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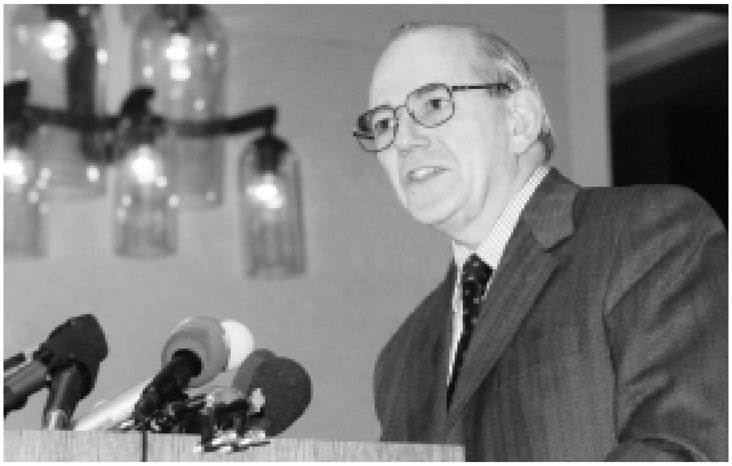
Contents

"The right moment"

Camdessus announces plans to resign, will leave office early in 2000

Michel Camdessus, the Managing Director of the IMF, announced on November 9 that he will resign his position in early 2000 after the IMF Executive Board has named a successor. (*The text of Press Release 99/52 announcing Camdessus's plans to resign and including his letter to the IMF Executive Board is available on the IMF's website: www.imf.org.)*



Camdessus announcing his resignation. From the beginning of his tenure, Camdessus has given a strong emphasis to the social aspects of economic adjustment and growth.

Camdessus, who was first appointed to his position in January 1987, said in a statement to the Board that he considered it was "the right moment to pass the baton." The IMF, he said, had "advanced in many fields. We have just established a demanding but exciting work program, and the *World Economic Outlook* allows us to anticipate favorable trends for the world economy. So I see it as my duty now to suggest that you take advantage of these favorable circumstances to select my replacement and to use these few months to help my successor become familiar with this superb but complex institution."

The IMF's seventh Managing Director, Camdessus was appointed to an unprecedented third term in January 1997. Prior to coming to the IMF, he had served successively as Director of the French Treasury (1982–84) and Governor of the Bank of France (1984–87), as well as Chairman of the Paris Club and of the Monetary Committee of the European Economic Community. He was named Alternate Governor of the IMF for France in 1983 and Governor of the IMF in 1984.

Camdessus meets with the staff to announce his plans to resign.

Period of transformation

Camdessus has been Managing Director during a period of momentous change for the international monetary and financial system. When he took office in January 1987, total quotas amounted to SDR 89.9 billion (about $125 billion), compared with SDR 212 billion (nearly $300 billion) today, and membership was 142 countries, compared with 182 now. A marked increase in IMF membership came after the breakup of the former U.S.S.R., as the Baltic countries, Russia, and the other countries of the former Soviet Union became members and the IMF took on new responsibilities in assisting these countries to face the challenges of the transition to a market economy.

From the beginning of his tenure, Camdessus gave a strong emphasis to the social aspects of economic adjustment and growth. One of his first public actions, in June 1987, was to propose a tripling of the size of the Structural Adjustment Facility, *(Please turn to the following page)*

(Continued from front page) which had been set up in March 1986 to provide assistance to the poorest developing countries. This led to the establishment of the Enhanced Structural Adjustment Facility (ESAF), designed to foster growth and strengthen the balance of payments of low-income developing countries. In August 1988, the Compensatory and Contingency Financing Facility (CCFF) was set up to provide broader protection against adverse changes in external economic conditions than had been available under the Compensatory Financing Facility that the CCFF replaced. In a further measure on behalf of the low-income countries, in September 1996 a joint IMF-World Bank initiative for the heavily indebted poor countries (HIPC Initiative) was announced.

Response to crisis

In recent years, the IMF has been directly involved in responding to a series of major crises affecting the international monetary and financial system. In February 1995, the Executive Board extended to Mexico the largest Stand-By Arrangement to date, in the amount of SDR 12.1 billion (nearly $17 billion), as part of an international program of assistance designed to support stabilization after a collapse of confidence in the country's currency. When the Asian crisis broke out in the summer of 1997, the IMF was quick to respond by providing financial assistance to Thailand, Korea, and Indonesia. It also established a Supplemental Reserve Facility to help affected members cope with sudden and disruptive losses of market confidence. Altogether some SDR 25.8 billion (about $36 billion) in financial assistance was approved for programs in these three countries during 1997.

In July 1998, the IMF activated the General Arrangements to Borrow (GAB) for the first time for a nonparticipant, to finance an SDR 6.3 billion (about $8.8 billion) augmentation of an Extended Fund Facility Arrangement (EFF) for Russia. Subsequently, the New Arrangements to Borrow were activated for the first time in December 1998 to help finance an SDR 13 billion (more than $18 billion) Stand-By Arrangement for Brazil when that country's currency came under attack. Contingent Credit Lines were created in April 1999 to help prevent crises by building

Camdessus informs IMF staff of his plans to resign

On November 9, IMF Managing Director Michel Camdessus informed the staff that he was planning to resign in February 2000, cutting short his final five-year term. Following is the text of his address.

As you can see, there are an unusual number of journalists in your midst today. But I want you to hear what I have to say from me personally, rather than reading it in the news, even if it is a hard message for me to have to tell you.

I have just read to the IMF Executive Board the following declaration:

"My dear colleagues, Members of the Executive Board:

The moment has come for me to ask you to discharge me of my responsibilities as Managing Director, preferably before the middle of February, by which time I will already be in my fourteenth year of service in the IMF.

Personal reasons, of which I did not even want to hear, particularly as long as we were in the midst of the Asian crisis, lead me to this decision—a decision I would never have thought would be so hard to take. But when you reappointed me for a third term, an immense honor indeed, I did not interpret it as an expression of your wish to see me serve for 15 years; that would be inappropriate in a world in permanent need of renewal of its institutions. You were generous in leaving to my judgment the choice of the right moment to pass the baton.

This is, I think, the right time.

We have advanced in many fields: we have just established a demanding but exciting work program, and the *World Economic Outlook* allows us to anticipate favorable trends for the world economy. So I see it as my duty now to suggest that you take advantage of these favorable circumstances to select my replacement, and to use these few months to help my successor become familiar with this superb but complex institution.

My friends, this is the right time. It is hard for me to tell you this. I do so with an enormous sense of gratitude to each of you, and to all in the IMF, for 13 years of support, understanding, and warm friendship. The time I have spent here has been the most rewarding in my long career of public service. I leave with absolute confidence in yourselves, in my management colleagues, and in the staff of the IMF. I am certain that you will continue to fulfill, under a new Managing Director and with the highest professionalism, integrity, efficiency, and continuous success, the purposes of the IMF.

Thank you all."

Let me just tell you that much today, as this is not a farewell speech, and I have still more or less 100 days to prepare myself to bid you farewell. I will certainly need that time! But let me also tell you, something you may already suspect—that I am immensely proud to have been your boss and immensely grateful for the wonders you have performed in the past 13 years. I say wonders, and this reminds me of something I told those who were here 13 years ago, on the day of my arrival at the Fund. Just before leaving Paris, I went to pay a visit to one of my predecessors, Pierre-Paul Schweitzer, to bid him farewell and to benefit from his counsels. He congratulated me and told me, "You will have the most extraordinary job in the world. The staff of the IMF will allow you to succeed in everything you undertake. They are wonderful people. Yes, the only problem you will find intractable in Washington—the only one—will be crabgrass in your garden!"

