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Managing Director's address

Transition countries must face triple challenges of corruption, role of state, external viability

Following are edited excerpts from IMF Managing Director Horst Köhler's remarks, as prepared for delivery at the conference "Completing Transition: The Main Challenges," held in Vienna, Austria, on November 6. The full text is available on the IMF's website (www.imf.org).

Horst Köhler

Ten years after the collapse of communism, most transition countries have passed the point of no return on the journey toward democracy and the market economy. But any serious assessment would recognize the differences among countries. Some, like Turkmenistan and Uzbekistan, are still in the early stages of building market economy institutions, while others, like Hungary, are grappling with the second generation of reforms—how to make the market economy work more effectively and competitively.

Areas of progress

First, what have been some of the successes?

- Economic growth has resumed in almost all the transition countries in the past two years, and inflation is under control across the region.
- In almost every country, prices, foreign trade, and exchange systems have been liberalized extensively. In just a few years, the transition economies have done what took the industrial countries decades after World War II.
- There has also been progress in many other areas of structural reform, including privatization. In a number of countries, the share of the private sector in the economy has risen to 70 percent or more. This is not too different

(Please turn to the following page)

First Annual Research Conference

Participants address issues of IMF lending, poverty, and exchange rate regimes

First Deputy Managing Director Stanley Fischer and Research Department Director Michael Mussa inaugurated the IMF's First Annual Research Conference on November 9–10. Fischer announced an informal contest for the catchiest acronym for the new conference, preferably something rivaling the mnemonic appeal of the World Bank's ABCDE (Annual Bank Conference on Development Economics). Featuring presentations by academics and policymakers, the conference focused on issues debated daily in the IMF, including whether policy interest rates should be lowered at the onset of a financial crisis; whether IMF programs encourage risky behavior by investors; whether IMF and World Bank policies raise poverty and inequality; and what impact exchange rate regimes have on macroeconomic performance.

Stanley Fischer (right) and Michael Mussa open the IMF's First Annual Research Conference.

Interest rate response to crises

Financial crises tend to mutate and stay a step ahead of academic researchers. Participants at the conference noted that the Asian crisis of

(Continued on page 372)

Köhler reviews challenges for transition countries

(Continued from front page) from the western market economies.

At the same time, there have been disappointments. In many countries, key sectors of the economy are still in decline, leaving whole regions facing catastrophic unemployment. For the vast majority of people, measured per capita incomes remain lower than a decade ago. The sharp decline in output associated with transition has also brought with it a severe increase in poverty and inequality.

Challenges ahead

What are the main challenges ahead? I see three main areas: fighting corruption, defining an appropriate role of the state, and preserving hard-won macroeconomic and financial stability. First, *fighting corruption* is as difficult as it is essential. Transition is about building up new market-oriented structures in a context where power relationships are fluid and evolving, and where some have much to gain from the fluidity or the preservation of the status quo. The abuse takes two forms. The most visible is grand corruption, where vested interests in effect "capture the state" and then use their power to preserve monopolies, hinder competition, and inhibit reform. In such situations, the authorities must be prepared to challenge the vested interests, in part by being fully committed to transparency in policymaking and public sector operations.

The other form is endemic corruption, where those in positions of authority exact payment for their cooperation and thereby not only impose additional taxes on the economy, but undermine the rule of law, which is essential to a market economy. Fighting this form of corruption requires transparent legal and regulatory frameworks, strong courts, trustworthy law enforcement agencies, and better trained, properly paid civil servants and judges.

Second, most transition countries still have state sectors that are too large, making it necessary to fashion a more *market-oriented role for the state,* again often in the face of strong vested interests. The state needs to disengage from commercial activities and reorient itself to concentrate on providing public goods, like education, regulation, and law enforcement. The other dimension is the privatization of state enterprises. It is critically important that the privatization process be transparent and competitive and that appropriate regulatory structures be in place.

The success of transition also calls for effective, affordable social safety nets to cushion the effects of restructuring. The immediate challenge for most countries in the years ahead is how to design effective income support within limited budgets. As economies grow stronger, they will become able to deliver progressively more generous support. But they will continually need to make sure that these benefits do not overstretch budgets or create disincentives to work or saving.

Köhler urges Europeans to focus on reforms, clarify enlargement process

Following are edited excerpts from IMF Managing Director Horst Köhler's address, as prepared for delivery at the meeting with European Union Parliamentary Committees in Brussels on November 7. The full text is available on the IMF website (www.imf.org).

The IMF's Annual Meetings took place against a background of a strong global economic upturn—in fact, the best growth performance since the fall of the Berlin Wall. While the outlook since then has been affected by rising oil prices, we still expect the coming year to bring further solid expansion in the global economy. There are clearly risks, which are now coming mainly from the advanced industrial countries. They include the volatility of equity market prices, particularly in the United States, and the large U.S. current account deficit; the fragility of the economic recovery in Japan; and misalignments among the major currencies, especially the euro and the U.S. dollar.

With good policy management, these risks should not materialize. There are increasing signs of a soft landing in the United States. That is encouraging. But beyond that, we also know that there is a need to increase private savings and for continued fiscal prudence. For Japan, the priority is to sustain the economic recovery and give it a stronger structural foundation.

It is clear that the euro is undervalued and that this poses problems, not least for growth in emerging market and developing countries. This misalignment needs to be corrected. But dramatization is not productive. There will be a reversal. The fundamentals of European economies have clearly improved. Growth in Europe is now catching up to the United States. I expect some dampening of the euphoria for transatlantic mergers, which could lead to a normalization of capital outflows. In my view, the European Central Bank (ECB) has done a good job under difficult circumstances. The Europeans themselves should stop talking down the ECB. The political debate in Europe should concentrate on accelerating the agenda of structural reforms and on clarifying the future process of European integration and EU [European Union] enlargement.

I very much welcome the commitment of the EU to the early launch of a new round of multilateral trade negotiations, as well as the European Commission's latest initiative to provide free access for exports of the poorest countries.

The IMF and its member governments have a challenging work program ahead. We look forward to active engagement with the European Union to help meet our shared goal of promoting stability and broadly shared prosperity.

Third, as countries increasingly move into the growth phase of transition and "reform fatigue" comes to the fore, it will be as important as before to *preserve external viability*. A careful watch will have to be kept on external current account deficits and the rise in external debt levels. To this end, maintaining macroeconomic and financial stability calls for action in a number of areas:

• Designing sound medium-term fiscal plans, which will require balancing necessary expenditures and tight financial constraints. These need to be weighed, however, in a context where tax burdens and debt ratios are already on the high side. The difficulty of reconciling these pressures is already evident in a number of national budgets, and one must be concerned that it might spill over into increased external vulnerability over the medium term.

• Much work needs to be done to strengthen and restructure financial sectors to make them effective. Effective regulation and supervision is indispensable.

• Those countries that are making more successful progress with transition may receive large capital inflows. New challenges for managing the economy will arise, including pressure on current account deficits and on domestic prices. Sound fiscal policy will be essential to lessen pressures from such inflows and reduce the risks of a disruptive reversal.

• In some countries, the management of external debt is the issue. Resolving it will require not only intensified adjustment but also support from creditors and donors.

The primary responsibility for meeting these challenges rests with the countries themselves. But the international community can also do a great deal to support the transition. In particular, industrial countries should open their markets further, including for nascent export industries in the transition countries. These are measures that would benefit not only the transition economies but the advanced economies as well, because of lower-cost products and stronger demand for their own exports.

EU accession

In my view, EU accession is a beacon that has been guiding the reform process in several countries and can play this role in the future for many others. The EU enlargement process must offer a credible and realistic path by which transition economies can, with time and appropriate policies, achieve membership. The membership criteria cannot be diluted without undermining the integrity of the enlargement process. This means that, for some countries, accession may take longer than they would like.

