes wreaked havoc with Albania's progress in transforming itself into a market economy. IMF Working Paper No. 99/98, The Rise and Fall of the Pyramid Schemes in Albania, describes the crisis and offers some lessons for other countries. The author, Chris Jarvis, was a Senior Economist in the European I Department when he wrote the paper. He discusses his research in an interview with the IMF Survey.

IMF SURVEY: *What is a pyramid scheme and why is this subject relevant now, given that Albania's pyramid scheme crisis is past history?*

JARVIS: A pyramid scheme is a form of fraud in which the operator offers very high returns to investors. A few people invest in the scheme, and, as news of the offer spreads, more investors are drawn in. The operator then uses the money paid in by later investors to pay interest to the early investors, giving the appearance of success. Encouraged by the high payouts, still more people are drawn in, and the scheme grows until the pool of gullible investors dries up. At that point, the scheme collapses. The collapse is usually accelerated by the operator's using some of the money to make impressive-looking but not very profitable investments, living well to create the appearance of prosperity, or just stealing the

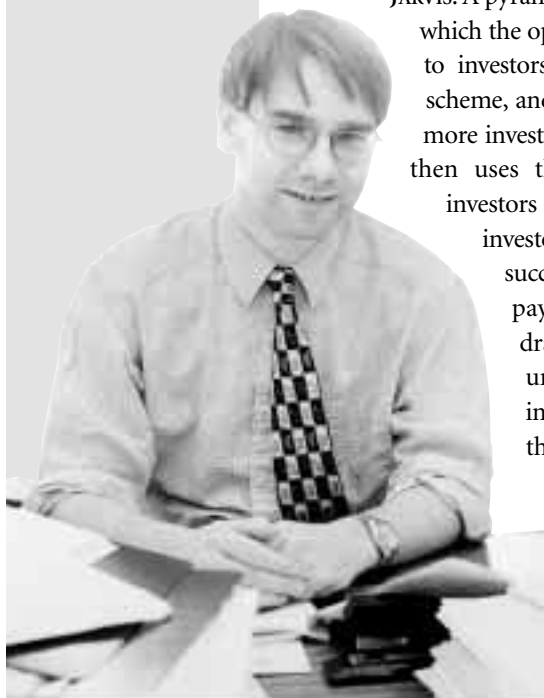
money. But a pyramid scheme is insolvent in the sense that its liabilities exceed its assets from the first day it does business. Unfortunately, the subject is still very relevant because there are new pyramid schemes cropping up all the time. The Internet abounds with them, and they also flourish in countries with undeveloped financial markets. The Albanian schemes were unusual because of their scale—at one point, over half the population had money in them—and because of the damage they did. But smaller schemes, with the potential to grow bigger, exist all over the world.

IMF SURVEY: *These schemes emerged during Albania's transition from central planning to a market economy. What conditions contributed to their emergence?*

JARVIS: The first condition was a badly functioning financial system. It was dominated by three state-owned banks, all of which had their lending severely constricted because they were losing money hand over fist. There were very few private banks. The ones that were operating were mostly interested in foreign trade finance, so there weren't many good avenues in the formal financial system for investment and for channeling money to people who wanted to borrow. In the face of these conditions, an informal financial market grew up, mostly funded from remittances—money that people had earned abroad and sent home to their families. The family members would invest this money with people who would then lend it at relatively high interest rates to others who were starting businesses. That in itself was not a bad thing. These investments were often profitable, and most new businesses in Albania started this way. But at the same time, there grew up investment funds where people took money and tried to invest it on their own account rather than lend it to others. Some of these investment funds either were or became pyramid schemes.

The second condition was a legal system that had lots of holes in it. In particular, administration was lax, and there was uncertainty about which institutions had responsibility for administering this law. There were also some special conditions applying in Albania. It was probably the most repressed and isolated communist regime up until 1992. People were completely unfamiliar with market economies or the basic concept that return and risk are related. Finally, there was the situation in the former Yugoslavia. During the early to mid-1990s, there were UN sanctions against Serbia because of the war in Bosnia. There was widespread violation of those sanctions and large-scale smuggling through Albania. It's pretty universally acknowledged that the pyramid schemes got their start as trading companies involved in smuggling. People were putting money into these companies because, for a while, they were generating high returns. Although smuggling was against Albanian law, nobody in Albania had much of a stake in enforcing the sanctions. At the end of 1995, the sanctions were suspended, and these companies lost a major source of income. In early 1996, they raised their interest rates. From this point on, they were clearly operating as pyramid schemes.

