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Interview with IMF Managing Director

## Major players must tackle global imbalances or markets will do it for them

In early June, Rodrigo de Rato, a national of Spain, took over as head of the IMF, succeeding Horst Köhler, who resigned in early March. Before joining the IMF, de Rato served for nearly eight years in the Spanish government, most recently as Minister of Economy and Vice President for Economic Affairs (2000–2004). He also had a long political career, including a stint as a member of Spain's parliament. Laura Wallace of the IMF Survey spoke with him about the forces shaping the global economic outlook and the ongoing strategic review of the IMF's role.



De Rato: "The United States needs to speed up reduction of its public deficit."

major players—the United States, Europe, Japan, and emerging Asia—if global growth is to be sustained. What does each of these parties need to do? And how does the IMF fit in?

**DE RATO:** Governments have two choices: one is to address the issue with a change in policies; the other is to let market forces resolve the problem for them, which could be much more costly and risky. The United States needs to speed up reduction of its public deficit, and we hope that this will be reflected in the new administration's policies as soon as possible. Europe has to accelerate its growth potential and its actual

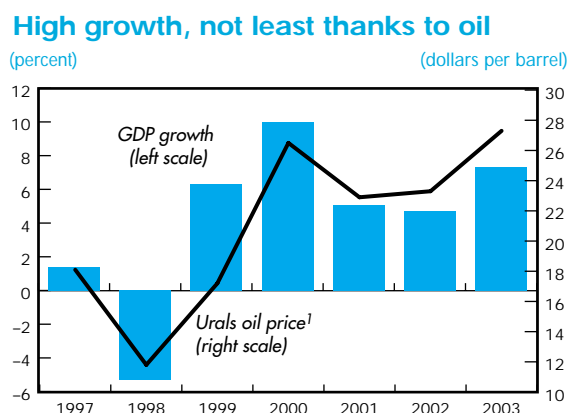
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**IMF SURVEY:** You've commented on the vital need to correct global imbalances among the

## How should Russia manage its oil wealth?

Strong economic growth and windfall revenues from oil as a result of higher prices (see chart below) are posing new challenges for fiscal policy in Russia. With basic public services still inadequate and much of the infrastructure run down, pressures to spend oil revenues have intensified. But with signs of rising inflation and tightening labor markets, fiscal policy should not add stimulus to the economy at this stage. In fact, it may have to be tightened. In this article, Gooheon Kwon, an IMF representative in Moscow, discusses the challenge of carrying out necessary—

but expensive—social reforms while preserving macro-economic stability.



<sup>1</sup>The Urals are the main oil-producing region in Russia. The price of Urals crude is quoted separately on world oil markets.  
Data: Rosstat and Reuters

The current system of social entitlements, a remnant of the Soviet era, is severely underfunded, highly inefficient, and prone to abuse. In its draft 2005 budget, the government is proposing to increase social spending by some  $\frac{3}{4}$  of 1 percent of GDP, associated with an ambitious social benefit reform. The reform, which will affect tens of millions of beneficiaries, aims to

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I don't think we have to be afraid of changes. We just have to be sure of two things: that what we do makes a difference and that we're good at what we do. And I believe in these two things.

—Rodrigo de Rato

## De Rato on Asian reserve buildup

(Continued from front page) growth; 2004 will again be a year in which growth in Europe was too weak. The same goes for Japan, which has to accelerate its reforms if it hopes to perform in a more dynamic way. The emerging market economies of Asia have to move toward exchange rate mechanisms that better reflect economic fundamentals and help them absorb changes in the world economy or external shocks. If these major players adopt these policies, which are quite reasonable, the global imbalances could be reduced in a positive way.

How does the IMF fit in? These imbalances are a global surveillance issue, and these days, we're much more conscious of systemic risks, which affect not just individual countries but much of the world or major regions.

**IMF SURVEY:** In the media, there is now talk of a possible 20 to 40 percent decline in the value of the dollar. What is your reaction to this type of speculation? What would such a decline mean for the global economy?

**DE RATO:** The debate is out there, and we'll hear a lot of predictions and analyses. But the fact is that there is a basis for the debate—people aren't just speculating in a void. Of course, it's very difficult to make predictions about the evolution of currencies, especially about when exchange rates will move and how sharply. That said, the U.S. current account deficit is very large, and it's in everyone's interest that the deficit be reduced in an orderly manner. If we look at the different possible scenarios, we see that there are scenarios in which there is a gain for everyone, and there are scenarios in which there is a loss for everyone.

**IMF SURVEY:** Is the massive buildup of foreign exchange reserves by Japan and key Asian emerging market economies in the interests of these countries or the international system? Can it continue?

**DE RATO:** It's the will of these countries—they're independent economic players—and if they want to build up reserves, it's a strategy to gain independence and limit risks. But like everything else in economics, such a buildup has its limits, and at a certain point, it complicates monetary policy and anti-inflationary policy. We're advising the countries to be aware of these limits, although they're already very aware of them. We're also advising them, as mentioned, to move toward more flexible exchange rate mechanisms.

As for the global economy, up to now these countries have been the ones financing the U.S. current

account deficit, which has been the main engine of growth for the world. So, on balance, we can't complain too much. The question is whether the buildup is sustainable, and there's growing evidence that the buildup is very big and the markets are asking for a change in policy. I don't think it's a traumatic situation, but I do think a change in policy is needed to avoid getting into a traumatic situation. And now is a good time for most of the players to make such a change, as their economies are in an upswing, although it's a little less vigorous because of oil prices.

**IMF SURVEY:** How worried are you about the impact of continued high oil prices on global growth? Any advice for the oil-importing and oil-exporting economies?

**DE RATO:** We've said from the beginning that the high oil prices are demand driven, which is very different from previous oil price hikes. That doesn't mean there aren't supply constraints in some areas or that there isn't a lack of transparency in the markets. But even taking all of this into consideration, the price of oil is high because more people are consuming oil. It's as simple as that. This means that the world economy is doing a much better job of absorbing shocks caused by supply constraints. It also means that it's going to be a more permanent situation—that is, the oil price floor has risen because of the demand—a reality that oil consumers will have to accept. And policymakers in oil-importing countries will have to carefully review their energy policies, focusing on conservation and efficiency.

In oil-exporting countries, policymakers will need to recognize that previous hikes in oil prices haven't always been a blessing. They often resulted in big disruptions in macroeconomic balances, inefficient public expenditure, and greater economic vulnerability, without enhancing development and reducing poverty. Of course, this isn't a universal truth, but it has happened enough times so that we should be very aware that high oil prices are a double-edged sword. For that reason, the IMF is advising these countries to save for the future, reduce debt, and spend on infrastructure and social needs today, but to do so with greater transparency and efficiency in allocating resources and selecting projects.