Role of IMF

For our part, the IMF will stay engaged with the transition countries, providing policy advice and offering technical and financial assistance when needed. But, just as the global economy is evolving, the IMF itself is changing to keep it effective in responding to new challenges. At the Annual Meetings in Prague, the IMF's Governors expressed strong support for reforming the IMF.

I see the IMF as an active part of the workforce to make globalization work for the benefit of all. This vision builds on an enhanced partnership with the World Bank, based on a clear sense of the complementarities of the two institutions.

The IMF's mandate to promote domestic and international financial stability demands that it place crisis prevention at the heart of its activities. We are doing so by reorienting our activities, particularly surveillance and technical assistance. We should also pay increased attention not only to national policies and their global effects but also to issues of regional cooperation, including through regional surveillance.

We are exercising stronger oversight of financial sectors, promoting standards and codes, and providing better information about the IMF's policies. Much of the international effort is still in its early stages, and the transition economies are in the vanguard of this work.

We will continue to provide policy advice to members in the areas of our core competencies—monetary, fiscal, and financial sector issues. I believe that the IMF must be candid in conveying its professional analysis and judgment. In those cases where financial support is provided, conditionality will be necessary, but in a way that enhances ownership of the programs. I am convinced that ownership is promoted when it is tailored to meet the varying needs of our members and when it is focused on the measures needed to achieve macroeconomic stability and growth. This approach also requires more effective coordination with other international agencies, in particular the World Bank.

Yugoslavia

The launching of democracy in Yugoslavia is welcome, and we stand ready to cooperate fully with the country as it seeks to recover from years of conflict. We can now hope and expect that the reestablishment of Yugoslavia's links with the international community will be a significant boost to the region more generally.

The transition has yielded some notable successes. Some countries are quite close to convergence with the advanced economies. Others still face a long journey. The international community, and the IMF itself, should be ready to provide support wherever it is needed. In a very real sense, all countries are "in transition." Today, all countries face the same challenge—how to continually adapt their economies to the demands of an increasingly globalized world economy to the benefit of all their citizens. ■

The IMF will stay engaged with the transition countries, providing policy advice and offering technical and financial assistance when needed.

First Annual Research Conference held at IMF

Philippe Aghion

Lawrence Christiano

(Continued from front page) 1997–98, for instance, could not easily be explained by extant theoretical models of crises. These models stressed governments' profligacy or inability to make credible commitments as sources of crises. An important feature of the Asian crisis, however, was the profligacy of the private corporate sector prior to the crisis (though implicit government bailouts and inadequate financial sector supervision played a role in encouraging this private behavior). With the onset of the crisis, the borrowing spigot was suddenly turned off; the resulting deterioration in corporate balance sheets played a big role, speakers noted, in the output collapse in the Asian crisis economies.

During the Asian crisis, Joseph Stiglitz, then Chief Economist at the World Bank, and others urged a reversal of the standard IMF prescription that a country facing a currency crisis temporarily raise its interest rates to stem currency devaluation and restore financial stability. Raising interest rates would worsen the condition of corporate balance sheets, these IMF critics argued, prompting further capital flight and weakening the currency. Hence, far from defending the currency, interest rate increases could have the "perverse" impact of further currency depreciation.

Results of the IMF strategy in Asia appear to suggest that these fears were not justified. Atish Ghosh of the IMF and Gabriela Basurto of the Inter-American Development Bank reported they found little econometric evidence that increases in interest rates depreciate a currency, leading them to conclude that "the perverse effect ... remains a theoretical curiosum."

Despite this evidence, academic researchers are in the throes of constructing theoretical models in which a perverse effect is possible. In the model presented at the conference by Philippe Aghion of Harvard University, Philippe Bacchetta of Studienzentrum Gerzensee, and Abhijit Banerjee of the Massachusetts Institute of Technology, the main burden imposed by a financial crisis is that the currency depreciation raises the foreign currency debt obligations of the corporate sector. Consequently, in their model, limiting depreciation through increases in interest rates is—in most cases—good policy.

Lawrence Christiano of Northwestern University, Chris Gust of the U.S. Federal Reserve, and Jorge Roldós of the IMF were more agnostic about whether interest rate increases are the right policy. In their model, the answer hinges on whether the economy's output can be maintained by substituting domestic resources, such as labor, for imported intermediate inputs, which become more costly as a result of currency depreciation. If substitution between labor and imported inputs is easy, interest rate cuts to maintain output may be a good option. If the economy is unable to adjust factors that are complementary to imported inputs—which may well be the case in the short run—then an interest rate cut could depress economic activity.

IMF lending, bailouts, and bail-ins

Evidence suggests that IMF lending improves the access of emerging market countries to private funds and the terms on which they obtain this access. But is this a good thing? Not according to critics of the IMF's "rescue packages," who see investor willingness to make more loans on better terms as an indication of the "moral hazard" fostered by IMF lending. Critics argue that investors make these loans because they believe the IMF will "bail out" countries (and, indirectly, investors) in the event of a crisis. Proponents of IMF lending, in contrast, take a very different view, linking the provision of an international financial safety net by the IMF and other agencies with a lower probability of financial crises and

Köhler welcomes strengthening of Argentina's economic program

In a news brief issued on November 10, IMF Managing Director Horst Köhler welcomed the steps announced by President Fernando de la Rúa to strengthen the Argentine economic program. The full text of IMF News Brief No. 00/101 is available on the IMF's website (www.imf.org).

"The steps announced by President de la Rúa demonstrate strong leadership and represent both a significant strengthening of Argentina's economic policy framework and further evidence of Argentina's commitment to the policy approach it has successfully followed for over a decade," Köhler said. "These steps should also give new momentum to a growth-oriented policy. Rapid implementation of these steps, in particular agreement on a fiscal pact between the federal government and the provinces, would help assure the sustainability of Argentina's fiscal position and, together with additional financial support from the international financial institutions, should also improve Argentina's access to capital markets.

"Negotiations with Argentina will continue and could be completed relatively quickly. When agreement is reached, IMF management would be prepared to recommend to the Executive Board that Argentina draw on its current precautionary Stand-By Arrangement with the IMF and that further financial support be made available to Argentina, including under the Supplemental Reserve Facility, in support of Argentina's strengthened economic policies.

"Argentina has also been discussing the strengthening of its economic program with the World Bank and the Inter-American Development Bank. These institutions will be making separate announcements shortly," Köhler said.

less severe crises when they do occur. This "catalytic effect" of official lending, proponents say, improves the access and the terms on which emerging market economies can obtain private funds.

It is not easy to discriminate between these two views, nor are they mutually incompatible. In the presence of moral hazard, events that make IMF rescue packages more likely should lower the interest rate at which investors are willing to lend to emerging market countries; more precisely, the spread between interest rates on risky emerging market bonds and U.S. government bonds (considered risk-free) should shrink. Such events should also weaken the link between interest rates and a country's economic fundamentals as the higher odds of being bailed out make investors worry less about the particular characteristics of each country.

Finding such events poses an empirical challenge. Giovanni Dell'Ariccia of the IMF, Isabel Goedde of Mannheim University, and Jeromin Zettelmeyer of the IMF suggested that the Russian crisis of August 1998 was such an event. But the widespread expectation of market participants that Russia would receive a rescue package because it was "too nuclear to fail" turned out to be wrong, they observed. The sign that the international community was less willing to rescue emerging markets should have led investors to exercise greater caution in lending to these markets, thereby raising emerging market spreads and strengthening the link between spreads and economic fundamentals. The presenters found modest evidence that spreads did increase in the aftermath of the Russian crisis; moreover, investors appear to have started differentiating more among countries' risks, as countries with sounder economic policies experienced a smaller increase in spreads.