As so frequently, this great man was right! And not only about the crabgrass.

up market confidence in countries that, while pursuing strong economic policies, may be vulnerable to balance of payments problems stemming from financial contagion.

Financial reform

The experience of the successive financial crises of the 1990s pointed to the need for a coordinated effort to strengthen the international monetary and financial system to guard against future disruptions. In a series of speeches and policy actions, Camdessus encouraged the international community to take steps to strengthen the international financial "architecture" through such measures as increasing the transparency of economic decision making, strengthening banking and financial systems, increasing involvement of the private sector, liberalizing trade regimes, and modernizing international financial markets.

Poverty reduction and growth

In September 1999, as a response to the continuing need for an international effort to help the poorest countries, the Interim Committee of the Board of Governors on the International Monetary System (subsequently renamed the International Monetary and Financial Committee) endorsed replacing the ESAF with the Poverty Reduction and Growth Facility, intended to make poverty reduction a more central element of growth-oriented economic strategies among low-income members of the IMF. ■

Press conference

Camdessus discusses achievements of his terms of office, plans for future

Following are excerpts from a press briefing by IMF Managing Director Michel Camdessus on November 9, announcing his plans to retire.

QUESTION: *What do you consider your most important achievement here in 13 years, what's your greatest frustration, and also what's next for you?*

CAMDESSUS: I will take the questions in the opposite order. What's next for me? It's extremely simple—to go to my country to enjoy my constitutional rights to life, freedom, and pursuit of happiness. Frustrations? Not to have been able to reverse significantly this propensity of the world to make this institution a scapegoat for whatever catastrophe occurs. And I have not been able to give a good name to the things the IMF must do—and does well, I believe—to help countries in stabilization and structural adjustment. If I am proud of something that occurred during the past 13 years, it is that inflation went down in the world. All of you have heard me say many times that inflation is the most cruel tax on the poorest countries and on the poorest among the poor. I have a sense of having been associated with great things. I have seen a consensus form in the world to bring poverty alleviation and human development concerns to the heart of our policies. It was a great moment for me when this consensus was formed. I have seen the golden rule of transparency emerge as one of the chief features of the new international financial architecture. I believe that to establish transparency in the relationship between people and institutions is great progress toward stability and fairness. And, indeed, I was very happy to see the world recognize that this institution had to be trusted for surveillance of not only macroeconomic developments but also the

soundness of banking and financial sectors and to help, with its expertise, countries going in a well-sequenced way toward freedom of capital movements. It was great to be here to help Latin American countries get out of debt or at least to bring debt to a sustainable level, to be here at the time the Berlin Wall went down—and this institution was entrusted with helping those countries go to market economies, whatever the misgivings and difficulties in the process. It was great to help the Asian crisis countries in the midst of the most adverse circumstances. Finally, to do what the students in Djakarta put on their banners, "Down with corruption, nepotism, and collusion"—this is what the IMF was doing, and we are immensely proud, the staff and myself, to have been there to do that.

QUESTION: *Can you tell us whether you've been frustrated by the fact that both the IMF and you yourself have sometimes been the object of criticism in the past several months, and could you give us an idea of the general profile the person who takes over for you should have—*

someone with a monetary background or, because the IMF is now more politically involved, someone with a political profile?

CAMDESSUS: To your last question, I would say that it is written in the Articles of Agreement of the IMF that, to whatever position in the IMF, you must select the best in the world. I would only suggest an addendum that will be part, I hope, of the next change of the Articles of Agreement—namely, that the person should have a solid sense of humor. Now, frustrations about criticism: really no. Of course, nobody likes to be criticized, everybody likes to be applauded, and so do I. But I have learned a lot from criticism. And I know that the more we are responsive, the more we are criticized. If we are criticized, it is because we are responsive; our work is to go to uncharted waters, to respond to the most difficult situations, and to confront vested interests. And so, of course, this generates crisis and criticism. So be it.

QUESTION: *You said that your successor should be the best. Do you consider that the best will always come from France or some other European country?*

CAMDESSUS: I know that there are traditions you are familiar with that, in some way, the United States dominates the presidency of the World Bank and that Europe elects the Managing Director of the IMF. This is the tradition that goes back almost to Bretton Woods, but the only rule for me is that the man be good, have a sense of humor, and be totally committed to the purposes of the institution. And, indeed, this man could be a woman.

QUESTION: *I was wondering if you could explain what the personal reasons are for your departure, and in the event that a successor is not chosen in time for your departure, does that mean that [First Deputy Managing Director] Stanley Fischer will take your place temporarily?*

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
November 8	3.74	3.74	4.25
November 15	3.76	3.76	4.28

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/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

CAMDESSUS: My personal reasons are extremely easy to qualify: they are personal. I hope that my successor will be elected promptly. If it were to take too much time, then I share entirely your view that Mr. Fischer would be an extremely good solution for the institution.

QUESTION: *Last year during the congressional debate about replenishing the IMF's reserves, [U.S. Senate Majority Leader] Trent Lott basically requested your resignation. Can you tell us to what extent, if any, this kind of political pressure had to do with your decision?*

CAMDESSUS: So, are there political reasons behind my resignation? Not at all. They are personal reasons. As you know, Mr. Trent Lott has been a little bit imprecise even on my identity. He saw me as a French socialist or a socialist from France. He was only 50 percent right, as I am, obviously, French.

QUESTION: *Is there some brief advice you can give to your successor as to how you can better identify and prevent the kinds of crises that developed during your tenure?*

CAMDESSUS: He will receive from the Interim Committee and from the staff of the IMF an extremely comprehensive briefing on that.

QUESTION: *You are resigning at a very critical moment—in particular, amid allegations concerning Russia about misuse of IMF funds. I wonder whether you have reached a conclusion as to what's happening in Russia concerning these allegations and whether your resignation would have any impact on what's going on?*

CAMDESSUS: My resignation has nothing to do with these allegations, and you have possibly observed that these allegations have proved to be totally unsubstantiated. So I don't see why I would have taken that in consideration at the time I made this decision after almost 13 years of service and for the constitutional and personal reasons you understand.

QUESTION: *What is your advice to your successor and is there anything you would have done differently if you had your term again?*

CAMDESSUS: I have plenty of ideas about what could be done in the IMF during the next few years. But I believe that the best service that I can pay to the IMF now is to allow new blood to be injected into this body, new approaches to be tried, and a new stamina, a new imagination, to be put at work.

QUESTION: *[Translated from French.]You have said that your successor must have a sense of humor, among other things. You have a sense of humor, as well as experience and competence, and you have successfully led the IMF through a number of crises. Today, things are on track. Why do you leave now when there is such a need for a man of experience to deal with future crises? Is it only* *the desire for happiness that makes you leave this institution?*

CAMDESSUS: [Translated from French]. No, I told you that I did not want to dwell on my personal reasons as long as there were problems of such immense urgency. I'm leaving because there comes a time when experience, the weight of one's experience, risks preventing new energies from manifesting themselves in the institution. I think it's time to take advantage of this period of tranquility in the world economy to find someone who can give new momentum to this superb institution.

QUESTION: *Is it perhaps time to consider someone from the private sector for the top job at the IMF, given that the difficult issues ahead often involve coordinating with the private sector?*

CAMDESSUS: I believe this is a good idea, provided the man is seen and recognized by the international community as the best for the job and provided he has the appropriate sense of humor, among other things. I would personally have no objections at all to having a private sector successor.