Photo Credits: Denio Zara, Padraic Hughes, and Pedro Márquez for the IMF, pages 353, 354, 358–360, and 366; Reinhard Krause for Reuters, page 368.



IMF SURVEY: *What effects did the schemes have on the Albanian economy?*

JARVIS: One of the curious things about the pyramid schemes, given the scale they were operating on, is that the direct effects on the economy seemed to be fairly limited. The face value of deposits in the pyramid schemes amounted, at one point, to more than half of GDP. We expected that their growth would have significant macroeconomic effects, and that their collapse would too. Toward the end of 1996, the year when pyramid scheme mania was at its peak, there was a surge in imports and a pickup in inflation, which may have indicated a splurge of pyramid-scheme-related spending. People were investing their money, thinking they were going to make huge profits, and spending some of the money in advance. But other things were going on in late 1996 as well—a fiscal loosening in particular—that could explain quite a bit of what was going on with imports and inflation. The effects of the collapse were more evident. There was a fall in GDP of about 7 or 8 percent in 1997—the year the schemes collapsed—following double-digit growth most of the previous years. But the collapse precipitated a near civil war, with a lot of destruction and loss of life, and it's difficult to separate out the economic effects of the pyramid scheme collapse. Of course, the distributional effects were profound. Some people made quite a lot of money—for example, the operators of the schemes, who often stole a lot of money—and then some people, particularly those who invested late, basically lost everything.

IMF SURVEY: *How did the Albanian authorities handle the crisis?*

JARVIS: During the growth of the pyramid schemes, there was governmental inattention to them and possibly governmental corruption. The government preferred to believe that the schemes were really just profitable Albanian companies that were making good investments and were going to be able to repay their depositors. It ignored the fact that the interest rates these companies were offering were evidently unsustainable. This overoptimism and complacency may have been reinforced by the fact that the pyramid scheme companies were significant contributors to the ruling party's election campaign. One notable exception was the central bank governor, who warned the government about the dangers of these schemes. He also refused to give their operators banking licenses in the face of substantial political pressure.

Later, when the schemes were collapsing, the government finally took action. It froze the assets in the banking system of two of the largest schemes. One peculiarity, especially of the pure pyramid schemes that came later, was that they were taking in money so fast that they didn't know what to do with it and simply deposited it in state banks. They were promising to

double investors' money in two months and to treble it in three months, and they were depositing it in banks paying maybe 25 percent a year. The government managed to seize \$400 million in the bank accounts of two of the pyramid schemes, and depositors in these two schemes got more than 50 percent of their money back. But the government still left untouched some of the biggest schemes.

The situation changed dramatically after the civil disorder in March 1997, when an interim government headed by the former opposition party took office. The finance minister took a firm line on the pyramid schemes and said that depositors would not be compensated from the budget. He agreed to bring in external accounting firms to administer the schemes, audit them, and collect what assets they could. With great political and personal courage, he took steps to wrest control of the pyramid schemes away from their owners. To take over the companies, the government needed to pass new legislation, which the IMF and the World Bank helped draft. Even so, it wasn't until after the elections and after various legal challenges brought by the pyramid scheme operators that the companies were finally brought under control. This took several months, during which time the operators looted the companies further.

IMF SURVEY: *Is there a similar risk in other countries with large informal markets?*

JARVIS: I think that industrial countries are not likely to be particularly susceptible to large-scale pyramid schemes because the legal infrastructure is well developed for nipping them in the bud. It's more of a risk in developing countries and economies in transition, where there is something wrong with the financial system or the financial system is just getting off the ground. There's probably a special risk in countries where people aren't used to the concept of investments having risks. Governments—and the IMF and the World Bank—need to be vigilant as they look at other countries where conditions exist for these kinds of things.