But there is also some evidence of a catalytic effect. Using data on interest rate spreads for emerging market bonds issued over the 1990s, Barry Eichengreen of the University of California, Berkeley, and Ashoka Mody of the World Bank reported that IMF lending under Extended Fund Facility (EFF) programs improves terms of market access to private lending. This effect, however, appears to hold only for countries with intermediate credit ratings. The speakers interpret this to mean that lenders view compliance with IMF programs as unlikely in countries with low credit ratings (which tend to reflect concerns about a country's policy environment). In these circumstances, they argued, the announcement of an EFF program has no effect. Likewise, countries with high credit ratings have already demonstrated a strong commitment to good policies, and IMF lending confers no further benefit in terms of market access. It is in the intermediate range, the authors suggest, that "the IMF can be seen as strengthening the commitment to reform," and thus the announcement of an EFF program does enhance market access.

Regardless of the debates over the effects of IMF and other official lending, there was broad agreement at the conference that the private sector has a key role to play in providing capital to emerging market economies, in preventing and resolving crises, and in ensuring that the flow of capital to emerging markets is not subject to sudden stops. Nouriel Roubini (New York University) noted that while the overall framework for involving the private sector in crisis prevention and resolution is still being worked out, there has been an important shift in the tone of the discussions between the official and private sectors moving from the coercive-sounding "bailing-in" of the private sector to a policy of "constructive engagement."

IFI policies, poverty, and inequality

Few ailments of modern economies have not been blamed, at some time or other, on policies recommended by the international financial institutions (IFIs). One charge has been that structural adjustment programs hurt the poor. William Easterly of the World Bank found mixed evidence on the issue. According to his research, structural adjustment programs appear to have shielded the poor from some of the pain of economic contractions but to have moderated the income gains of the poor during economic expansions.

What explains these findings? Easterly suggested that adjustment lending has a greater impact on the formal sector than on the informal sector to which many of the poor tend to be attached. Hence, "the poor may be ill placed to take advantage of new opportunities created by structural adjustment reforms," but they may also suffer less "from the loss of old opportunities in sectors that were artificially protected prior to reforms." The inclusion of provisions to strengthen social safety nets in lending programs also cushions the impact of recessions on the incomes of the poor.

IFI lending and policy prescriptions are also often blamed for increasing inequality of incomes, particularly

Members' use of IMF credit
(million SDRs)

	During October 2000	January–October 2000	January–October 1999
General Resources Account	**32.11**	**2,874.37**	**8,906.47**
Stand-By Arrangements	32.11	1,851.10	6,429.07
SRF	0	0	3,636.09
EFF	0	1,023.27	1,797.00
CFF	0	0	680.40
PRGF	**38.02**	**373.38**	**668.73**
Total IMF Credit	**70.13**	**3,247.75**	**9,575.20**

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

Isabel Goedde

Ashoka Mody

Nouriel Roubini

WIlliam Easterly

in transition economies that have undergone tremendous economic change over the last decade. However, Michael Keane of New York University and Eswar Prasad of the IMF challenged this conventional wisdom for one of the more successful transition countries, Poland. Using very comprehensive data on the incomes and consumption of Polish families, they found that the increase in income inequality during the transition had been quite modest, leaving Poland with income inequality "closer to those of Scandinavian countries than that of the United States."

Though changes in income inequality were modest, earnings inequality did increase substantially during transition; however, transfers of income from some

Extended Fund Facility Arrangements are designed to rectify balance of payments problems that stem from structural problems.

Stand-By, EFF, and PRGF Arrangements as of October 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By Arrangements				
Argentina	March 10, 2000	March 9, 2003	5,398.61	5,398.61
Bosnia and Herzegovina	May 29, 1998	March 31, 2001	94.42	30.15
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	113.38
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,087.50
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Mexico	July 7, 1999	November 30, 2000	3,103.00	1,163.50
Nigeria	August 4, 2000	August 3, 2001	788.94	788.94
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	56.66
Philippines	April 1, 1998	December 31, 2000	1,020.79	237.56
Romania	August 5, 1999	February 28, 2001	400.00	260.25
Russian Federation	July 28, 1999	December 27, 2000	3,300.00	2,828.57
Turkey	December 22, 1999	December 21, 2002	2,892.00	2,226.84
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			**43,660.59**	**17,160.15**
EFF Arrangements				
Bulgaria	September 25, 1998	September 24, 2001	627.62	156.92
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2002	3,638.00	2,786.85
Jordan	April 15, 1999	April 14, 2002	127.88	91.34
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	September 3, 2001	1,919.95	1,207.80
Yemen	October 29, 1997	March 1, 2001	105.90	65.90
Total			**9,088.45**	**6,977.91**
PRGF Arrangements				
Albania	May 13, 1998	May 12, 2001	45.04	9.41
Benin	July 17, 2000	July 16, 2003	27.00	20.20
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	27.94
Cambodia	October 22, 1999	October 21, 2002	58.50	41.79
Cameroon	August 20, 1997	December 20, 2000	162.12	0.00
Central African Republic	July 20, 1998	July 19, 2001	49.44	32.96
Chad	January 7, 2000	January 7, 2003	36.40	26.00
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	13.63
Gambia, The	June 29, 1998	June 28, 2001	20.61	10.31
Ghana	May 3, 1999	May 2, 2002	191.90	120.85
Guinea	January 13, 1997	January 12, 2001	70.80	15.73
Guyana	July 15, 1998	July 14, 2001	53.76	35.84
Honduras	March 26, 1999	March 25, 2002	156.75	64.60
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	28.69
Madagascar	November 27, 1996	November 30, 2000	81.36	9.48
Mali	August 6, 1999	August 5, 2002	46.65	33.15
Mauritania	July 21, 1999	July 20, 2002	42.49	30.35
Mozambique	June 28, 1999	June 27, 2002	87.20	42.00
Nicaragua	March 18, 1998	March 17, 2001	148.96	53.82
Rwanda	June 24, 1998	June 23, 2001	71.40	28.56
São Tomé and Príncipe	April 28, 2000	April 28, 2003	6.66	5.71
Senegal	April 20, 1998	April 19, 2001	107.01	42.80
Tajikistan	June 24, 1998	June 23, 2001	100.30	40.02
Tanzania	March 31, 2000	March 30, 2003	135.00	95.00
Uganda	November 10, 1997	March 31, 2001	100.43	8.93
Zambia	March 25, 1999	March 28, 2003	254.45	234.45
Total			**2,762.61**	**1,446.70**
Grand total			**55,511.65**	**25,584.76**

[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

segments of the population to others mitigated the rise in earnings inequality. Keane and Prasad suggested that by directing the transfers of income to those who stood to lose the most from the transition, Poland may have been able to build political support for the reform process in the critical initial years of transition.

Effects of exchange rate regimes

With increasing experimentation among countries in the choice of exchange rate regimes, the issue of how regimes affect economic performance has remained critical. One immediate challenge for researchers is in deciding how to classify a country's exchange rate regime, particularly because there is often a gulf between a country's stated regime and the one it follows in practice. The IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (*AREAER*) provides a detailed classification of countries' stated regimes. Eduardo Levy-Yeyati and Federico Sturzenegger of the Universidad Torcuato Di Tella attempted an alternative classification based on observed volatility in exchange rates and reserves. A country with low volatility of exchange rates and high volatility of reserves, for example, is classified as a fixed exchange rate regime, regardless of its announced regime.

With this new classification, the authors found that intermediate exchange rate regimes tend to have higher inflation rates than either a fixed or a floating exchange rate regime. Levy-Yeyati and Sturzenegger also found lower output growth and higher output volatility in countries with fixed exchange rate regimes.