QUESTION: *There have been rumors for weeks that you were leaving, so have any candidates for your replacement come forward, and what exactly is the procedure for replacing you from now on?*

CAMDESSUS: I'm sure you will find people of talent and dedication for the job. The process is very simple now. Under the dean of the Executive Board, the Board will meet and select the new chairman of the board and Managing Director of the IMF. It's a vote by a simple majority, I believe, but the tradition is that, when the membership perceives that a consensus is forming on a given name, unanimous consent is given to this name. It can take time—and we have an extremely competent dean who will be patient but at the same time effective at trying to make sure the process does not take too much time—because this institution needs to be managed, needs to have a leader in place to respond to crisis situations. I hope that this process will develop properly and promptly. ■

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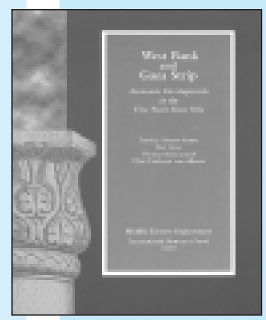

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Highlights of Camdessus's tenure, 1987–99

Camdessus (left) at his first Annual Meetings in 1987, with H. Onno Ruding, then Chairman of the Interim Committee.

Camdessus confers with IMF staff during the 1995 Mexican financial crisis.

Camdessus at the 1999 Annual Meetings with Alan Greenspan, Chairman of the U.S. Federal Reserve Board (center), and Wim Duisenberg, President of the European Central Bank.

1987

January 16

Camdessus takes office as Managing Director.

December 29

Enhanced Structural Adjustment Facility (ESAF) established.

1988

August 23

Compensatory and Contingency Financing Facility (CCFF) set up.

1990

July 2

IMF Board of Governors authorizes a 50 percent increase in IMF Quotas to SDR 135.2 billion ($180 billion) under the Ninth General Review.

1991

September 30

Executive Board appoints Camdessus to second term.

October 5

Camdessus signs agreement with Soviet President Mikhail Gorbachev establishing a Special Association between the U.S.S.R. and the IMF.

1992

August 3

Five-month Stand-By Arrangement approved for Russian Federation in the amount of SDR 719 million (about $1.0 billion).

1993

April 16

IMF Executive Board approves creation of the temporary Systemic Transformation Facility.

1994

February 28

Executive Board initiates operations under enlarged and extended ESAF, raising total loan resources under the ESAF Trust to SDR 10.1 billion.

October 2

Interim Committee recommends a temporary increase in members' access to IMF financial resources—from 68 percent of quota to at least 85 percent.

1995

February 1

Largest IMF financial commitment to date is approved, as Mexico enters into a Stand-By Arrangement for SDR 12.1 billion.

1996

April 16

IMF establishes Special Data Dissemination Standard for members having, or seeking, access to international capital markets.

May 22

IMF Executive Board selects Camdessus for a third term.

September 29

Interim and Development Committees endorse joint IMF-World Bank Heavily Indebted Poor Countries Initiative (HIPC Initiative).

October 1

Camdessus welcomes new Partnership for Sustainable Global Growth, containing 11 principles for governance of the world economy.

1997

January 27

IMF Executive Board approves the New Arrangements to Borrow (NAB), under which the IMF may borrow up to SDR 34 billion from 25 participating countries and institutions.

July 2

Asian crisis erupts in Thailand.

August 20

IMF approves SDR 2.9 billion ($3.9 billion) Stand-By Arrangement for Thailand.

November 5

IMF approves SDR 7.3 billion ($10.1 billion) Stand-By Arrangement for Indonesia.

December 4

IMF approves a record SDR 15.5 billion ($21.0 billion) Stand-By Arrangement for Korea.

December 17

IMF establishes Supplemental Reserve Facility to help members cope with sudden and disruptive loss of market confidence.

1998

April 16

Interim Committee adopts the Code of Good Practices on Fiscal Transparency: Declaration on Principles.

July 20

IMF activates General Arrangements to Borrow for first time in 20 years, and first time for a nonparticipant, to finance SDR 6.3 billion augmentation of Extended Fund Facility Arrangement for Russia.

October 6

Camdessus presents a special report to the Interim Committee on strengthening the architecture of the international monetary system.

December 2

IMF activates NAB for the first time to help finance an SDR 13 billion Stand-By Arrangement for Brazil.

1999

January 1

The new European Central Bank is granted observer status in the IMF.

January 22

Quota increases under the Eleventh General Review take effect, raising total quotas to SDR 212 billion (nearly $300 billion).

April 25

IMF creates Contingent Credit Lines to prevent crises by shoring up market confidence in countries pursuing strong economic policies but that may be vulnerable to balance of payments problems stemming from financial contagion.

September 26

Interim Committee endorses replacement of ESAF by the new Poverty Reduction and Growth Facility.

Views at conference

Second-generation reforms call for varied approaches to institution building and growth

Sound social, political, and economic institutions are now widely accepted as necessary complements to the sustained implementation of sound macroeconomic policies and the attainment of high-quality growth. Transparency in government and financial activities; good governance; sound legal, regulatory, and supervisory frameworks; and fiscal policy sensitive to the social and economic needs and situation of its citizens—all these elements have been combined under the rubric "second-generation reforms." Many questions about the reform process remain unresolved: what is the relationship between first- and second-generation reforms; how universally applicable are they and how can country ownership of a program be reconciled with internationally agreed codes and standards, how effective have they been so far, and where do we go from here?

Representatives from academia, government, the private sector, and multilateral institutions tackled these and other questions during a conference organized jointly by the IMF Institute and the Fiscal Affairs Department on November 8 and 9. IMF Managing Director Michel Camdessus provided welcoming remarks, and World Bank President James Wolfensohn delivered the keynote address.

Background and new developments

By the early 1980s, Camdessus said, much of the world had come to realize that macroeconomic stability was not enough to ensure sustained growth. The need to eliminate market distortions and inefficiency provided the motivation for a first generation of reforms.

The acceleration of globalization during the past decade and its long-term implications provided much of the impetus for the second generation of reforms, Camdessus noted. Few would now dispute the need for sound social, political, and economic institutions. For this reason, first- and second-generation reforms should not be seen as sequential. Indeed, the institution building typically associated with the second generation often can and should occur in parallel with the first generation.

Poverty is central to the activities of the World Bank, James Wolfensohn said. If you want stable growth, you must also address the social and poverty issues and related structural issues, thereby creating a "virtuous circle" of sustained, high-quality growth whose benefits accrue to all levels of society.

Second-generation reforms must also address the question of how to build consensus in a society, Wolfensohn said. How a society moves forward, in terms of both reforming its structure and in the program it adopts, must be controlled by the society itself.

Institutions matter, but politics rules

The concentration of political power determines the formulation of institutions that influence the outcome of political decisions, no matter what type of government, according to Robert H. Bates of Harvard University. There is no reason to expect that a particular kind of government will be best in terms of the expected choice of policies.

Political analysts, Bates said, tend to view policies as the result of deliberations from a single entity that chooses policies to facilitate attainment of those objectives. But policies typically emerge from competitive political processes, in which diverse interests advance competing alternatives, resulting either in the victory of one or in a compromise among several. The type of government is immaterial, Bates said, because even within a single-party or totalitarian state, competing interests and internal political conflicts are rife.

In his response, Anthony Lanyi of the University of Maryland suggested that the type of government might be more relevant than Bates had suggested. Most second-generation reforms, because they entail the introduction of transparency and accountability into a country's political, financial, and social systems and legal and regulatory frameworks, would find more fruitful soil in an environment of political openness.