IMF SURVEY: *Were international observers at fault in viewing informal companies as a benign influence?*

JARVIS: Both the IMF and the World Bank gave strong warnings about the schemes in 1996. However, their influence was limited. The IMF-supported program was already off track, and the World Bank had suspended most of its lending for other reasons. It is arguable that the IMF and the World Bank should have spotted the schemes earlier. But there are a lot of extenuating factors. One is that it was difficult to distinguish between the legitimate informal market, which was and continues to be a benefit to Albania, and the schemes that were set up as investment funds. A second one is that the



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PHOTO NOT AVAILABLE

Albanian demonstrators in the southern port of Vlore. The collapse of the pyramid schemes precipitated a near civil war.

pyramid schemes were basically criminal organizations, and the IMF is not in the business of investigating criminal organizations. The third thing, and it's a related point, is that the IMF was hesitant to call publicly for an investigation and for a freezing of assets. It has a responsibility to try to head off major financial crime with a macroeconomic impact, but it also has a responsibility not to recklessly blacken the reputation of companies that may be legitimate. It's a difficult thing to balance. You can imagine, for example, how people in the United States would react if the IMF suggested that a major bank was insolvent. It's not a farfetched comparison because the scale of the largest of these companies was like the scale of the largest banks in the United States.

IMF SURVEY: *Which was more damaging to the Albanian economy—the pyramid schemes or the recent Kosovo conflict?*

JARVIS: No question, the pyramid schemes. Purely in terms of economic indicators, there's been an improvement in Albania as a result of Kosovo because it generated substantial inflows of aid and logistical support. The economic effect of the pyramid schemes and the civil disorder that followed were completely negative. In terms of human tragedy, what happened in Albania does not compare with Kosovo. But the extent of suffering in Albania was still great. Following the pyramid scheme collapse and the civil disorder, about 2,000 people were killed out of a population of 3½ million. It was a real tragedy that touched almost everybody in the country.

IMF SURVEY: *What lessons can be drawn for other countries from the rise and collapse of Albania's pyramid schemes?*

JARVIS: Well, first, to look out for them. Second, to try to do something about conditions that generate these kinds of schemes, particularly unreformed financial systems and unclear and badly enforced laws. Prevention is

a lot better than cure. If the schemes already exist, seizure of the assets is the most effective way to preserve some money for the investors. Also, it can sometimes be helpful to bring in people from outside to deal with the problem, especially when the situation is politically loaded. I think it was a benefit for Albania to be able to call in external administrators from Western accounting firms. It was certainly a political benefit; the economic benefit was a bit less clear because the firms weren't all that successful in recovering assets.

IMF SURVEY: *Albania was the poorest and most isolated country in Europe when the transition began and initially made rapid progress in reforming its economy. Did the*

pyramid scheme crisis negate any of its accomplishments?
JARVIS: Yes. I think the collapse of the pyramid schemes and the civil disorder that followed set Albania back in terms of economic development by at least a couple of years. What may have been even more damaging was the effect on confidence. I worked on Albania for only a short time before the pyramid scheme collapse, but I noticed—as did other people who had worked on Albania before—that there was real confidence and optimism around the country. There was a feeling that it had made tremendous progress from a terrible starting point in 1992, and the country's prospects were very good. The pyramid scheme episode dented that. In 1997 and 1998, there was a mood of depression in Albania. A lot of people were emigrating, and there was a feeling among those who stayed that life was going to be much more difficult. There was also a sense in the international community that Albania was going to have periodic crises—it would do well for a while and then something would go wrong again. There was some resistance to helping Albania because of that sense of pessimism. Since then, the way the Albanian government and the Albanian people reacted to the Kosovo crisis may have boosted both their international reputation and their confidence. So, I suspect that the country is on the upturn again. I hope it can get the basic structures and political institutions and governance concerns right this time. First and foremost, the pyramid scheme was a problem of governance. That's probably the most important thing to address in Albania right now. ■

Copies of IMF Working Paper No. 99/98, *The Rise and Fall of the Pyramid Schemes in Albania*, by Chris Jarvis, are available for \$7.00 each from IMF Publication Services. See page 363 for ordering information.