Two other papers at the conference investigated particular aspects of the choice of exchange rate regimes. Antonio Fatás of INSEAD and Andrew K. Rose of the University of California, Berkeley, studied whether fiscal policy differed more in "extreme" exchange rate regimes, namely, currency board or common currency areas, than in others. Rupa Duttagupta and Antonio Spilimbergo of the IMF tackled the puzzle of why exports of Asian crisis countries responded with a substantial lag to the large real depreciation of their currencies. They presented evidence that the near-simultaneous depreciation of these currencies neutralized the competitive advantage that any one country might have gained had its currency been the only one devalued.

Federico Sturzenegger

Antonio Spilimbergo

From Mundell to Obstfeld

The conference also featured two special lectures. Nobel Prize winner Robert Mundell reviewed the history of the Mundell-Fleming model—the workhorse of international macroeconomic models and a product of Mundell and J. Marcus Fleming when both were members of IMF's Research Department in the 1960s. And Maury Obstfeld offered a follow-up, "Beyond the Mundell-Fleming Model." With Ken Rogoff, Obstfeld has played a critical role in developing the so-called New Open Economy Macroeconomics. ■

Prakash Loungani
IMF External Relations Department

Maury Obstfeld

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
November 6	4.84	4.84	5.61
November 13	4.85	4.85	5.62

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?2000).

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

Data: IMF Treasurer's Department

Recent publications

Working Papers ($10.00)

00/173: *The Disappearing Tax Base: Is Foreign Direct Investment (FDI) Eroding Corporate Income Taxes?* Reint Gropp and Kristina Kostial

00/174: *Voting on the "Optimal" Size of Government*, Jan-Peter Olters

00/175: *Trade and Domestic Financial Market Reform Under Political Uncertainty: Implications for Investment, Savings, and the Real Exchange Rate*, Rina Bhattacharya

IMF Staff Country Reports ($15.00)

00/141: Germany: 2000 Article IV Consultation—Staff Report; Statement by Staff Representative; and Public Information Notice Following the Consultation

00/142: Germany: Selected Issues

00/143: Japan: Economic and Policy Developments

00/144: Japan: Selected Issues

Publications are available from IMF Publication Services, Box X2000, IMF, Washington, DC 20431 U.S.A.
Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

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

Meeting at IMF headquarters

Committee discusses means of improving countries' balance of payments statistics

The thirteenth meeting of the IMF Committee on Balance of Payments Statistics was held at IMF headquarters in Washington, October 23–27.

Background

The Committee was established in 1992 to oversee the implementation of the recommendations of two IMF working parties that investigated the principal sources of discrepancy in the global balance of payments statistics; to advise the IMF on methodological and compilation issues in balance of payments and international investment position statistics; and to foster greater coordination of data collection among countries. The Committee is chaired by the IMF, and in 2000 included 15 national experts in balance of payments statistics from a range of countries. In addition, the Bank for International Settlements (BIS), the European Central Bank, the Organization for Economic Cooperation and Development (OECD), and the Statistical Office of the European Communities are invited to send representatives to the meetings.

The IMF Committee on Balance of Payments Statistics in session.

Reflecting the growth of international financial markets, many of the major achievements of the Committee have been in the area of the financial account of the balance of payments. In 1993, the Committee began work on a Coordinated Portfolio Investment Survey (CPIS). This survey, which had a reference date of end-December 1997, measured the cross-border, long-term security holdings of major investing countries. Data were collected on holdings of equities and debt securities with an original maturity date of one year or more and issued by nonresidents, with a full geographic attribution of these securities by the country of issue. Twenty-nine countries participated in this CPIS, and in 1999 the IMF published the *Results of the 1997 Coordinated Portfolio Investment Survey*. The Committee and participating countries found the survey helped improve the quality of both asset and liability portfolio positions, and related flows.

Analysis of the 1997 Coordinated Portfolio Investment Survey Results and Plans for the 2001 Survey, a companion document to *Results*, was released in September 2000. A second CPIS, with broader coverage, will be conducted with a reference date of end-December 2001. So far, 71 countries have indicated their intention to participate, including 18 offshore financial centers. At its 2000 meeting, the Committee recommended that, after the 2001 CPIS, the survey should be undertaken annually. The data will provide a useful time series to complement the international banking statistics produced by the BIS on bank creditor positions vis-à-vis debtor countries.

Committee activities

In 1994, the Committee began work on issues concerning the statistical measurement of transactions and positions in financial derivatives. Discussions on this topic, which also involved the Inter-Secretariat Working Group on National Accounts and extensive international consultation with compilers, resulted in the publication in 2000 of *Financial Derivatives: A Supplement to the Fifth Edition (1993) of the Balance of Payments Manual*. These new standards are now being implemented worldwide.

The Committee has also worked with the BIS to improve coverage of the international banking statistics, which have been found to be particularly useful for compiling and/or evaluating the coverage of balance of payments and external debt statistics.

The Committee has also been involved in improving the quality of balance of payments statistics through the *Survey of Implementation of Methodological Standards for Direct Investment* (SIMSDI), carried out in 1997 jointly by the IMF's Statistics Department and the OECD Working Party on Financial Statistics. The survey is a comprehensive study of country data sources, collection methods, and dissemination and methodological practices for foreign direct investment (FDI) statistics, providing information on the extent to which countries compile FDI statistics in conformity with international statistical guidelines. A total of 114 countries replied to the 1997 survey. In March 2000, the IMF and the OECD jointly published the metadata (information on data) collected from the survey in the *Report on the Survey of Implementation of Methodological Standards for Direct Investment.* (This report may be found on the IMF's website at www.imf.org/external/np/sta/di/rep97.htm.)

IMF BOP Committee on the Web

The IMF's website (www.imf.org) contains information on the activities of the Committee, including recent annual reports, many of the research papers that have been discussed at recent committee meetings; information about the 1997 CPIS and the 1997 SIMSDI; and the *Balance of Payments Newsletter* from 1995.

Since its inception, the Committee has discussed and made recommendations on a wide range of other balance of payments statistics issues, including the estimation of barter trade, shuttle trade, and travel; data availability for current transfers; measurement of insurance services, accrued interest, and reinvested earnings on direct investment; and the statistical treatment of repurchase agreements and securities lending. The Committee also reviews and comments on the work of the Inter-Agency Task Force on Statistics of International Trade in Services in its work in developing the *Manual on Statistics of International Trade in Services* and the Inter-Agency Task Force on Finance Statistics in developing a guide for external debt statistics—*External Debt Statistics: Guide for Compilers and Users*.

Recent activities

At this year's meeting, the Committee devoted one day to a discussion of the data quality assessment framework for balance of payments statistics being developed by the IMF's Statistics Department. This work responds to a number of needs; in particular, it complements the quality dimension of the IMF's Special Data Dissemination Standard and the General Data Dissemination System, focuses more closely on the quality of data provided to the IMF for surveillance purposes, and assesses evenhandedly the quality of the information provided as background for the IMF's Reports on the Observance of Standards and Codes.

Other items on the agenda included the 2001 CPIS; development of an international securities database to assist compilers in conducting portfolio investment surveys; the statistical treatment of repurchase agreements, accruals of interest on debt securities and loans that have been traded; estimation of international travel transactions; the policy uses of balance of payments statistics; and the process of updating of the fifth edition of the IMF's *Balance of Payments Manual*.

The Committee's next meeting, to be hosted by the Japanese government in Tokyo, will be held on October 24–26, 2001. ■

IMF Statistics Department

Committee participants (from left to right) Toru Oshita (Ministry of Finance, Japan) and Masahiro Hoka (Bank of Japan).