Building institutions

A market economy relies on a wide array of nonmarket institutions that perform regulatory, stabilizing, and legitimizing functions that are not inherently generated by the market. Therefore, the question before policymakers, according to Dani Rodrik of Harvard University, is no longer "Do institutions matter?" but "Which institutions matter and how does one acquire them?"

How does a developing society acquire functional institutions that will support a healthy, sustainable market-based system? Rodrik said the choice lay between importing wholesale a "blueprint" from the more advanced economies and relying on the expertise of technocrats and foreign advisors or relying completely on hands-on experience, local knowledge, and experimentation. The local knowledge approach relies on mechanisms for eliciting and aggregating local information. The most reliable forms of such mechanisms, Rodrik argued, are participatory political institutions. Democracy, in his view, helped build better institutions for achieving high-quality growth. For that reason, international conditionality might be better targeted at basic political freedoms than at economic performance and adherence to international standards.

Robert H. Bates

Dani Rodrik

Vito Tanzi

Michael Trebilcock

Vinod Thomas

Francis Fukuyama

Saleh M. Nsouli, Deputy Director of the IMF Institute, expressed concern about Rodrik's suggestion that international institutions, like the IMF, should move away from economic conditionality toward political conditionality. How far, he asked, can they go in this direction? Also, it would be useful to distinguish between institutions that are applicable across all countries (such as accounting standards) and those that would be more dependent on a country's individual circumstances (such as capital account liberalization).

Role of the state

The state has a major role in implementing second-generation reforms, Vito Tanzi, Director of the IMF's Fiscal Affairs Department, said. As societies become more complex, the state must assume additional responsibilities if it wishes to contribute fully to the welfare of individuals. Markets are not efficient when they are distorted by monopolistic tendencies or when essential information is unavailable or too costly. The state, accordingly, has been called upon to regulate markets and provide essential information to market participants. Within this framework, an efficient public sector should achieve the state's objectives with a minimum degree of market distortion, the lowest possible burden of taxation, a minimal number of public employees, and the smallest possible absorption of economic resources by the state.

Commenting, Hilton Root of the Milken Institute observed that one of the major obstacles facing the modern state is the "misalignment" between the interests of leaders and of the public. He pointed to many parts of the developing world where schemes for equitable income distribution have been undermined by backdoor cronyism. Ameliorating this condition will require, among other things, greater efficiencies in public management, Root said.

Kevin Davis and Michael Trebilcock of the University of Toronto presented a paper on the role played by legal institutions in development. While the field boasts a rich intellectual tradition, "surprisingly little" is known about the relationship between them, they maintained. Existing research does, however, provide a road map for a limited number of important policy initiatives. More attention should clearly be given to reforming those key institutions that are responsible for enacting laws and regulations. Scholars should also be encouraged to pay more attention to how public bureaucracies influence law enforcement and administration.

William Holder, Deputy General Counsel of the IMF's Legal Department, commented that unraveling these complexities requires a policy-oriented and dynamic approach that views law as a "creative instrument," both to promote minimum order in society and to achieve the shaping and sharing of other values. He also noted that the IMF has long been involved in identifying, assessing, and advising on national law.

Addressing the social dimensions of growth, Vinod Thomas of the World Bank urged the international community to devote more attention to quality and sustainability issues. At the top of this list should be legal and judicial system reform. In addition, policies should be undertaken that both promote growth and protect the environment. Sustained growth is not possible, Thomas said, without macroeconomic stability, and, hence, it is critical that, as far as possible, the economy be insulated against external shocks.

In his response, Andrew Feltenstein of the Virginia Polytechnic Institute cautioned against relying on untested generalizations, such as "a rising tide lifts all boats." In reality, robust growth has not always led to uniform reductions in poverty. Similarly, he said, it is difficult to show the causality between social spending and growth proposed in Thomas's paper.

Civil society and social capital

Building social capital has typically been seen as a task for second-generation economic reform, observed Francis Fukuyama of George Mason University. Unlike economic policies, or even economic institutions, however, social capital cannot be easily created or shaped by public policy.

While states do not have many obvious levers for creating social capital, they can foster it in a variety of ways through education and the provision of public goods, particularly property rights and public safety, Fukuyama maintained. Religion and globalization are also vital sources of social capital. "Everyone is well aware of the ways in which globalization injures indigenous cultures and threatens long-standing traditions. But it also leaves new ideas, habits, and practices in its wake," he concluded.

Social capital, however, is not a free good, observed Paul Collier of the World Bank. Access to telecommunications technology—such as telephones and computers—is far greater in developed than in developing countries. As a general proposition, open, democratic, political systems that promote freedom of information are richer in social capital than closed, authoritarian ones, he argued.

Sound regulation

Changing state-market relations is not a zero-sum game where markets expand at the expense of the state, said Scott Jacobs of the Organization for Economic Cooperation and Development. What is happening is far more complex. The reconstruction of essential institutional relationships holds the promise of making all players better at what they do.

The international institutions can reduce the risks of mistakes and speed up the learning process by pooling and comparing national experiences, Jacobs maintained. Second-generation reforms in this arena will likely include increasing the flexibility and responsiveness of national governments, reducing the costs of moral hazard, and preserving the effectiveness of the state and the rule of law, he said.

Regulatory reform poses a major challenge to reformers, observed Paul Bradburd of Williams College. Firms are traditionally sensitive to changes in regulatory regimes. Effective adaptation on their part will require more, not less, regulatory stability, he said.

According to Lawrence White of New York University, although this decade has witnessed the spread of market-based economic policies, it will be remembered no less for its financial crises. Even in a world that relies much more on markets and less on governmental intervention, sensible financial regulation remains critical.

The proliferation of financial regulations has confused the public, according to Stefan Ingves, Director of the IMF's Monetary and Exchange Affairs Department. Greater efforts must accordingly be made to clarify these various instruments. A first step might be to focus more attention on "transaction regulations," which align buyers and sellers in the modern financial marketplace. On a broader canvas, the international community should be encouraged to work toward a new standardization regime.

Culture, institutions, and development

Employing an array of sociological, cultural, historical, and psychological examples, Deepak Lal of the University of California, Los Angeles, suggested that developing countries could "modernize" without "Westernizing." The danger inherent in second-generation reforms, Lal suggested, is that their advocates assume that economic development and the ability to prosper in a globalized market economy are possible only through the wholesale acceptance of Western values—"global moral crusades," concerning "so-called human rights and democracy." What matters for intensive growth, he said, is that the market should be allowed to function.

Responding to Lal, Peter Montiel, Senior Policy Advisor, IMF Institute, agreed that Western values could make no claim to universality, but he questioned Lal's assertion that they were wholly unrelated to economic prosperity. He also noted that many second-generation reforms addressed the efficient functioning of the market—the one Western institution that the developing world did embrace. As Dani Rodrik noted earlier, it was not the function of the institution that was necessarily in question, but rather finding or creating the institution within a society or culture best suited to carry out that function, Montiel said.

Fads and fashions in economic reform?

The 1990s began with the widespread expectation that achieving sound market-oriented macroeconomic fundamentals was the ticket for the prosperity that had long eluded poor countries, according to Moises Naim, editor of *Foreign Policy*. The decade, he said, is ending with the more frustrating but also more realistic understanding that sound macroeconomics is not a goal, but just a precondition for prosperity. In the intervening years, theories about economic development have moved through several stages, starting with the so-called Washington Consensus, which focused on restoring macroeconomic balance and crushing inflation, to fuel growth. But at each level of development theory, Naim contended, confusion reigned. Even the seemingly widely accepted Washington Consensus, from its beginnings, meant different things to different people.