**IMF SURVEY:** You returned from the Middle East just a few weeks ago. What is the economic prognosis for the region?

**DE RATO:** The region is at a good point, in the sense that the macroeconomic picture in many countries has strengthened, and new and old economic teams are very clear on the policies needed for macroeconomic stability and reforms. Moreover, the region will benefit from the higher oil prices, with some of the countries big winners. The challenge is to use the oil wealth wisely to help reduce macroeconomic imbalances, spur growth, and lessen dependence on oil for growth. The region also needs to cope with the challenge of regional integration, both in the Gulf and in North Africa. In all of these areas, the IMF can help with policy advice and technical assistance.

**IMF SURVEY:** With the 60th anniversary of the Bretton Woods institutions and prompting from the major industrial countries, the IMF is undertaking a strategic review of its work. Can you fill us in on how this review is coming along and what we should expect from it?

**DE RATO:** First, the IMF is responding to what is clearly a demand by many countries and by public opinion to think about its role and work. The IMF is proving both that it has the capability to do so and that it's open-minded enough to take on board what others think. Second, an international institution that deals with macroeconomic and financial issues has to be very aware of the depth and speed of changes in the world and how those changes affect it. So it isn't that the IMF is looking for a job, but rather that the job is changing—over the past 10 years, we've seen a change in the strength of international markets, the demand for technical assistance, and the way we can prevent and resolve crises. This is a very good exercise, and it's not a theoretical one.

**IMF SURVEY:** When should we have some results?

**DE RATO:** By the time of the IMF–World Bank Spring Meetings. I'd like to try to float some ideas by that time.

**IMF SURVEY:** Do you expect any changes in the way the IMF does its work as a result of the review?

**DE RATO:** Why not? I don't think we have to be afraid of changes. We just have to be sure of two things: that what we do makes a difference and that we're good at what we do. And I believe in these two things. I would hope that there are changes in how the IMF performs its work as a result of this analysis; after all, that's what it's all about.

**IMF SURVEY:** Any preset changes that you expect?

**DE RATO:** I don't want the exercise to be determined by any one person's preferred changes, even my own. It should be a collective analysis that draws on all of the

IMF's intellectual resources and is shared and understood by everyone. I will be a part of it, but just one part.

**IMF SURVEY:** In Africa, many leaders are raising the question of giving African countries a stronger voice in the IMF's operations and policies. In Asia, also, many countries feel that they are underrepresented in the IMF because their quotas are out of line with their current economic importance. Do you think the legitimacy of the IMF is being threatened by the failure of the membership to reach agreement on a reform of quotas and representation?

**DE RATO:** I don't think our legitimacy has been threatened, because we're operating on an agreed system. But there are a lot of voices asking for a new agreement to reinforce our legitimacy, and it's a very serious problem.

**IMF SURVEY:** What would it take to get an agreement?

**DE RATO:** Political consensus. I don't think it's a technical issue of finding more appropriate quotas or voting weights. It's a question of countries being willing to sit down and make this issue a priority. I think it's a priority, and I said that in my October speech at the Annual Meetings.

**IMF SURVEY:** One of the IMF's top priorities is helping the poorest countries—most of which are in Africa—reach the Millennium Development Goals [MDGs]. Jeffrey Sachs argues that what Africa really needs is “a big push”—a flood of foreign aid. Is that the answer to ending its desperate plight? What do you say to those who say that there is too much focus on the MDGs, given that we need to be concerned about post-2015 also?

**DE RATO:** We agree that more and better aid is needed, and it's needed now! We urge governments to realize that aid has to be increased, that it has to be more predictable, and that donors should improve their coordination to ensure that their respective requirements do not impose excessive burdens. We also need to strengthen our work, such as supporting countries in their preparation of Poverty Reduction



During a visit to Nakiwogo primary school in Entebbe, Uganda, de Rato points out the location of his home country, Spain.

Strategy Papers, which underpin debt relief and IMF and World Bank lending programs. These papers are extremely useful in helping countries develop good and sustainable strategies for poverty reduction that are homegrown.

Is there too great a focus on the MDGs? I don't think so. They're very useful because progress toward them is measurable. In fact, the IMF is closely involved in the international community's effort to monitor progress toward the MDGs.

**IMF SURVEY:** Over the past six months, you've visited all of the regions in the world as part of a "listening tour." What are the most important things that you've learned?

**DE RATO:** The trips over the past five months have been very enlightening. I've been able to meet with many heads of state, prime ministers, finance ministers, and central bank governors, along with IMF staff who work in the field. This has allowed me to broaden my perspective on problems and listen to different approaches to solving them. The trips have certainly reaffirmed the idea that national ownership is an essential element in the design of economic policy—an idea that I already had before I came to the IMF, based on my own experience. They have also reaffirmed that our advice, along with sound macroeconomic policy, does help countries better position themselves to cope with challenges. ■

## Russia should keep fiscal policy in check

*(Continued from front page)* downsize entitlements to affordable levels, ensure full funding of remaining benefits, delineate the social spending responsibilities of federal and local governments, and replace in-kind benefits with monetary compensation.

In addition, the government is proposing to cut the social security tax, a measure that would reduce revenue by nearly 1¼ percent of GDP in 2005. The social security tax, levied mostly on payrolls, is the government's single most important source of revenue, collecting what amounts to nearly 8 percent of GDP. This revenue is earmarked for pensions, health care, and disability benefits.

Reducing the social security tax is not in itself a bad thing. The tax represents a burden on business and is holding back the growth of small and medium-sized businesses by impeding investment and encouraging tax evasion. Advocates of the tax cuts believe that any adverse effect on revenue will

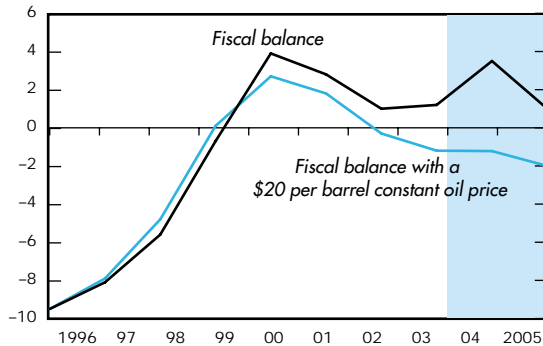
be offset by better tax compliance and positive supply effects. But the extent of such revenue gains is uncertain. Experience with previous tax cuts suggests that stronger tax administration is essential for broadening the tax base.