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Available on the web (www.imf.org)

Press Releases

00/59: IMF Approves European Central Bank Application to Become a Holder of Special Drawing Rights, November 15

News Briefs

00/98: IMF Approval of Tajikistan PRGF Credit Takes Effect, November 3

00/99: IMF Publishes Third-Quarter Emerging Market Financing Report, November 8

00/100: IMF Completes Second Review of Madagascar Program and Approves $9 Million Credit, November 8

00/101: IMF's Köhler Supports Strengthening of Argentina's Program, November 10 (see page 372)

Public Information Notices (PINs)

00/83: Russian Federation, November 9

00/93: Monetary and Exchange Rate Policies of the Euro Area, November 9

00/95: France, November 13

00/96: St. Vincent and the Grenadines, November 13

00/97: IMF Executive Board Reviews Proposal for Streamlining Preliminary HIPC Documents, November 10

00/98: Spain, November 11

Speeches

IMF Managing Director Horst Köhler, Conference on Transition, Austrian National Bank, Vienna, November 6 (see page 369)

IMF Managing Director Horst Köhler, meeting with EU Parliamentary Committees, Brussels, November 7 (see page 370)

Flemming Larsen, Director, IMF Office in Europe, at hearing by the Commission on *Articulations entre coopérations bilatérales et multilatérales* of the *Haut conseil de la coopération internationale,* at the Assemblée nationale, Paris, November 7

IMF First Deputy Managing Director Stanley Fischer, "Strengthening Crisis Prevention: The Role of Contingent Credit Lines," Banco de México, Mexico City, November 15

Poverty Reduction Strategy Papers (date posted)

Cameroon (interim), November 14

Concluding Remarks for Article IV Consultations (date posted)

Tunisia, November 15

Report on the Observance of Standards and Codes (date posted)

France, November 10

Other

Schedule of Public Engagements of IMF Management, November 3

IMF Financial Activities, November 3

IMF Financial Activities, November 10

IMF Terminology: A Multilingual Directory, November 13

Updated Draft Chapter of Quarterly National Accounts Manual, November 15

IMF Financial Resources and Liquidity Position, November 15

Interview with Olivier Blanchard

European unemployment has origins in shocks, institutions, and interactions between them

In late October, Olivier Blanchard, professor of economics at the Massachusetts Institute of Technology, offered a course on unemployment at the IMF Institute. He spoke with the IMF Survey *about the role that shocks, institutions, and the interactions between shocks and institutions have played in European unemployment.*

IMF SURVEY: European unemployment is commonly perceived to have been rising steadily. True?

BLANCHARD: Nearly, but not quite. Until 1970, European unemployment was very low. Teams of U.S. economists crossed the ocean to try to understand why Europe had 2 percent unemployment, while U.S. unemployment remained at 5 percent. The talk was of the "European unemployment miracle." Then in the late 1960s, European unemployment began to rise—slowly at first, and then, with the two oil shocks, very quickly. By the end of the 1970s, unemployment was very high, and it continued to rise for most of the 1980s. In the 1990s, it more or less plateaued—increasing a bit, but not much.

Blanchard: "Oil price shocks did trigger the recessions of the mid- and late 1970s, but the major event was happening behind the scenes."

The "not quite" refers to the past three years, when most European countries saw a decline in unemployment. Spain's unemployment dropped from 22 percent to around 15 percent. French unemployment went from 12.5 percent to under 10 percent. There's still a long way to go, but that's clear progress. In addition, the Netherlands and Ireland saw their unemployment rates drop to less than 4 percent—basically no unemployment at all.

IMF SURVEY: But European unemployment has remained a hot topic. What characteristics differentiate it, for example, from the U.S. experience?

BLANCHARD: In the mid-1970s, the initial focus was, quite naturally, on oil shocks. Oil prices eventually came down, but European unemployment remained very high, while it declined in the United States. So oil price shocks became a less convincing explanation for what was happening.

Many politicians and economists then shifted the blame from shocks to institutions. European labor markets are organized differently from the U.S. labor market: there is more social insurance, more employment protection, and a larger tax wedge between take-home pay and the cost of labor to firms. It became very tempting to say, well, these institutional differences explain why Europe is not doing well. The old argument that a generous welfare state makes people lazy resurfaced and provided the underlying theme for a number of major studies in the early 1990s.

Sure, European institutions are different. But they were different in the 1960s and the 1970s when unemployment was low. So the simple answer that "the welfare state did it" has difficulty explaining why it worked for so long and why it suddenly became the trigger for higher unemployment.

IMF SURVEY: But the United States did seem better able to digest the shocks of the 1970s and 1980s.

BLANCHARD: The theme of my lectures at the IMF—which reflects, I think, a growing consensus among researchers—is that an explanation for high European unemployment must be constructed on three pillars: shocks, changes in institutions, and interactions between shocks and institutions.

Adverse shocks, the first pillar, have been important. In retrospect, the oil shocks were partly a smoke screen. Oil price shocks did trigger the recessions of the mid- and late 1970s, but the major event was happening behind the scenes: a slowdown in the rate of total factor productivity growth—essentially a slowdown in the underlying rate of technological progress.

From the end of World War II until the early 1970s, Europe grew at an amazing rate, fed initially by postwar reconstruction and then, at least in part, by a process of catch-up with the United States. Real wages went up about 5–6 percent annually without putting pressure on costs. But in the 1970s, the growth rate of total factor productivity decreased. By the end of the 1970s, we were on a path where wages could rise only 2–2$1/2$ percent if they were to be consistent with the evolution of factor productivity.

This major change in the economic environment required major adjustments in expectations. For quite a while, though, workers continued to bargain, and firms negotiated, on the basis of the earlier, stronger growth. Amid oil shocks, changes in relative prices, problems of measurement, and two recessions during this period, it was difficult to know just what was going on. But when the smoke cleared, it was clear that lower factor productivity growth was a new fact of life and that there had been an effective wage explosion relative to what should have happened. That shock, which was not obvious at the time, now looks very, very big.

But there were other shocks, too. Real interest rates moved as they have never moved, at least in recent memory. In the 1970s, inflation exploded; central banks increased nominal rates but typically by much

less, so real rates plunged, often becoming negative. Then, in the 1980s and 1990s, central banks tightened money, and there were high real interest rates due to German reunification at the beginning of the 1990s. Interest rates went up and inflation went down, leading to very large positive real interest rates.

These swings in interest rates had an effect on unemployment. Lower borrowing costs partly offset higher labor costs in the 1970s, leading to more capital accumulation and less unemployment than might have been otherwise. Conversely, in the 1980s and 1990s, higher borrowing costs added to unemployment. In effect, some of the increase in unemployment that would have happened in the 1970s was deferred to the 1980s and early 1990s.

Changes in institutions are the second pillar, and the question here is how much of the increase in unemployment came from an increase in the welfare state. Thanks to work done at the Organization for Economic Cooperation and Development (OECD) and elsewhere, we now have good measures of the generosity of unemployment benefits and of the degree of employment protection across both countries and time.

Unemployment benefits did become a bit more generous in the 1960s and in the 1970s, but not by much. Since then, there has not been much action in average replacement rates (the ratio of unemployment benefits to take-home pay), but the most extreme distortions have been reduced, and the most generous replacement rates have decreased.

Employment protection was also strengthened in the 1970s and early 1980s, as, under pressure from labor, governments often tried to prevent firms from laying off workers on a large scale. But again, the increase was incremental; employment protection had been high before. And, while progress has happened at a glacial pace, employment protection is less stringent now than it was in the mid-1980s. This doesn't quite fit the evolution of unemployment.