In the late 1990s, Naim said, the reform agenda has become broader and infinitely more complex. For most countries, however, the means to attain "utopia"—honest governments, open legislative and transparent regulatory systems, well-trained and well-paid officials, and an official commitment to fight corruption—are themselves utopic goals. These are valid aspirations, Naim noted, but they are overwhelming. The challenge is to use the many lessons accumulated throughout decades of development efforts to create agendas that include specific prescriptions, intermediate stepping-stones, and more manageable goals.

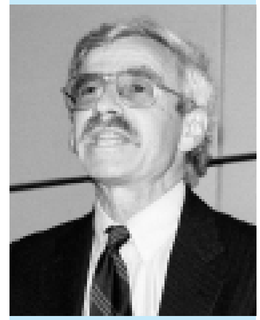
Commenting on Naim's paper, Ke-young Chu, Senior Advisor in the IMF's Fiscal Affairs Department, suggested that the definition of institutions be broadened to include not only public and formal institutions but private and informal ones as well. Understanding private and informal institutions would provide the designers of a reform program with ideas for realistic and effective public institutions.

International institutions

A roundtable, chaired by IMF Institute Director Mohsin Khan, focused on second-generation reform from the perspective of regional and multilateral institutions. Participants included Ted Nkodo of the African Development Bank, Faris Bingaradi of the Arab Monetary Fund, Jungsoo Lee of the Asian Development Bank, Ricardo Hausmann of the Inter-American Bank, and Rolph van der Hoeven of the International Labor Organization. All the speakers agreed on the need for second-generation reforms but also recognized that different levels of economic development—often within the regions their organizations represented—and varying social and cultural needs should dictate the pace of reforms as well as the institutional framework adopted to meet specific country needs. ■

Sara Kane, Deputy Editor, *IMF Survey*
John Starrels, IMF External Relations Department


Scott Jacobs


Lawrence White

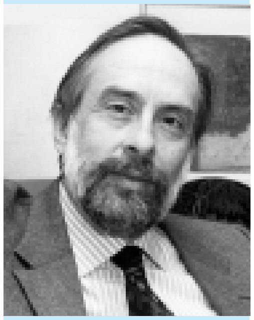

Deepak Lal


Moises Naim

Recovery in Asia

Social agenda is a necessary prerequisite for poverty reduction and growth

The following are edited excerpts from an address by Peter Heller, Deputy Director in the IMF's Fiscal Affairs Department, to the Manila Social Forum on November 9.



Peter Heller

After almost two years of economic disruption, the Asian economies have begun to rebound. Yet the crisis period was no ordinary cyclical trough. It was partly due to an absence of the policy reforms necessary to prosper in a global economy with increasingly open capital markets. The costs of the crisis were not small: output declined and remains below trend, and poverty rates increased, reflecting in some countries significant declines in real wages and in others a large increase in unemployment.

The IMF firmly believes that a social agenda should be part of the reform initiatives in Asia, in addition to necessary reforms in structural, regulatory, and macroeconomic policy management, which are now clearly recognized as prerequisites for sustainable growth. We know that growth is necessary to reduce poverty in the long run.

Structural architectural agenda

Since the Asian crisis, a consensus has emerged on the priorities for institutional reform. The objective is to support vibrant, growing economies that can benefit from global investment capital seeking high returns while remaining resilient to potentially destabilizing pressures caused by contagion, capital movements, or external economic developments. High growth *is* consistent with openness; the task is to ensure that capital mobility and free trade do not destabilize or undermine the financial and real sectors of an economy. Avoiding steep recessions and providing an environment that facilitates rapid growth in output and employment are powerful preventive strategies for reducing poverty. Such growth, and the jobs it creates, can lift real wages and enable workers to manage the inevitable transitions associated with the evolution of the industrialized and service-based economies of the coming century.

Instituting stronger legal, regulatory, and supervisory frameworks is crucial for sustaining growth. These "second-generation" reforms would encompass new or strengthened bankruptcy and foreclosure laws; judicial procedures that allow for expeditious resolution of claims; transparent accountancy practices; tax reforms; and institutions that ensure greater transparency in fiscal and monetary operations as well as in corporate governance. More flexible labor market policies and adherence to the principles of the International Labor Organization are equally relevant. Ensuring responsive and transparent political institutions and responsible governance within public agencies is vital for ensuring confidence and trust and effective policy formulation and implementation.

As a result of the crisis, Asian policymakers have initiated efforts in the area of financial and structural reform. It is important that Asian countries persevere in these efforts.

Social policy agenda

There are four essential elements of an enhanced social policy agenda: investing in human capital, protecting the poor during economic shocks, establishing cost-effective social insurance policies that reflect local cultural norms without creating large disincentive effects in the labor market, and establishing vehicles for long-term savings in the context of aging populations.

Investing in human capital has long been recognized as central to any growth strategy. The Asian economic miracle witnessed the achievement of high literacy rates, the promotion of investment in secondary and higher education, the proliferation of networks of primary health care facilities, and the spread of high-quality secondary and tertiary medical care. The challenges now faced by many Asian economies are similar to those encountered by industrial countries—to ensure that social sector spending is efficient, costs are contained, and equity in access is achieved. Such investments need to be complemented by well-designed policies for regional development and some policies to ensure that the poor, who are less well integrated in the formal economy, can take advantage of the opportunities afforded by rapid growth.

A salient lesson of the recent crisis was governments' lack of preparedness to respond to losses in wages and the large jump in unemployment rates. Most governments were unable to monitor household income developments and track situations where the nonpoor were being thrown into poverty or experiencing a sharp drop in their assets and where remedial programs were most necessary. Governments should have the capacity already set up to identify those groups and regions where poverty is particularly a problem, as well as to understand the factors and dynamics responsible for persistent poverty.

An equally important element of any social agenda must be the institutionalization of a capacity for a rapid targeted response of income relief and measures to generate employment. In the recent crisis, public works schemes were slow in getting off the ground and those that did were likely to be subject to serious governance problems. Throughout the industrial world, formal systems are in place to ensure against disability, unemployment, death of a household's main income provider, and old age. Such systems have begun to develop in some emerging market countries of Asia. Those Asian economies that are participating in the global economy are certain to experience flux in the industrial and service sectors—as dynamic firms grow and inefficient ones shrink and close down. Moving from situations without formal unemployment insurance or only enterprise-specific systems to some form of broader unemployment benefits will become a necessary piece of the social architecture in these countries.

The critical task will be to design systems that do not conflict with the equally important objective of fostering growth in employment in these economies and maintaining job search incentives. The recent efforts of the World Bank and some UN agencies to develop broad principles of good conduct in the social area should provide further guidance to countries.

The challenges of designing a financially viable multipillar pension system that can sustain an aging population has been the subject of much attention in recent years. Our understanding of the risks and benefits associated with different approaches—public, private, or mixed, defined benefit and defined contribution—is now quite substantial. We also understand much about the institutional prerequisites of different systems—the types of financial products and institutions that need to be developed and the challenges that are posed. There is no one right system; the appropriate solution for a country will depend on its history, culture, and political economy. Most Asian countries have much work to do, both in designing systems with broader coverage and in developing an institutional framework that can deliver on the promises that will be implicit in any scheme.

Role of the IMF

Finally, I want to highlight how these social issues are influencing the IMF's work. The initiatives unveiled at the World Bank-IMF Annual Meetings six weeks ago have placed poverty reduction at the center of the IMF's efforts for its low-income member countries. The IMF's concessional lending facility, the Enhanced Structural Adjustment Facility, has been transformed into the Poverty Reduction and Growth Facility (PRGF), which makes poverty reduction a key element of a renewed growth-oriented economic strategy. The cornerstone of the new approach is a nationally owned, comprehensive Poverty Reduction Strategy Paper (PRSP), which will be prepared by a country's authorities with assistance from the World Bank and the IMF. The PRSP will reflect an open, participatory process involving civil society, relevant international institutions, and donors and will identify priorities for public action to reduce poverty. It will also address the critical and often complex issues of enhancing good governance and supporting transparency in policymaking.