Cutting the social security tax—combined with the proposed increase in social spending—will therefore most likely leave a big hole in the budget. And while the government is expecting to raise additional revenues through other taxes—including on personal property, dividends, and mixed income—these gains are likely to be minor. This leaves oil taxes. According to the government, these will become steeply progressive, with marginal rates increasing at high oil prices. The government expects this will boost tax revenue by some ½ of 1 percent of GDP at oil prices over \$30 a barrel (there will be almost no gains, though, at \$20 a barrel). The 2005 budget expects to raise additional revenue totaling ¾ of 1 percent of GDP mostly through windfall taxes on the oil sector.

The tax cut also brings to light the urgency of a comprehensive pension reform. Public pension expenditures are projected to rise by as much as 4 percentage points of GDP by 2040 (owing mainly to a rapidly aging baby-boom generation) unless benefits are scaled back and the retirement age is increased. The pension fund will receive an additional ¼ of 1 percent of GDP as a result of a planned diversion of some pension contributions from the fully funded system to the pay-as-you-go system. But this still leaves a substantial deficit for 2005, which the government is proposing to cover by drawing 75 billion rubles from the oil stabilization fund. According to the government, this is a

### Government finances would be in deficit, were it not for higher oil prices

(percent of GDP)



Note: Shaded area indicates projections.  
Data: Russian Ministry of Finance and IMF

one-off measure, and comprehensive pension reform—including an extension of the retirement age—will be needed to restore the long-term solvency of the public pension system.

### Avoiding oil-induced booms and busts

In the short term, given the very strong oil price outlook, gains from oil taxes will probably more than offset losses from the tax cut, helping the government maintain a budget surplus while carrying out its planned reforms (see chart, page 332). But over the longer term, the proposed changes will expose government revenues to the vagaries of changing oil prices. Revenue volatility has already increased substantially since the 1998 crisis because of the heightened importance of the oil sector in the economy and the changes in tax laws.

This makes it all the more important for the government to institutionalize a system of saving revenue windfalls by maintaining the oil stabilization fund that was set up in 2004. The fund has begun accumulating revenue windfalls, defined as oil taxes arising from Urals oil prices over \$20 per barrel, and is expected to reach its cap of 500 billion rubles (about 2¾ percent of GDP) before the year is out. After that,

current legislation allows the government to spend any surplus, removing statutory safeguards against a fiscal policy that will amplify—rather than attenuate—oil-induced booms and busts.

To remedy some of these problems, the finance ministry recently proposed to increase the cap of the oil stabilization fund—possibly by as much as 4½ percent of GDP—and to use surplus revenue to repay external debt and finance a moderate increase in infrastructure projects. It also proposed to discontinue the use of windfall revenues to finance pension deficits.

Russia should think hard about what it does with its oil riches. If used unwisely, the country's oil wealth could quickly undo years of hard work in bringing down inflation and putting the economy on a sounder footing. The finance ministry's proposals would help preserve these hard-earned gains. ■

Copies of IMF Country Report No. 04/316, "Russian Federation: Selected Issues," are available for \$15.00 each from IMF Publication Services. See page 335 for ordering information. The full text of the report is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

### De Rato warns Russia against relaxing fiscal policy

During a November 17–18 visit to Moscow, IMF Managing Director Rodrigo de Rato counseled President Vladimir Putin to fully save Russia's windfall oil revenues. "We support the prudent budgetary policy pursued by the Russian authorities in recent years, in particular the saving of oil revenue windfalls. This cautious policy has prevented overheating and helped preserve competitiveness," de Rato told President Putin during his two-day visit. Pointing to the need to slow inflation, he advised the Russian government against relaxing the 2005 budget. By continuing to channel windfall oil revenues into the stabilization fund, the government



De Rato (left) praised Russia's economic policies during his visit to Moscow, but told President Putin the country would do better economically if it continued to fully save its oil revenue windfalls.

could slow down the appreciation of the ruble, which would free monetary policy to focus on lowering inflation, he said.

De Rato also encouraged President Putin to use oil revenues to repay external debt ahead of schedule, as proposed recently by the Russian finance ministry. According to the Russian news agency ITAR-TASS, President Putin told de Rato during their discussion that he was considering the early repayment of loans owed to the IMF and the Paris Club. With outstanding loans amounting to \$3.7 billion, Russia is the IMF's fifth largest debtor.

Please refer to Press Release

No. 04/244, available on the IMF's website ([www.imf.org](http://www.imf.org)), for more information.

## Bretton Woods institutions, World Council of Churches find common ground

Leaders of the IMF and the World Bank met for the first time with leaders of the World Council of Churches (WCC) in Geneva on October 22. The meetings followed a number of staff-level discussions since 2002 on issues related to poverty reduction and development. The leaders acknowledged significant

areas of common ground between the Bretton Woods institutions and the WCC but also continuing differences that need to be further explored.

The main meeting, moderated by Cornelio Sommaruga, former president of the International Red Cross, took place in the WCC headquarters before members of its governing council and staff, participants from affiliated institutions, rep-

representatives of the Christian press, and World Bank and IMF staff. Rev. Dr. Sam Kobia, General Secretary of the WCC, explained that his organization, the main interdenominational organization of Protestant churches, established in 1948, has a proud history of giving voice to the voiceless. The WCC is committed, he said, to a people-centered world economy and development process. Growth and “trickle down” are not enough to reduce poverty; inequalities must also be

dealt with, and he called on reasonable people to acknowledge that environmental realities leave no room for assuming that there can be “growth without limit.”

Dr. Agnes Abuom, the WCC’s President for Africa, pointed to the highly visible gaps between rich and poor, and argued that redistributive measures are needed to encourage just, participatory, and sustainable communities. She also criticized the lack of democracy in the Bretton Woods institutions, saying that at present they essentially function as a platform for industrial countries.

World Bank President James Wolfensohn said he had long been convinced of the valuable role of faith-based groups in development and had sought to build bridges with these groups—sometimes over the objections of his own Board. A 2002 WCC publication had questioned the Bank’s commitment to fighting poverty, but that commitment, he said, was not only deep, it was often driven, at the staff level, by faith-based beliefs. Wolfensohn also called on critics of governance in the Bretton Woods institutions to recognize that it is their member countries, not management, that can change the situation. What concerned him most, he said, was the possibility that the fight against global poverty could fall victim to the current preoccupation with security and to a crisis of inaction that has left many promises unfulfilled.