In short, the welfare state did not suddenly come into being in 1975, and everyone did not stop working because it became attractive to be unemployed. Of course, you do find instances where institutions have had perverse effects. In the late 1980s, France introduced a guarantee of a minimum income level, whether or not people work. With the minimum income level set at roughly half the minimum wage, there seemed to be sufficient incentive to look for work. The problem, however, was that often the unemployed lost housing subsidies and lunches for their kids if they returned to work. So the incentive to return was weak. It is an example of bad design and presents a problem for France at this juncture. Unemployment is coming down, but as many as 1 million of the roughly 2.5 million unemployed may not have much financial incentive to take the jobs that are coming on line.

But for every case like this, many others have been improved. Indeed, given the urgency, the French government is working on this one as well. Blaming the increase in the welfare state for the increase in unemployment reflects more ideology than fact.

IMF Survey: But in terms of institutional changes, can't changes in the environment also make institutions less relevant to the needs of the job market?

Blanchard: That's the perfect transition to the third pillar: the interactions between shocks and institutions. It could be that institutions stayed the same, but a change of circumstances made them less appropriate—like winter clothes in the summertime.

Blanchard: "It could be that institutions stayed the same but a change of circumstances made them less appropriate—like winter clothes in the summertime."

A popular hypothesis—articulated, for example, by the OECD's jobs study of the early 1990s—is that while Europe was a quiet place—growing fast but without much reallocation—it was okay to have high employment protection and generous unemployment benefits. If a firm does not want to lay off in the first place, firing costs are irrelevant. If people do not become unemployed, unemployment benefits may not be very important, and so on. Then, the argument goes, the environment changed and became more turbulent. Europe now needs a lot of reallocation, the old labor market institutions are standing in the way, and this leads to higher unemployment.

This all sounds plausible but it has empirical and conceptual problems. The empirical problem is that the measures of turbulence we have constructed—be it relative changes in employment across firms, sectors, or regions—show little evidence of an increase in turbulence. This could be a problem with our measurements, but I believe the measures deliver the right message: Sure, the world is changing, but it has changed in the past as well. Maybe "always changing" is the nature of the change. Perhaps the high-tech sector and the new economy of the past five years or so are indicative of more intense structural change, but this clearly does not account for the change in unemployment since 1975.

The conceptual problem is that if you need to reallocate labor but are prevented from doing so by high firing costs, it may be very bad for efficiency and growth. But it may not lead to high unemployment; the result may be that no one moves and no one is unemployed. Indeed, the empirical evidence is that high employment protection does not systematically lead to higher unemployment; it leads to a longer duration of unemploy-

We must avoid long-term unemployment traps. This means getting the currently long-term unemployed back into jobs and preventing new entrants from falling into the trap.

ment, but lower flows through unemployment. The result for the unemployment rate is ambiguous.

I find another explanation more plausible and better grounded in the empirical data—although, even there, there are still a few holes. One of the dramatic differences between the U.S. and the European labor markets is that even at the same unemployment rate, Europe has much longer duration of unemployment and much lower flows of workers through the labor market. For example, over the past 20 years, Portugal and the United States have averaged about 6 percent unemployment. But the average individual duration of unemployment in the United States has been about 2–3 months, while in Portugal it has been around 8–12 months. At the same time, flows in and out of unemployment have been about four times smaller in Portugal. Since the unemployment rate can be thought of as the product of flows times duration, overall unemployment rates have been roughly the same in both countries, but the two labor markets are completely different. In the United States you lose your job, you wait a few months, you get another one. In Europe, you are much less likely to lose your job but more likely to remain unemployed longer if you do. This is why Europe, even at the same unemployment rate as the United States, has a very high proportion of long-term unemployed.

The second point is that the long-term unemployed are different from the short-term unemployed. Some are different from the start, and that is why they are long-term unemployed. But some become different—long-term unemployment makes you lose morale, self-confidence, and skills. And for all these reasons, if you become long-term unemployed, your chances of finding a new job fall dramatically. In effect, you become irrelevant to the labor market. And this has an important macroeconomic implication: If the unemployment rate is high, but a high proportion of the unemployed are long-term unemployed, there will be little pressure on wages, which is the mechanism a market economy typically relies on in the medium run to return to lower unemployment.

In the United States, if unemployment reaches 10 percent, there is tremendous pressure on wages to come down. In Europe, if we go from 5 to 10 percent unemployed, a lot of the unemployed are going to end up long-term unemployed. And shocks are going to be larger and last longer, because Europe has a weaker feedback mechanism to translate high unemployment into lower wages and rising employment.

Caricaturing only slightly, I would say that the shocks that affected Europe and the United States in the 1970s and the 1980s may not have been that different. Differences in labor market institutions are the reason why their effects have been longer lasting in Europe.

IMF SURVEY: What are the implications of your thesis, then, for European policymakers?

BLANCHARD: Prospects for the future strike me as bright—with a footnote. The effects of the slowdown in total factor productivity growth have long been absorbed, and, if the United States is any example, Europe may be on the verge of an increase in total factor productivity growth. Very high interest rates, I hope, are a thing of the past, so the cost of borrowing is lower. Thus, some key contributors to persistent unemployment are gone.

Macroeconomic fundamentals are good as well. The profit rate is as high as it has been in 40 years, and wage moderation continues. All of these factors point to the feasibility of high investment rates, sustained growth, and a continued reduction in unemployment. We are seeing all of this in the sharp reductions in unemployment in Spain and France.

Institutional reforms are still needed—some sooner than others—otherwise, lower unemployment will soon translate into higher inflation. We must avoid long-term unemployment traps. This means getting the currently long-term unemployed back into jobs and preventing new entrants from falling into the trap. A number of countries are making progress on both fronts. Unemployment insurance systems are changing, so that unemployment benefits are contingent on really trying to get a job, and benefits are lost if a job offer is not taken. Such a change is probably one factor—but by no means the only one—behind the dramatic fall in unemployment in the Netherlands. The United Kingdom has introduced a similar program, and France is on the verge of adopting it as well.

Employment protection provisions are costly. They lead to high unemployment rates among specific groups, such as the young and the old. Governments have worked mostly at the margin here, allowing, for example, fixed-duration contracts for new workers. These fixed-duration contracts make it easier for firms to hire new workers, but also make it very tempting to fire these workers at the end of the period before they come under employment protection. A better solution, from a political and an economic point of view, may be to simplify rather than drastically decrease the level of employment protection: offer automatic severance pay, with many fewer legal and administrative steps and delays.

The political economy of labor market reforms is a delicate one, but progress can be made, especially in an environment of sustained growth. The conditions for sustained growth are there, and I am optimistic about the future. ■

Professor Blanchard's course at the IMF was based on his Lionel Robbins lectures. The full text of these lectures is available on his website (web.mit.edu/blanchar/www/articles.html).

Working Paper

Noncash transactions increase in Russia after transition to market economy

During the 1990s, noncash transactions rose in Russia. In an IMF Working Paper, Determinants of Barter in Russia: An Empirical Analysis, *Simon Commander of the European Bank for Reconstruction and Development and Irina Dolinskaya and Christian Mumssen of the IMF explain this phenomenon. Two of the authors discuss their findings with the* IMF Survey.

IMF SURVEY: How prevalent are nonmonetary transactions in Russia?

DOLINSKAYA: Our study focuses mainly on barter, which is an exchange of one good for another, and on offsets, which are exchanges of goods for debt or for arrears. In our sample, barter and offsets each account for about 30 percent of enterprise sales in Russia.

IMF SURVEY: Have noncash transactions increased more in certain kinds or sizes of firms? If so, why?

MUMSSEN: Large industrial firms, in particular, use barter transactions and offsets a lot. Noncash transactions are more prevalent in sectors such as utilities and construction firms and less prevalent in sectors very close to the final consumers' market and in export-oriented firms, which typically earn more cash than firms selling primarily in the domestic market. The use of barter also depends on a firm's immediate environment. Where barter is widespread, firms are more likely to engage in noncash transactions. We suspect there are thick market effects that can make firms participate although they are not naturally inclined to barter.