In the necessary division of labor between the IMF and the World Bank, the latter will be at the forefront of discussions with authorities on the design of policies for poverty reduction. The IMF will seek to ensure that these social and sectoral programs can be accommodated and financed within a supportive, growth-enhancing, low-inflation macroeconomic and budgetary framework. The IMF's PRGF will place high priority on the key reform measures critical to achieving rapid and sustainable growth that also leads to faster poverty reduction.

It is also important to understand the IMF's contribution in the social area for countries that are not implementing IMF-supported programs. Traditionally, the focus has been heavily macroeconomic, but the IMF has become increasingly aware of the importance of a country's structural policy framework for the global macroeconomic environment and has paid increased attention to the social implications of its policy advice. Poverty, unemployment, and severe inequalities in income distribution can undermine growth and lead to large welfare transfers that burden the budget. It is for this reason that the IMF has emphasized, as part of its surveillance process, collecting and monitoring social and poverty indicators as needed. Policies in the social sectors may need to be taken into account, including the adequacy of social policy instruments, the performance of social safety nets, and the potential social ramifications of macroeconomic and financial policies. Equally, in situations where social policies threaten to give rise to significant vulnerabilities in macroeconomic policy management—over either the short or the long term—the policy implications may need to be addressed in the surveillance process.

The crisis in Asia has made us all aware not only of the remarkable strengths and resiliency of the Asian economies, but of the important policy agenda—both economic and social—that must be tackled in the coming years if these countries are to make a sustained transition to high-income economies with low rates of poverty. ■

Member's use of IMF credit
(million SDRs)

	During October 1999	January – October 1999	January – October 1998
General Resources Account	**372.16**	**8,906.47**	**14,089.77**
Stand-By Arrangements	361.50	6,429.07	7,232.74
SRF	0.00	3,636.09	5,125.00
EFF	10.66	1,797.00	4,700.48
SRF	0.00	0.00	675.02
CCFF	0.00	680.40	2,156.55
ESAF	**39.64**	**668.73**	**711.98**
Total	**411.80**	**9,575.20**	**14,801.75**

SRF = Supplemental Reserve Facility
EFF = Extended Arrangements
CCFF = Compensatory and Contingency Financing Facility
ESAF = Enhanced Structural Adjustment Facility

Figures may not add to totals shown owing to rounding.

Ernest Sturc Memorial Lecture

IMF and World Bank face challenge of coordination and streamlining in next century

On November 4, Anne O. Krueger, professor of economics at Stanford University and Director of the Stanford Institute for Economic Policy Research, gave the Annual Ernest Sturc Memorial Lecture at the Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C. The webcast of the address, entitled "Whither the World Bank and the IMF in the Twenty-First Century?" is available on the SAIS website (www.sais-jhu.edu).

Krueger addressed an overflow audience on November 4, not surprisingly, since her topic was two large and prominent international organizations located just a few blocks away from the SAIS auditorium.

World Bank

Krueger first addressed the World Bank, overviewing the evolution of the Bank from a lender to sectoral development projects to a leader of structural adjustment. Krueger noted that since middle-income countries can now finance development projects for themselves, the World Bank has a choice of lending to a smaller base of low-income countries, or embracing what she called "softer issues." She was quick to point out that by "softer," she did not mean social issues per se, because spending and reform in the health and education sectors had proved to be important and valid components of economic development. The term referred instead to the World Bank's taking on issues such as resettling indigenous peoples or requiring adherence to core labor standards—concerns where Krueger considered the link with economic development less clear. She suggested that this tendency of the World Bank to "go all over the place" could possibly contribute to the diminution of public support for the institution.

International Monetary Fund

Turning to the IMF, Krueger suggested that for the monetary institution, the debt crisis in the 1980s was a key period that in some ways presaged the controversy that surrounded the IMF during the Asian financial crisis. During the debt crisis, the key was to keep the private creditors at the table, since IMF resources were low compared with the troubled countries' total external debt, and this same point is still relevant today. Krueger said that the starting point for any analysis of the IMF has to be the recognition that the institution simply does not have the resources to counterbalance international capital flows.

Three other issues came to the fore with the Asian crisis: the greater size and varied composition of private capital flows; the weightier role of the exchange rate regime; and the centrality of domestic financial sector issues—which "muddied the waters quickly." The key relationship, which is not understood by the IMF's critics, is that when a country has an unrealistic foreign exchange rate and banks have been—one way or another—encouraged to borrow overseas, then a balance of payments crisis will likely go hand in hand with a sharp deterioration in the quality of the banks' balance sheets. Krueger made it clear that she agreed with the current thinking that favors the polarized options of a currency board or a freely floating exchange rate. Solutions to the exchange rate–financial sector link include prohibiting industrial country banks from lending their domestic currency to developing countries except when a liability in the local currency is created, and raising reserve requirements for such cross-border lending. If such solutions are not firmly applied, and perhaps even if they are, the future of the IMF is going to be inextricably linked to domestic financial sector issues. The centrality of the financial sector led Krueger to the subject of coordination of the various international institutions.

Coordination of international institutions

Surprisingly, it was not the coordination of the World Bank and the IMF that interested Krueger, who said that the two institutions coordinated fairly well and that, moreover, a bit of competition was a good thing. Rather, she expressed concern about the coordination of the World Trade Organization (WTO) with the Bretton Woods institutions and the even wider coordination that international financial supervision required.

With regard to the WTO, in Krueger's view, developing countries lack the institutional ability to comply with changes in trade practices, and the World Bank and, to a lesser extent, the IMF will need to help their members in this regard. To accomplish effective international financial supervision, many different bodies—ranging from official entities to trade associations to national authorities—covering many different disciplines—including banking, corporate finance and management, accounting, property rights, and legal procedures for bankruptcy—need to be involved. This is a real coordination problem, because the whole process is at risk of bogging down as one group feels it cannot do its assessment properly until another institution completes its part of the work. Ultimately, Krueger said, political realities may be a stumbling block to the technical solutions to the coordination dilemma that one might envision. ■