For the IMF’s part, Deputy Managing Director Agustín Carstens said, one of the key steps in a dia-



IMF Managing Director Rodrigo de Rato (right), en route to the Middle East, met briefly with James Wolfensohn and Rev. Dr. Sam Kobia before the main discussion.

### Recent publications

#### IMF Working Papers (\$15.00)

- 04/173: “Domestic Competition Spurs Exports: The Indian Example,” Tushar Poddar
- 04/174: “Microfinance in Africa: Experience and Lessons from Selected African Countries,” Anupam Basu, Rodolphe Blavy, and Murat Yulek
- 04/175: “Insurance Value of International Reserves: An Option Pricing Approach,” Jaewoo Lee
- 04/176: “Sources of Growth in Sub-Saharan Africa,” Bernardin A. Akitoby, Dhaneshwar Ghura, Amor Tahari, and Emmanuel Brou Aka
- 04/177: “What Is an Emerging Market?” Ashoka Mody
- 04/178: “Trade Liberalization, Exchange Rate Changes, and Tax Revenue in Sub-Saharan Africa,” Terence Agbeyegbe, Janet G. Stotsky, and Aseggedech WoldeMariam
- 04/179: “Quota Brokers,” Susumu Imai, Kala Krishna, Abhiroop Mukhopadhyay, and Ling H. Tan
- 04/180: “An Institutional Framework for Comparing Emerging Market Currency Boards,” Marie-Therese Camilleri Gilson
- 04/181: “Pension Funds and Emerging Markets,” Jorge A. Chan Lau
- 04/182: “What Do We Know About Tariff Incidence?” Stephen P. Tokarick
- 04/183: “Intercreditor Distribution in Sovereign Debt Restructuring,” Ousmene-Jacques Mandeng
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- 04/187: “Defining Financial Stability,” Garry J. Schinasi
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- 04/189: “Can Higher Reserves Help Reduce Exchange Rate Volatility?” Ketil Hviding, Michael Nowak, and Luca A. Ricci
- 04/190: “The Internal Job Market of the IMF’s Economist Program,” Greg Barron and Felix Vardy

logue such as this one is to ensure that the organization's mandate is understood. The IMF helps member countries create the stable macroeconomic foundations needed for sustained growth and poverty reduction, and, in times of crisis, helps countries take the steps needed to ward off serious damage. In addition, Carstens underscored the importance of trade in facilitating development and poverty reduction. In response to questions about the IMF's work, he emphasized that the organization's surveillance of member countries' policies ensures that all countries receive the same rigorous analysis and that its global economic and financial reviews keep an eye on the effects of industrial country policies on developing countries.

In summing up, Sommaruga praised the "high quality" of the dialogue and suggested, partly on the basis of questions that had arisen in the discussion, five areas for future consideration: issues relating to indigenous peoples; country feedback on the poverty reduction strategy process; continued efforts to implement the UN Millennium Development Goals, with a particular emphasis on community programs and education; governance issues; and stepped-up measures to treat and reduce the incidence of HIV/AIDS. There was agreement that the dialogue between the Bretton Woods institutions and the WCC would continue at the staff level, including through case studies of country experiences.

The three organizations also released a joint statement and a paper, "Common Ground and Differences of View Between the Bretton Woods Institutions and the World Council of Churches." The paper emphasizes that "the three organizations share the objective

of reducing poverty and are working to achieve this objective in the respective areas of our mandates and responsibilities. Important among the aims of our dialogue are that it should help to increase the effectiveness of our work to reduce poverty, including by improving the communication and cooperation between the Bretton Woods institutions and the WCC."

The paper, which reflects work in progress in the continuing dialogue, focuses on four areas:

- institutional and governance issues in the Bretton Woods institutions (including voice and representation of developing and emerging market countries);
- the evolving roles and activities of the IMF and the World Bank in improving human welfare and assisting its member countries in reducing poverty and achieving the UN Millennium Development Goals;
- the domestic and international strategies needed to achieve successful economic and social development (strategies that will need to address such issues as market failures, international trade and capital flows, balance of payments problems, resource transfers, country ownership of its policies, debt relief and debt reduction, and globalization); and
- a report on economic and social progress, which welcomes sharp reductions in poverty in Asia but notes that there is much that still needs to be done elsewhere, including tackling the HIV/AIDS scourge. ■

The joint statement and paper are available on the websites of the three organizations, including the IMF's (<http://www.imf.org/external/np/sec/pr/2004/pr04220.htm>). Also on the IMF's site is the full text of Agustín Carstens's remarks.



Abuom: Just, participatory, and sustainable communities must be encouraged.



Carstens: The IMF helps member countries create the stable macroeconomic foundations needed for sustained growth and poverty reduction.

- 04/191: "A New Taxonomy of Monetary Regimes," Mark R. Stone and Ashok J. Bhundia  
 04/192: "The Mussa Theorem and Other Results on IMF-Induced Moral Hazard," Olivier D. Jeanne and Jeromin Zettelmeyer  
 04/193: "Work Absence in Europe," Leo Bonato and Lusine Lusinyan

#### IMF Country Reports (\$15.00)

(Country name represents an Article IV consultation)

- 04/276: Former Yugoslav Republic of Macedonia: Second Review Under the Stand-By Arrangement and Ex Post Assessment of Performance Under Fund-Supported Programs  
 04/277: Bangladesh: Joint Staff Assessment of the PRSP Status Report  
 04/278: Republic of Tajikistan: Joint Staff Assessment of the PRSP Progress Report  
 04/279: Bangladesh: PRSP Status Report  
 04/280: Republic of Tajikistan: PRSP Progress Report  
 04/281: Philippines: ROSC—Data Module  
 04/282: Tanzania: PRSP Progress Report  
 04/283: Tanzania: Joint Staff Assessment of the PRSP Progress Report  
 04/284: Tanzania: Selected Issues and Statistical Appendix  
 04/285: Tanzania  
 04/286: Dominica: Second Review Under the Three-Year Arrangement Under the PRGF and Request for Waiver of Performance Criterion  
 04/287: Jordan: Third Review Under the Stand-By Arrangement  
 04/288: Russian Federation: ROSC—Fiscal Transparency Module

PRSP=Poverty Reduction Strategy Paper  
 ROSC=Report on the Observance of Standards and Codes

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*New evidence from Malaysia*

## Do foreign banks perform better in financial crises?

**O**ver the past decade or so, foreign banks have greatly increased their presence in emerging market countries. But has their presence afforded greater stability? Enrica Detragiache and Poonam Gupta of the IMF Research Department recently examined how domestic and foreign banks weathered the financial crisis that hit Malaysia in 1997. Their case study revealed sharp performance differences between banks (both foreign and domestic) that were active mainly in Asia and foreign banks that did not specialize in Asia. Jacqueline Irving of the IMF Survey spoke with them about their findings.