DOLINSKAYA: By market thickness, we mean that if everybody around you barters, it may be hard for you not to. Enterprises may have difficulty finding partners willing to transact with them in cash, and if your customers pay you in goods, you don't get the cash revenues you need to pay your own suppliers. These sorts of multiplier effects usually arise when nonmonetary deals involve more than one firm. For example, tax offsets tend to be multilateral deals. There is an important asymmetry at work here. A lot of firms owe taxes to the state, but few supply goods to the state directly. The state may issue tax offsets that are passed on not only to the firm but also to firms that have claims on the state's supplies. These network effects mean that nonmonetary transactions can become pervasive and involve both viable and nonviable enterprises.

IMF SURVEY: Noncash transactions have not increased in all transition economies. Why have they in Russia?

MUMSSEN: Our study addresses two questions. First, why have barter and offsets been so pervasive in Russia, Ukraine, and a few countries of the Commonwealth of Independent States? Second, why did barter and offsets rise in Russia almost continuously from 1992 until the crisis in 1998? The increase in barter and offsets in Russia went alongside an increase in arrears—interenterprise arrears, arrears to the budget, wage arrears, and so on. Liquidity problems at the firm level are indicative of the inclination to engage in nonmonetary transactions. Our theory is that Russia experienced a sharp drop in demand after the beginning of price and trade liberalization, when direct subsidies to enterprises were cut and demand for a lot of industrial products fell. That led to a credit crunch, which wasn't really alleviated by the financial sector, because bank lending to enterprises is very limited in Russia. In response, enterprises ran up arrears to suppliers and finally settled these arrears through offsets. Rather than pay off their debts in cash, they passed their products upstream to suppliers. However, the use of barter and offsets as a substitute for a normal trade credit or for normal bank credit wasn't the only mechanism at work. The state played an important role in fostering the noncash economy in Russia. By allowing tax offset deals, the federal and local budgets accepted goods in lieu of tax payments, and state utilities accepted most of their receipts in kind. This amounted to an infusion of implicit credit and subsidies from the state to the industrial enterprise sector, which helped to keep nonviable enterprises alive.

Irina Dolinskaya and Christian Mumssen.

IMF SURVEY: What do firms gain from resorting to noncash transactions?

DOLINSKAYA: Firms are able to survive in a credit-constrained environment because noncash transactions can substitute for trade or bank credit. In time-lagged nonmonetary deals, you might arrange a deal today, but receive the in-kind payment later. During this time, an enterprise effectively enjoys a credit from its partner. Even in a spot deal, an element of trade credit may be involved because of the time it takes to sell goods received as payment. Spot barter also helps reduce credit risk for enterprises in an environment like Russia's. Enterprises often face the choice of accepting goods now or money later or, possibly, never. So it may be less risky for them to accept goods now. This creates artificial demand for goods that are produced by old-style, inefficient enterprises, thus helping them survive.

The state played an important role in fostering the noncash economy in Russia.

There is also a tax-related issue. The noncash economy is fueled by implicit subsidies from the state in the form of tax offsets, resulting in tax discounts for the enterprises. Some enterprises may barter to avoid the banking system and thereby evade taxation. Firms can also manipulate pricing, because barter is nontransparent and barter prices are largely arbitrary. There is room for rent seeking and personal gain by enterprise managers, and a whole industry of firms specialize in arranging barter deals. But some firms barter involuntarily and don't necessarily gain.

IMF Survey: What are the disadvantages of noncash transactions to firms? Is their performance affected?
Dolinskaya: Barter is not very efficient and carries transaction costs that enterprises have to bear. Barter may also crowd out productive investment. Although enterprises survive in this environment, they do so by not restructuring. There are also indirect effects that work by preserving existing enterprise networks. The network issue suggests that there may be entry barriers for new firms. In effect, a vicious circle is created because barter makes it harder to screen the firms and monitor their performance. Their access to bank credit is further reduced, and they have to barter more.

IMF Survey: How, if at all, did the Russian crisis of 1998 affect firms' use of nonmonetary transactions?
Mumssen: Initially, we thought the crisis would make matters worse because the banking sector all but collapsed. But within a month or two, noncash transactions decreased quite a bit. There was so little normal bank lending to enterprises before the crisis that it seems to have made no difference afterward. Far more important was the real depreciation of the ruble. Firms with access to export markets were able to export more and earn more cash. But import-substituting firms also became more competitive as imports became more expensive. So the aggregate effect was a strong increase in the liquidity of industrial firms in Russia. And liquidity is closely linked to noncash transactions, which means that noncash transactions did fall initially.

IMF Survey: How is the Russian economy as a whole affected by the size of the noncash economy?
Dolinskaya: The effect is quite large. All firms, viable and nonviable, are in this noncash economy, and there is a vicious circle of lack of transparency, lack of restructuring, and lack of bank credit. On the micro level, the effect of the noncash economy is the prevalence of soft budget constraints, which allow inefficient enterprises to survive. The preservation of old networks and chains prevents entry of new private firms, thus blocking an important dimension of the transition process. On the macro level, the implicit subsidies that have fueled the nonmonetary economy have created fiscal problems for the state because tax collection has been eroded. And fiscal problems were at the root of the 1998 financial crisis.

IMF Survey: Has the federal government taken steps to discourage the use of noncash transactions?
Mumssen: In the last few years, the federal government has virtually phased out tax offsets. But local and regional tax collections are still partly based on noncash transactions. Large utilities—Gazprom and Russia's main electricity company, in particular—have tried to increase cash collection rates, but still have a long way to go.

IMF Survey: What can the government do?
Mumssen: The federal government is able to control tax offsets at the federal level but not at the subnational level. The intergovernmental transfer system should be more transparent and rules-based and less subject to ad hoc bargaining, which can give regions an incentive to collect less cash. We suggest a transfer system based on the regions' capacity to tax rather than on its actual cash tax collections. More has to be done to increase the transparency and governance of the large utilities. They need to be depoliticized, and they need to be able to cut off nonpaying customers and those unable to pay in cash. The problem of barter, offsets, and arrears is related to the structural reform and transition problems Russia faces. If the Russian economy had more competition, more transparency, and a better investment climate, more enterprises would have an incentive to make profits in the cash market, and barter levels would be reduced.

IMF Survey: What are the policy implications?
Mumssen: It is safe to say that the federal and local governments, and all state-owned enterprises, have no business collecting noncash revenues. But enterprises' liquidity problems were hard to avoid at the beginning of transition. There was a strong negative demand shock, and thus a natural process whereby loss-making illiquid firms eventually closed down or restructured radically. Firms in those circumstances would temporarily resort to arrears and, possibly, to noncash transactions. We would not advise any government to intervene in how private firms transact with each other. However, the state can contribute to lower noncash transactions by transacting purely in cash. ■

Copies of Working Paper 00/155, *Determinants of Barter in Russia: An Empirical Analysis*, by Simon Commander, Irina Dolinskaya, and Christian Mumssen, are available for $10 each from IMF Publication Services, Box X2000, IMF, Washington, DC 20431 U.S.A. Telephone: (202)623-7430; fax (202) 623-7201; email: publications@imf.org.

Alan Blinder draws seven key lessons for international finance from tumultuous 1990s

The 1990s were a tumultuous decade in international economics. As a result of various crises in Europe, Mexico, Asia, Russia, and Brazil, economists now look at the world very differently. In his Sturc Memorial Lecture on November 9, Princeton economist (and former vice chair of the U.S. Federal Reserve Board) Alan S. Blinder took stock of the lessons learned from the past 10 years.