Lynn Aylward
IMF External Relations Department

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By			**39,577.64**	**13,427.54**
Bosnia and Herzegovina	May 29, 1998	April 28, 2000	77.51	24.24
Brazil[1]	December 2, 1998	December 1, 2001	13,024.80	5,969.70
Cape Verde	February 20, 1998	December 31, 1999	2.50	2.50
El Salvador	September 23, 1998	February 22, 2000	37.68	37.68
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,087.50
Mexico	July 7, 1999	November 30, 2000	3,103.00	2,068.60
Philippines	April 1, 1998	March 31, 2000	1,020.79	475.13
Romania	August 5, 1999	March 31, 2000	400.00	347.00
Russia	July 28, 1999	December 27, 2000	3,300.00	2,828.57
Thailand	August 20, 1997	June 19, 2000	2,900.00	400.00
Uruguay	March 29, 1999	March 28, 2000	70.00	70.00
Zimbabwe	August 2, 1999	October 1, 2000	141.36	116.62
EFF			**11,749.03**	**6,593.10**
Argentina	February 4, 1998	February 3, 2001	2,080.00	2,080.00
Azerbaijan	December 20, 1996	December 19, 1999	58.50	5.26
Bulgaria	September 25, 1998	September 24, 2001	627.62	366.12
Croatia, Republic of	March 12, 1997	March 11, 2000	353.16	324.38
Indonesia	August 25, 1998	November 5, 2000	5,383.10	1,585.40
Jordan	April 15, 1999	April 14, 2002	127.88	106.56
Moldova	May 20, 1996	May 19, 2000	135.00	47.50
Pakistan	October 20, 1997	October 19, 2000	454.92	341.18
Panama	December 10, 1997	December 9, 2000	120.00	80.00
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
ESAF			**3,749.05**	**2,025.32**
Albania	May 13, 1998	May 12, 2001	45.04	23.69
Armenia	February 14, 1996	December 20, 1999	109.35	0.00
Azerbaijan	December 20, 1996	January 24, 2000	93.60	11.70
Benin	August 28, 1996	January 7, 2000	27.18	10.87
Bolivia	September 18, 1998	September 17, 2001	100.96	67.31
Burkina Faso	September 10, 1999	September 9, 2002	39.12	33.53
Cambodia	October 22, 1999	October 21, 2002	58.50	50.14
Cameroon	August 20, 1997	August 19, 2000	162.12	36.03
Central African Republic	July 20, 1998	July 19, 2001	49.44	32.96
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	16.36
The Gambia	June 29, 1998	June 28, 2001	20.61	17.18
Ghana	May 3, 1999	May 2, 2002	155.00	132.84
Guinea	January 13, 1997	January 12, 2000	70.80	23.60
Guyana	July 15, 1998	July 14, 2001	53.76	35.84
Honduras	March 26, 1999	March 25, 2002	156.75	96.90
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	43.00
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	27.28
Madagascar	November 27, 1996	July 27, 2000	81.36	40.68
Mali	August 6, 1999	August 5, 2002	46.65	39.90
Mauritania	July 21, 1999	July 20, 2002	42.49	36.42
Mongolia	July 30, 1997	July 29, 2000	33.39	21.89
Mozambique	June 28, 1999	June 27, 2002	58.80	50.40
Nicaragua	March 18, 1998	March 17, 2001	148.96	53.82
Pakistan	October 20, 1997	October 19, 2000	682.38	417.01
Rwanda	June 24, 1998	June 23, 2001	71.40	47.60
Senegal	April 20, 1998	April 19, 2001	107.01	57.07
Tajikistan	June 24, 1998	June 23, 2001	100.30	53.34
Tanzania	November 8, 1996	February 7, 2000	181.59	0.00
Uganda	November 10, 1997	November 9, 2000	100.43	26.78
Yemen	October 29, 1997	October 28, 2000	264.75	114.75
Zambia	March 25, 1999	March 24, 2002	254.45	244.45
Total			**55,075.72**	**22,045.96**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
ESAF = Enhanced Structural Adjustment Facility.
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Adjustment measures under ESAF-supported programs are expected to strengthen a country's balance of payments and to foster growth.

Japan

Study examines causes of slump in business investment in the 1990s

In the 1990s, business investment in Japan declined more precipitously than at any other point in its postwar history, with a particularly sharp drop being registered in 1998. A background paper prepared in conjunction with the IMF's annual Article IV consultation discussions with Japanese authorities examines the possible causes of the slump in business investment. In this interview, the author of the paper, Ramana Ramaswamy, a Senior Economist in the IMF's Asia and Pacific Department, discusses his conclusions.

IMF SURVEY: *What led you to examine the decline in Japan's business investment?*

RAMASWAMY: Over 1991–98, the Japanese economy grew at an average of 1½ percent a year. In the 1980s, it had grown at 4 percent a year. Trying to explain what happened in the 1990s led me to look at business investment, and ultimately to ask why investment collapsed.

Ramaswamy: If you want to look at what happened to Japanese business investment, you must look at the structural factors.

It is fairly well known that the collapse of Japanese equity and land prices in the early 1990s precipitated the crisis. What is less well known is that, unlike other countries that had had an asset price bubble burst—notably Sweden and the United Kingdom—Japan did not experience a subsequent collapse in private consumption expenditure. Instead, it experienced a severe decline in business investment.

The share of business investment in GDP fell from about 20 percent in 1990 to about 16 percent in 1998. To view this decline from an international perspective, the share of business investment in GDP in Japan was about 11 percentage points higher than in the United States in 1990. Now, following the slump that persisted for several years, the share of business investment in GDP is just about 3 percentage points higher than in the United States. The 1990s was not only a period during which business investment collapsed dramatically in Japan, but also a period in which the United States experienced a structural increase in investment. All this makes a study of the causes of the slump in business investment in Japan particularly interesting.

IMF SURVEY: *What does your study aim to do?*

RAMASWAMY: Quite a few explanations have been offered for the decline in Japanese business investment. Some of these are based on fact, some, on study, and some, simply on observers' biases and speculations. My study examined the principal explanations that have been offered so far and attempted to see to what extent they made sense in the Japanese context. The study also provided econometric estimates of the determinants of aggregate business investment in Japan.

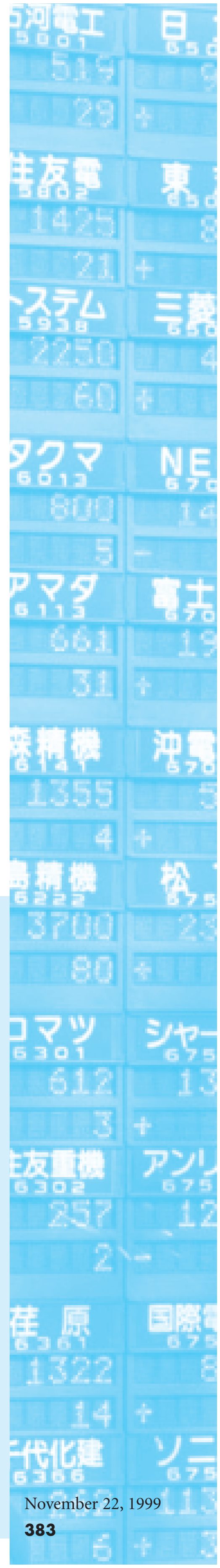
IMF SURVEY: *Why did Japan's business investment decline so steeply in the 1990s?*

RAMASWAMY: There are four major theories. The first is that an excessive buildup of debt served as a drag on investment. Japanese firms got themselves indebted in a big way in the 1980s, as did Korea and other Asian countries. This theory argues that Japan in the 1990s faced the consequences of the buildup of that debt. A second theory is that the steep decline represented an unwinding of the overinvestment that had characterized the 1980s.

A third explanation attributes the slump to a credit crunch. This suggests the decline in business investment is an extension of the banking crisis that started in the early 1990s, but really came to the fore in 1997–98 before things improved in 1999. This explanation argues that the banking crisis led to a credit crunch—that is, it led to a drying up of funds for investment. And the fourth explanation links the fall in investment to deeper structural factors. It suggests that the decline in business investment is related to a long-term decline in the labor force and the process of deindustrialization that has taken place in the Japanese economy.

IMF SURVEY: *How is excess debt tied to Japan's business investment slump?*

Photo Credits: Denio Zara, Padraic Hughes, and Pedro Márquez for the IMF, pages 369, 371, 374, and 382; Susumu Takahashi for Reuters, page 384.



RAMASWAMY: Let me first say that it is not bad for firms to take on debt—investors are sometimes more willing to buy bonds than equity because they know bond purchases are a contingent contract and they are legally assured of a stream of earnings. So by issuing debt, firms may tap into an investor group they would not otherwise have access to. There's also an extensive literature that argues that debt disciplines a firm's activities, since it requires firms to pay a certain part of their profits or cash flows as interest and to pay the principal back on an agreed-upon date. Such constraints on cash flows discourage firms from diversifying into activities where they lack expertise.