**IMF SURVEY:** Why did you decide to examine how foreign banks perform relative to domestic banks during financial crises? And why Malaysia?

**DETRAGIACHE:** There has been a lot of foreign bank entry in emerging markets in the past 10 years or so, and many researchers and policymakers are wondering how this will affect the banking sector in these markets. While there have been studies of how foreign bank entry affects market competition, local bank performance, and other factors, we are not aware of any studies that have looked at how foreign banks perform during crises relative to domestic banks. We also thought this would be an interesting topic because there have been many such crises.

**GUPTA:** As for Malaysia, one interesting question is whether the presence of foreign banks declines or increases during or just after a crisis. When emerging markets' financial sectors are liberalized following a crisis, one finds that the number of foreign banks increases because of the liberalization, and this effect cannot be distinguished from the actual effects of the crisis. We chose to look at Malaysia because it has had a sizable foreign bank presence for a long time, provides a typical case of an emerging market crisis, and has good data availability. We were able to obtain macro level as well as bank level data, and we had detailed information on government support to individual banks during the crisis.

**IMF SURVEY:** Did foreign banks weather the crisis better than domestic banks?

**DETRAGIACHE:** We found that the sharpest difference was not between foreign banks and domestic banks, but between foreign banks that were mainly active in Asia and those that were not. Some foreign

banks—for example, a few from other Southeast Asian countries and two U.K. banks that specialized in Asia—tended to perform more like domestic banks. In contrast, foreign banks from outside the region—for example, certain U.S. and German banks that did not specialize in Asia—seemed to perform better during and following the crisis. This latter group of banks did not see declining profitability; its nonperforming loans increased less markedly; and, in general, its performance indicators were better. This group also experienced less of a decline in deposit growth.

**GUPTA:** Aside from banks' performance indicators, we also looked at whether their postcrisis presence in the market changed and whether they received government support. On market presence, we found the results statistically indistinguishable among the three bank groupings. After the crisis, foreign banks did not reduce their presence faster than domestic banks. However, the results strongly showed less government support for foreign banks—particularly for foreign banks that were more active in Asia despite having high nonperforming loans.

**IMF SURVEY:** What do you think explains this difference in behavior between foreign banks that did and did not have an Asia orientation?

**DETRAGIACHE:** There is no obvious explanation, and it probably is still somewhat of an open question. One possibility is that the banks that did not have an Asia orientation received more financial support from their parent banks and therefore were not as affected by liquidity problems as the more locally oriented banks. When we looked at the bank data, however, we saw that the non-Asia-oriented banks had lower amounts of nonperforming loans. So, not only did they have more access to liquidity, they also had better loan portfolios to begin with.

The question then became: why did their loan portfolios perform better? One hypothesis we had was that these banks were lending to multinational corporations. Since these banks were not specialized in Asia, their overall client base would tend to do relatively less business in Asia and thus be more insulated from the effects of the Asian crisis.

This seemed plausible, but then we found data showing this was not the full explanation. The sectoral composition of loan portfolios showed that

We found that the sharpest difference was not between foreign banks and domestic banks, but between foreign banks that were mainly active in Asia and those that were not.

—Enrica Detragiache



### Less exposure to risky sectors helped non-Asia-oriented foreign banks

	Broad property sector (percent of total loan portfolio <sup>1</sup> )	Manufacturing sector
All banks	35.1	15.3
Asia-oriented foreign banks	34.0	21.5
Non-Asia oriented foreign banks	15.4	34.2

<sup>1</sup>End-1998.  
Data: Bank Negara Malaysia

the non-Asia-oriented foreign banks had more manufacturing loans [see table above]. They also were less exposed to the real estate sector and had made fewer loans to finance the purchase of securities by private investors—two trouble spots where most of the loan quality problems were concentrated. The Asia-oriented foreign banks and the domestic banks had relatively high exposure in these two areas. So, clearly, the banks' different behavior before the crisis explained performance differences after the crisis.

#### **IMF SURVEY:** Why did the banks choose different kinds of portfolios?

**GUPTA:** One possible explanation could be moral hazard, although this does not explain why Asia-oriented foreign banks chose to follow a high-risk strategy similar to that of domestic banks. The foreign banks did not receive government support in any significant way. The other possibility is herd behavior.

**DETRAGIACHE:** To elaborate further, the loan portfolio managers of Asia-oriented foreign banks may have chosen to follow the “herd” of bankers in the region who sought to make high profits by investing in risky sectors and, so, became caught up in the speculative bubble along with their peer groups. In contrast, the relevant peer group for bank managers not specialized in Asia may have been different, shielding them more so from risky lending.

This points to good governance within a bank, whether domestic or foreign, as mattering more than access to emergency liquidity. One of the arguments in favor of emerging markets being more open to foreign bank entry is that, in some sense, these countries are able to import sound supervisory rules and practices because it is the home country supervisor that supervises the foreign banks. But we could not find very convincing evidence of this. We should stress, however, that this is just one country case study looking at a small sample of banks, and it would be premature to generalize without further research.

**IMF SURVEY:** Thailand's financial crisis of 1997–98 blurred the once clear division between domestic and foreign banks: four of the five smallest domestic banks came under the control of foreign owners. Did this occur in Malaysia as well, to any extent?

**GUPTA:** We looked at very detailed information at the bank level, and we did take into account any big changes in bank history and operations, including mergers and acquisitions. But we did not see this happening in our sample of banks. In terms of whether foreign banks acquired domestic banks and whether that changed the sample in any way, the answer is no.

**DETRAGIACHE:** I do not think there was a policy shift on the part of the Malaysian authorities to let in more foreign banks. But we did not focus in our research on whether the crisis triggered more foreign entry per se.

**IMF SURVEY:** Two Singaporean banks, OCBC and United Overseas Bank, emerged in the five years following the crisis in Malaysia to advance into the top ranks. Do you plan to look further at differences in bank performance several years in the wake of crises?

**DETRAGIACHE:** We don't have immediate plans to do so, but crises lead to major changes in market structure along many dimensions, and the extent to which these changes lead to better performance is a very interesting question in the medium term and awaits an answer.

**IMF SURVEY:** Do you or your colleagues have plans to see whether these findings would hold in other countries or regions?