Blinder recalled three ideas that had become conventional wisdom by 1990: floating exchange rates were subject to sustained periods of misalignment; the international economic system was vulnerable to crises; and large exchange rate adjustments—or under fixed exchange rate regimes, incipient adjustments—could play a major role in instigating or propagating crises.

The past decade has, if anything, reinforced these beliefs. Yet as Blinder noted, something has also changed. International capital markets are now much deeper and broader and react more quickly than ever before, thus propagating crises with a speed and virulence previously unimagined. And with the spread of technology, this brave new world is here to stay. Blinder cited seven new lessons that the 1990s have taught us.

With exchange rate regimes, the center may not hold

Intermediate exchange rate regimes between clean floats and hard pegs were relatively popular in the 1980s. But as emerging market countries became more integrated into global capital markets, Mundell's famous impossible trinity—that full capital mobility, a fixed exchange rate, and independent monetary policy cannot coexist—came of age. Some countries found that intermediate regimes, such as traditional soft pegs, could not be sustained if domestic policy were not oriented toward maintaining that peg. Once the probability of a devaluation started rising, capital outflows could become a torrent.

Nowadays, the consensus view holds that countries that have integrated themselves closely with global capital markets must choose between extremes—of a floating currency or a hard peg. A number of economies have hardened their pegs by introducing currency boards, most notably Hong Kong SAR and Argentina. Yet even in these instances, interest rate premiums suggest that markets believe there is still some nonzero probability of devaluation. To achieve complete credibility, a country may have to adopt even harder pegs, such as joining a monetary union or embarking on dollarization. The adoption of the euro among the countries of the European Economic and Monetary Union (EMU) appears to be quite credible, but formal dollarization has to date found few adherents.

"Fixed exchange rate bubble"

Introductory economics textbooks—including, Blinder hastened to add, his own—teach that devaluations are expansionary, since they stimulate net exports. Yet while currency declines in recent emerging market crises had this effect, economies nonetheless slumped because of the greater contractionary effects of sudden sharp increases in the domestic value of external debt.

Why should residents of these countries have risked borrowing so much in foreign currencies? Blinder's answer was that exchange rates had been fixed for so long that the risks of devaluation had been discounted. Blinder termed this a "fixed exchange rate bubble." When the bubble burst—that is, when the currency was devalued—balance sheets were decimated. Some argue against this interpretation on the grounds that it assumes that the borrowers were irrational. However, Blinder noted that only academic economists would rule out an otherwise compelling explanation on the grounds that it assumed irrational behavior.

Blinder believed that under floating exchange rates, the illusion that money could be borrowed at low foreign interest rates and without risk would be dispelled and less foreign-currency-denominated debt would be taken on. He did, however, question the claim that in this case, foreigners would be unwilling to assume the exchange rate risk by lending in domestic currencies. He noted, for example, that South Africa has a floating exchange rate, borrows in rand, and, adjusting for inflation, does not pay much of a risk premium on rand-denominated debt.

Floating rates are better than fixed rates

Blinder argued that the last decade has tilted the scales quite sharply in favor of floating rates. The "lethal interaction" of a fixed exchange rate combined with excessive borrowing in foreign currency, he said, was at the heart of almost all emerging market crises of the 1990s. In short, fixed exchange rate regimes often end badly.

Nonetheless, truly fixed exchange rates can work in special circumstances

While not an advocate of hard pegs, Blinder did believe they could succeed in certain circumstances. A country with ample foreign exchange reserves, a sound banking system, and a resolute political will—this last element being the most crucial—may be able to stick with a hard peg. But while a hard peg may be feasible, it does not necessarily follow that it is desirable. In this respect, Blinder thought that it would be years before a judgment could be made about the wisdom of the EMU countries adopting a common currency.

Sturc Memorial Lecture

The Ernest Sturc Memorial Lecture was established by his family at the Johns Hopkins School of Advanced International Studies (SAIS). The lecture series on international economic relations commemorates a man who headed the IMF's Exchange and Trade Relations Department from 1965 to 1976 and, as SAIS notes, was "widely admired and respected for his efforts to achieve peace and progress through international cooperation."

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Crises are harder to resolve in a capital-market-dominated world

While earlier crises in developing countries were by no means easy to solve, they at least unfolded more slowly, and perhaps somewhat more predictably, than modern capital market crises. Most important, the creditors of the debt crises of the 1980s were relatively small in number and identifiable. Regulators and international officials could, figuratively or literally, gather all the creditors and debtors in a single room and cajole or coerce them into orderly resolutions. By contrast, when debt is issued through capital markets, there may be thousands of creditors, many unidentified and many with holdings so small they do not consider the collective interest in working out a solution.

Photo not available

IMF should overhaul its rescue missions

In a modern crisis induced by capital market movements, a government may face significant fiscal distress due to a sudden increase in debt burden (because of the need to raise interest rates to defend the currency), a sharp decline in tax revenues as the economy slows, and new bills for cleaning up the financial system.

While Blinder did not believe the IMF ignores the poor in times of crisis, he did think tightening fiscal policy in a situation such as the Asian crisis harms "innocent bystanders" by curtailing expenditures on social safety nets. Belt tightening is needed when unsustainable fiscal deficits are being monetized, but Blinder urged the IMF to think twice about recommending fiscal austerity when crises result from sudden reversals of capital flows.

By the same token, he added, you could question the case for tight monetary policy in such a crisis. No doubt, the argument that higher interest rates would help defend the domestic currency was correct.

However, there are other considerations. Where foreign exchange markets are relatively thin and debtor and creditor country bonds lack much substitutability, sterilized intervention may be feasible; that is, it may be possible to prop up the domestic currency without recourse to tightening monetary policy. Also, policymakers should consider whether a depreciated exchange rate impairs the viability of domestic businesses as much as higher interest rates do. It is, Blinder believed, at least an open question that should be asked on a case-by-case basis. And to the extent that emerging markets have floating exchange rate regimes and, as already noted, smaller foreign-currency-denominated external debt burdens, the case for defending the currency in order to protect balance sheets would correspondingly be less compelling, he said.

Reform international financial architecture

While there is consensus on the need for reform of the international architecture, there is none on how it should be done. Blinder identified the three issues that would top his list of priorities.

Capital account liberalization. While full capital account liberalization is clearly the correct long-term goal, it should be approached slowly by developing countries that have not yet met the preconditions—for example, sound banking and accounting systems—to protect themselves from the downside risks.

Debt workouts. There is a need for orderly debt workout procedures. While an international bankruptcy court is not an idea whose time has come, smaller steps should be possible. Among the intermediate measures that could be taken are collective action clauses in sovereign debt contracts (the stigma currently attached to the clauses could be overcome if industrial countries routinely included them in their debt contracts); provisions in debt contracts that would require creditors to roll over debt (albeit at a penalty rate), if there is a bona fide crisis; and credit enhancements by public authorities to induce creditors to stay engaged.

Contingent Credit Lines. The IMF's Contingent Credit Lines (CCL) are a facility designed to discourage speculative attacks on currencies by prearranging lines of credit for countries with first-class economic policies. Unfortunately, it has so far had no takers, Blinder observed, due to countries' fears of being stigmatized by applying for the facility and concerns about how to exit from the CCL without precipitating the crisis it was designed to prevent. Blinder advocated a universal CCL with finer gradations of access than the current binary distinction between qualified and unqualified countries. Thus, countries would not have to apply for the CCL and could move from one level of access to another without having to exit it.

Blinder concluded by observing that while capital markets have become larger, faster, and more powerful than ever before, they have not become more sensible. There is scope at the margins for better international coordination and regulation to curb some of the negative aspects of greater capital mobility, but in the end, he said, the best hope is that as capital markets grow, they will become wiser. ■

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