The problem with debt is when you have too much of it. Excessive debt leaves firms vulnerable to any negative shocks. If things do not go well, firms will not have the cash flow to invest in physical or human capital. Debt is also a problem when actual inflation is lower than expected inflation. A contract is fixed in nominal terms, so it will have to pay much more in real terms when inflation is lower than expectations. Both of these things happened in Japan. The country had built up very high levels of debt compared with other industrial countries; when asset prices collapsed in the 1990s, the expectations on which the debt was initially taken out did not materialize subsequently. In the late 1980s, the Japanese, extrapolating from past experience, assumed their economy would grow at 4 percent forever. And, of course, that did not happen in the 1990s.

The combination of high debt levels and lower than expected inflation and growth rates caused enormous problems for firms. These problems were compounded at times by lax bank enforcement of debt contracts in the 1980s. When the firms didn't pay back interest, the banks often rescheduled it. Then, in the 1990s, the banks had a crisis of their own and were unable to perform effective due diligence. Thus, problems that could have been nipped in the bud were allowed to fester and resulted ultimately in a massive collapse of business investment.

Overall, my study found that structural factors, notably the impact of the debt burden and the unwinding of overinvestment, were the dominant factors driving the slump in Japan's business investment.

IMF SURVEY: *How did the unwinding of overinvestment contribute to the slump?*

RAMASWAMY: The first step for the study was determining whether there had been overinvestment. This is not easy to measure. A sharp increase in the capital output ratio may signal overinvestment, but this could also occur when, for example, a country moves from low-technology to high-technology industrial production. I wanted to determine whether Japan's capital output ratio increased in relation to its trend growth. Beginning in the late 1980s, you do see a large gap developing between actual and trend investment levels (see chart, page 384). This provides one measure of overinvestment. The recent narrowing of that gap suggests that, by now, a significant part of the overinvestment has been unwound. But the remaining gap indicates there may still be some way to go before investment can really pick up. Another way to gauge overinvestment is to draw a comparative picture. While international comparisons cannot be pushed too far, the contrast between business investment in Japan and the United States discussed earlier offers some pointers about the extent of overinvestment in Japan in the 1980s.

Then, you ask yourself, why did Japan overinvest? One reason is that monetary policy was quite loose in the latter part of the 1980s, because Japanese monetary policy was influenced in part by international agreements that attempted to stabilize the dollar. But that is a complicated argument, because inflation was very low and the monetary authorities presumably thought things would be okay, because inflation did not shoot up.

The second explanation is the boom in Japan's stock market. Many Japanese companies were able to issue equity very cheaply and finance their investment. And in the latter half of the 1980s, banks started lending heavily to the small sector and for real estate investment. These banks had lost their large corporate clients. With financial globalization, their traditional clients were able to issue their own equities and bonds. So the banks turned to new clients and extended large amounts for sometimes questionable endeavors. Essentially, this is just what happened in other countries that underwent

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Concluding Remarks for Article IV Consultations. At the conclusion of annual Article IV discussions with the authorities, and prior to the preparation of the staff's report to the Executive Board, the IMF mission often provides the authorities with a statement of its preliminary findings.

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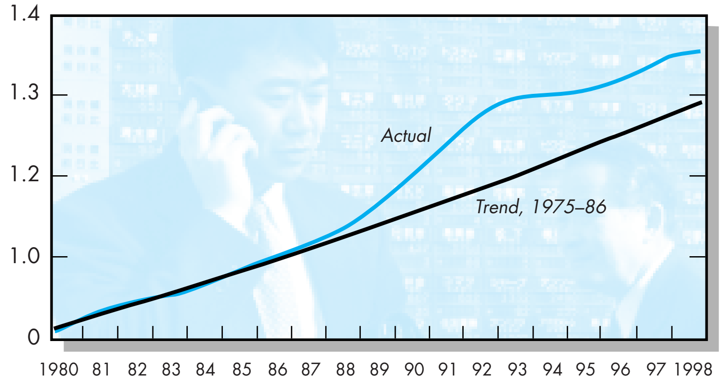
financial liberalization, such as Sweden and the United Kingdom.

The third reason for overinvestment has to do with the banking crisis. It is not a particularly strong explanation of the trend decline in investment, because the banking crisis really hit hard only in 1997 and 1998, whereas investment had been falling before that. But, even in the early 1990s, there might have been a relationship between bank lending and investment. In Japan, banks can count a portion of their capital gains on equity holdings as part of their bank capital. When equity prices collapsed, bank capital also declined. In that sense, banks' capacity to lend might have been adversely affected even before the banking crisis flared up fully.

Business capital-to-output ratio and the efficiency of investment

(Ratio of net business capital to potential GDP)



Note: Potential GDP is generated using a production function approach.

Data: OECD; and NIKKEI Telecom

In fact, econometric estimates showed a strong correlation between equity prices and business investment in Japan. This link can take place through two channels. If equity prices collapse, it is more expensive for firms to make investments by issuing equity. But it also means the banking sector can lend less because bank capital has eroded.

The fourth reason—the structural explanation—has two elements. All industrial countries have experienced a decline in the share of employment in manufacturing. In the 1970s and 1980s, Japan's decline was not as steep as that in the United States or Europe. But beginning in 1994, there was a very sharp decline in Japan's manufacturing sector for a wide variety of reasons. Since there is a strong correlation between the rate of investment and the size of the manufacturing sector, the drop in investment might in part be linked to the shrinking manufacturing sector. Also, Japan's labor force is growing more slowly than that of other industrial countries. As a result you would expect that the potential growth of the economy would be negatively affected—it would be lower because the labor force is growing at a lower rate. And this, too, suggests that investment could not have continued growing at the same pace as in the 1980s.

Ultimately, this paper argues that if you want to look at what happened to investment, you must look at the structural factors. Excess debt, overinvestment, and the collapse of asset prices all played major roles in the business investment slump. Cyclical factors are much less important in explaining the slump in business investment in the 1990s.

IMF Survey: *Looking ahead, what do you see as the prospects for investment?*

Ramaswamy: The current rate of private investment in Japan right now is in the neighborhood of historic lows. This, as well as international comparisons of investment rates, suggests that the process of capital stock adjustment is more or less complete. The payoff period for the earlier sins appears to be coming to an end.

IMF Survey: *Are there lessons to be learned for Japanese policymaking?*

Ramaswamy: Yes, there are indeed a number of lessons that can be learned from this study. Good corporate governance is needed, not only for a strong economy, but also for macroeconomic stability. Japanese firms extended themselves into activities in which they had very little expertise and built up huge amounts of debt in the 1980s, because the institutional infrastructure whereby shareholders can question management when profits decline did not exist in practice.

A strong financial system, especially in cases in which bank lending is important, is also a prerequisite for macroeconomic stability. In the case of Japan, some of the problems of overinvestment could have been minimized if banks had carried out adequate due diligence earlier.

But Japanese policymakers have learned their lessons. A lot has been done in the past year and a half to strengthen the banking system and corporate governance. The institutional infrastructure to sustain a revival of investment and growth is being put into place. I am personally quite optimistic about growth prospects in Japan in the coming years. ■

This paper will be a chapter in a forthcoming book to be published by the IMF, *Post-Bubble Blues: How the Japanese Economy Responded to Asset Price Collapse*, edited by Tamim Bayoumi and Charles Collyns.

The next issue of the *IMF Survey* will appear on December 13, 1999.