**DETRAGIACHE:** It would depend on whether we could find the right episodes. We originally looked at a larger sample of countries to find countries for which we could obtain foreign bank data. We ended up choosing Malaysia. Since we started our research, there have been a few more episodes of financial market distress—for example, in Uruguay, where the crisis has been different. This could provide another interesting case study. ■

Copies of IMF Working Paper No. 04/129, “Foreign Banks in Emerging Market Crises: Evidence from Malaysia,” are available for \$15.00 each from IMF Publication Services. See page 335 for ordering information. The full text of the paper is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

**After the crisis, foreign banks did not reduce their presence faster than domestic banks.**

—Poonam Gupta

## Getting a truer measure of producer price inflation

Ever since the mid-1990s, when Alan Greenspan, Chair of the U.S. Federal Reserve Board, labeled the U.S. consumer price index biased, the search has been on for more accurate price indices. That effort is now bearing fruit with the release, in July, of the International Labor Office's revised *Consumer Price Index Manual* and with the publication, in September, of the IMF's new *Producer Price Index Manual*. Paul Armknecht, a Deputy Division Chief in the IMF's Statistics Department, explains why statistical improvements in price indices are needed and what users can expect from the new producer price index (PPI) manual.

In a sense, Greenspan's concern—that the index used to measure consumer prices was overstating inflation—was a fairly technical matter. But it was a technical issue with huge implications for the federal budget. Since the

U.S. government uses the consumer price index (CPI) to index payments for such large-scale programs as social security, welfare, and federal pension payments, even a small increase in the CPI translates into significant sums for the U.S. budget.

Spurred by the Greenspan remark, the U.S. Senate Finance Committee convened an advisory commis-

sion, chaired by Michael Boskin, to examine the accuracy of the CPI. Its report, released in December 1996, suggested that the U.S. CPI overstated inflation by between 0.8 and 1.6 percent annually. Why this upward bias? Principally, the report said, because the market basket of products and shops had been kept fixed for long periods and because improvements in the quality of products were not being adequately captured.

This potential bias in the CPI raised questions, too, about the accuracy of the PPI. CPI measures changes in the prices of goods (such as milk and appliances) and services (such as rent and auto repair) bought by households, while the PPI measures inflation for goods (for example, steel girders and cases of tomato paste) and services (for example, accounting and legal services) bought and sold by businesses. A true picture of the inflationary pressures facing an economy requires an accurate measurement of both the CPI and the PPI.

### Fixing what's broken

The issues first raised in the United States had ramifications for statistical offices around the world. In response, the international organizations concerned with inflation measures formed the Intersecretariat Working Group on Price Statistics. Atop that group's agenda was the development of new manuals on best practices for price indices. The IMF's Statistics Department, which is the primary provider of technical assistance on inflation-related statistical topics and is heading the effort to develop international standards for the PPI (see box), was asked to take the lead in improving producer price statistics.

Under its guidance, preparation of the new manual focused on recent developments in relevant statistical theory and practice as well as key changes in the economy and weaknesses that had been identified in current practices. In particular, the IMF Statistics Department identified six weaknesses:

- **Problems in standard fixed baskets.** Advances in index number theory have pointed to weaknesses in the standard fixed basket (Laspeyres-type) indices commonly used to develop a PPI. The manual suggests that a better market basket is one that includes both current and comparison periods (symmetric index) in the calculation. Three such indices—the Fisher Ideal index, the Walsh index, and the Törnqvist index—offer more sophisticated approaches.



### Why the IMF took the lead in PPI

In the early 1990s, when the Soviet Union dissolved and a number of independent countries were being formed, the new national statistical agencies found themselves with no ready provider of technical assistance in price statistics. The International Labor Office, which has technical oversight for methods and procedures in the consumer price index, lacked the budgetary resources to provide assistance on producer prices. The UN Statistics Division, which produced the previous manual on producer price indices in industrial activities, had discontinued its work in this area for similar reasons.

That left the IMF, which needed measures of inflation to gauge economic performance, to provide technical assistance through its Statistics Department. Over the years, the IMF has continued to help countries worldwide develop the means to measure consumer and producer price inflation.

- **Low-level indices.** Recent evidence suggests that there is a significant potential for upward bias in low-level indices where prices for detailed products, such as sheets of rolled aluminum, are first combined to produce an index. Currently, low-level indices are compiled as an unweighted, simple average of price observations. This generally gives more importance to products with larger price changes than to those with small or declining price changes. The manual recommends that geometric averages of price changes be used to help resolve this problem and that detailed product weights information be obtained to compute weighted averages.

- **Quality differences.** At present, no, or inadequate, adjustments are made for quality differences among existing and new products. If no adjustments are made for quality differences, price differences due to improved quality are counted as price changes. Newer statistical models, such as “hedonic” regression analysis, permit compilers to measure the quality component and adjust for the quality contribution using standard index number methods.

- **Seasonal products.** At present, seasonal price movements distort monthly price movements and make it more difficult to measure underlying trends. The manual recommends applying statistical methods to reduce the effects of seasonal changes and smooth the time series.

- **PPIs typically exclude services.** While services are the fastest growing sector in most economies, it is often difficult to measure price changes in this sector, and most countries are still reluctant to include services in the PPI. To encourage the inclusion, the manual highlights the experience of a number of countries that have been successful in including more services.

- **Family of indices needed.** Because inflation does not affect all segments of the economy equally or during the same time period, a single index number does not satisfy the needs of most users. The manual recommends using a family of indices to measure the PPI by industry, product, stage of processing, and the like. This allows the PPI to track inflationary movements throughout the chain of distribution in the economy (from primary products to intermediate

goods and services to final demand).

### Reading the manual

The IMF’s *Producer Price Index Manual* pulls together both analysis and best practices in compiling more accurate data and is intended for both expert and general audiences. Chapters 1 and 2 are intended for general readers, with an overview and summary in the first chapter that can serve as a primer on index number theory and practice.

The second chapter offers background on index number history and the uses of the PPI.

Chapters 3–13 are meant to provide guidance for compilers on coverage, construction, processing, and publishing the producer price index. Chapters 14–22 present the concepts and theory of the producer price index for professional economists, students of economics, and more advanced compilers. ■



Steel products at a construction site in Korea. PPI measures inflation for goods and services bought and sold by businesses.

Copies of both the *Producer Price Index Manual: Theory and Practice* (English) (French, Spanish, and Russian forthcoming) and the *Consumer Price Index Manual: Theory and Practice* (English) (French, Spanish, and Russian forthcoming) can be ordered from IMF Publication Services for \$125.00 each. See page 335 for ordering details. The IMF’s Statistics Department is currently also developing the *Export/Import Price Index Manual*, which is expected to be available late next year.

### Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
November 8	2.14	2.14	3.30
November 15	2.17	2.17	3.34
November 22	2.18	2.18	3.36

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?2004](http://www.imf.org/cgi-shl/bur.pl?2004)).

General information on IMF finances, including rates, may be accessed at [www.imf.org/external/fin.htm](http://www.imf.org/external/fin.htm).

Data: IMF Finance Department

**Photo credits:** Henrik Gschwindt De Gyor, Eugene Salazar, and Michael Spilotro for the IMF, pages 329–31, 336–38, 342, and 344; Tatyana Makeyeva for AFP/Getty Images, pages 332–33; Yuri Kochetkov for AFP/Getty Images, page 333; H. Salgado for World Council of Churches, pages 334–35; Jung Yeon-Je for AFP, page 339; and Grigory Dukor for Reuters, pages 340–41.

The government's budget deficit was crowding out bank lending to the real sector by creating an environment in which banks could invest more profitably in the treasury bond market.

## Escaping banking traps: Russia's experience

At least on the surface, several aspects of the Russian economy before and after the financial crisis in 1998 just don't make sense. For instance, companies started building up massive arrears after macroeconomic policies had stabilized the economy, and barter trade exploded in 1994—despite the fact that many new banks had opened their doors in the years following the collapse of the Soviet Union. Following the outbreak of crisis, which brought down many banks, arrears and barter mysteriously started to decline, even though one would have expected them to increase further because of a drying up of credit. Furthermore, contrary to the experience of most countries hit by crisis, Russia's economy began to grow almost immediately after the crisis.

In a recent Working Paper, Haizhou Huang (IMF Research Department) and Dalia Marin and Chenggang Xu (both visiting scholars in the Research Department) take an in-depth look at these anomalies. They suggest that Russia was caught in a banking trap before the crisis. Because of perverse incentives created by the Russian government, the banking sector had become almost completely divorced from the real sector. Instead of lending to companies in dire need of cash, Russia's new banks were busy cashing in on government treasury bonds, known as GKOs.

After the collapse of the Soviet Union in 1990, Russia traveled a bumpy road in its transition to a market economy. The real sector contracted sharply, with output in 1998 still at only about 50 percent of the level in 1989. In this climate, companies accumulated large debts and built up arrears. As a result, non-cash payments and barter rose from 8 percent of sales in 1994, when inflation was still under control, to more than 50 percent of sales in 1998.

In contrast to the struggling real economy, the financial sector was having a field day, with the number of banks swelling from fewer than 100 in 1988 to more than 2,500 in 1998. But despite this explosion in the number of banks, and despite the fact that many of them were owned by large firms, the financial sector failed to lend money to companies in the real sector. The ratio to GDP of credit to the private sector declined from 12 percent in 1994 to 8 percent in 1997. Instead, commercial banks invested in treasury bonds. By the end of 1997, they had invested almost three-quarters of their ruble deposits in federal government securities. Even those companies that owned banks chose to finance their investments through other means and went as far as letting their banks absorb company credit so that it, too, could be invested in GKOs.

Given Russia's poor economic performance, the crisis in 1998 did not come as a surprise. What did surprise many was the economy's rapid and strong recovery. Total arrears and barter started to decline almost immediately, with barter and noncash payments dropping by 20 percent in 1999. What's more, banks began to lend to the real sector almost immediately after the crisis. Ruble loans to the economy more than doubled in nominal terms between 1998 and 1999, rising from 123 billion rubles to 293 billion rubles. At the same time, interest rates on loans declined sharply in nominal as well as real terms.

### The banking trap

To explain why events unfolded as they did, Huang and his coauthors developed a model that assumes the existence of severe information asymmetry in the Russian economy, which made banks unable to distinguish good credit risk from bad. As a consequence, banks charged high interest rates on all loans to the private sector. This, in turn, induced even sound companies to turn to nonbank finance, such as trade credits and barter trade, where information asymmetry was less of a concern—but costs were much higher. The fact that viable firms were able to raise liquidity through nonbank finance drove up the cost of bank lending even more, since banks now expected that only lower-quality firms would borrow. Within this new equilibrium, the banking sector developed a strong preference for investing in high-yield government securities.

The model suggests a link between the government's budget deficit and the noncash economy that has been overlooked so far. It is often argued that the increase in arrears and barter trade in Russia was driven by tax motives. According to the traditional argument, by allowing firms to hide some profits and thereby lower their taxable income, nonbank finance contributed to the difficulty of raising taxes and, thus, caused the government's budget deficit to explode. Huang and his coauthors point to another reason for the increase in arrears and barter trade: the government's budget deficit was crowding out bank lending to the real sector by creating an environment in which banks could invest more profitably in the treasury bond market. This forced the real sector to turn to nonbank finance. This banking trap—where the financial sector has separated from the real sector—hinders banking sector development and economic growth, although on the surface there is financial exuberance, particularly in the government securities market.

The model also highlights the role of the financial sector after the crisis and explains why the 1998 crisis was beneficial in some ways for the Russian economy. When the Russian government defaulted on its bonds in August 1998, the government securities market collapsed. Although many banks with large holdings of government securities went bankrupt, the economy turned around, moving from negative to positive growth. The nonexistence of a market for government bonds induced the surviving banks to reallocate their assets to loans in the real sector—offered at lower interest rates to attract borrowers. Lower interest rates, in turn, made it attractive for some better-quality firms to start borrowing from banks rather than continuing to use nonbank finance. This improved the average creditworthiness of the pool of borrowers, further lowering interest rates and inducing more firms to switch from barter trade to bank loans. The regressions carried out by Huang and his coauthors suggest that the financial crisis changed the behavior of the banking sector in a fundamental way. The strong economic recovery that followed the crisis was thus largely the result of Russia's escape from the banking trap.

#### A cathartic effect

The model suggests that a financial crisis, though often causing a credit crunch and a deep economic

recession, may have benefits. If the economy is stuck in a banking trap, a crisis may help it escape the trap and, thus, bring about a strong economic recovery. This, in turn, sets the stage for developing the financial sector.

These findings also have implications for what policymakers need to do after an initial economic recovery. If sustainable growth is to be achieved, banking reform must be undertaken. Reducing the information asymmetry between banks and their borrowers through policies aimed at improving corporate governance, accounting, transparency, and credit risk management is key. And as bank lending grows, developing mechanisms for enforcing contracts becomes increasingly important. Fiscal policy should also be given high priority. The government should tighten its budget and avoid recreating an environment in which government bonds crowd out bank loans. ■

Copies of IMF Working Paper No. 04/105, "Financial Crisis, Economic Recovery, and Banking Development in Russia, Ukraine and Other FSU Countries," by Haizhou Huang, Dalia Marin, and Chenggang Xu, are available for \$15.00 each from IMF Publication Services. See page 335 for ordering information. The full text of the paper is also available on the IMF's website ([www.imf.org](http://www.imf.org)).

This banking trap—where the financial sector has separated from the real sector—hinders banking sector development and economic growth, although on the surface there is financial exuberance, particularly in the government securities market.

### Available on the web ([www.imf.org](http://www.imf.org))

#### Press Releases

- 04/235: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of His Visit to Mexico, November 9
- 04/236: IMF Mission Statement at the Conclusion of the 2004 Article IV Consultation Discussions with El Salvador, November 10
- 04/237: Statement by the IMF Resident Representative in Chad, November 12
- 04/238: IMF Completes Fifth Review Under Sierra Leone's PRGF Arrangement and Approves \$21.1 Million Disbursement, November 12
- 04/239: IMF Managing Director Rodrigo de Rato to Visit Russia, Germany, Poland, and Spain, November 15
- 04/240: IMF Executive Board Approves \$4.4 Million in Emergency Assistance for Grenada, November 16

#### Public Information Notices

- 04/121: IMF Concludes 2004 Article IV Consultation with France, November 3
- 04/122: IMF Concludes 2004 Article IV Consultation with Ireland, November 4
- 04/123: IMF Concludes 2004 Article IV Consultation with Tunisia, November 8

- 04/124: IMF Concludes 2004 Article IV Consultation with Australia, November 8
- 04/125: IMF Concludes 2004 Article IV Consultation with Papua New Guinea, November 10
- 04/126: IMF Concludes 2004 Article IV Consultation with the Republic of Estonia, November 11
- 04/127: IMF Concludes 2004 Article IV Consultation with Benin, November 12
- 04/128: IMF Concludes 2003 Article IV Consultation with St. Lucia, November 15
- 04/129: IMF Concludes Article IV Consultation with Rwanda, November 16

#### Speeches

- "Agricultural Trade Reform: The Role of Economic Analysis," Anne O. Krueger, IMF First Deputy Managing Director, Department of Foreign Affairs—Australian Bureau of Agricultural Research Conference, Canberra, Australia, November 4
- "Spreading Prosperity and Resisting Economic Divergence: The Significance of Richard Snape's Academic Legacy," Anne O. Krueger, IMF First Deputy Managing Director, Richard Snape Memorial Lecture, Melbourne, November 8

PRGF = Poverty Reduction and Growth Facility

Mundell-Fleming Lecture

## Frankel re-examines why currency crashes are so costly

A political leader in a developing country is twice as likely to lose office in the six months following a currency crash as otherwise, regardless of whether the devaluation takes place in the context of an IMF program. How is it that a strong ruler like Indonesia's Suharto could easily weather 32 years of political, military, ethnic, and environmental challenges only to succumb to a currency crisis? Jeffrey Frankel tackled this question in this year's Mundell-Fleming Lecture at the IMF's Jacques Polak Fifth Annual Research Conference. His address, presented at a November 5 IMF Economic Forum, also explored whether currency devaluation necessarily means a loss of output and how policymakers can minimize vulnerability to devaluations and associated economic contractions.

The most obvious interpretation of why devaluations carry high political costs is that they are accompanied by painful recessions. But why? After all, devaluations are supposed to boost competitiveness, increase production and exports of tradable goods, reduce imports, and thereby improve the trade balance, GDP, and employment.

One possible explanation, says Frankel, is that, even if there is no negative effect on GDP in the aggregate, the redistributive effects could be politically costly to leaders. For example, a devaluation in an African country may benefit small rural coffee and cocoa farmers because the price of their products is determined in foreign currency terms on world markets; but farmers tend to have less political power than urban residents, who may consume imported goods and thus be hurt by the devaluation. The problem with this theory, Frankel points out, is that there are so many examples that go the other way, where the producers of the tradable products (agricultural, mineral, or manufactured) tend to have *more* political power than the producers of nontraded goods.

One can argue that simultaneous monetary and fiscal austerity (or banking failures or the sudden stop in foreign lending itself) are the true causes of these declines in economic activity. But Frankel says this misses a key point. According to the standard textbook theories, when a country faces a sudden stop in capital flows, there exists some optimal combination of expenditure-reducing policies (monetary or fiscal contraction) and expenditure-switching policies (devaluation) that should achieve external balance without inducing a recession.

But reality is different. All the countries in the East Asia crisis of 1997–98, for example, suffered a sharp loss in output regardless of their mix of devaluation and expenditure reduction. The simple generalization seems to be that most developing countries that are hit by financial crises go into recession. The reduction in income is the only way of quickly generating the improvement in the trade balance that is the necessary counterpart to the increased reluctance of international investors to lend.

By now the evidence seems strong that devaluation is contractionary, at least in the first year, and perhaps in the second as well. Until the currency crashes of the 1990s, a mainstream view had been that any negative effects from a devaluation were relatively quickly offset by the stimulus to net exports, so that by the second year, when exports had gathered strength, the overall effect on output would turn positive. Now, however, the negative effects seem stronger than first thought, and the positive effects weaker. The depressing conclusion is that there is no escape from recession. All policy instruments that work to improve external balance do so by reducing income in the short run—devaluation, fiscal contraction, and monetary contraction. Even structural policy reform, such as insisting that nonviable banks close, may have a negative effect on economic activity in the short run.

### Why is devaluation often contractionary?

Of the many possible contractionary effects of devaluation, which ones were, in fact, responsible for the recessionary currency crashes of the 1990s? Several of the most important contractionary effects of a devaluation are hypothesized to work through a corresponding increase in the domestic price of imports or of some larger set of goods. Indeed, rapid pass-through of exchange rate changes to the prices of traded goods is the defining assumption of the “small open economy model,” which was thought to apply fairly well to emerging market countries. The contractionary effect would then follow in any of several ways: the higher prices of traded goods would, for example, reduce real money balances or real wages of workers, or increase costs to producers in the nontraded goods sector. These mechanisms were not much in evidence in the currency crashes of the 1990s. In fact, the pass-through coefficient fell significantly in the course of the 1990s, and the speed of decline was twice as fast among developing countries.

**Most developing countries that are hit by financial crises go into recession. The reduction in income is the only way of quickly generating the improvement in the trade balance that is the necessary counterpart to the increased reluctance of international investors to lend.**

—Jeffrey Frankel

November 29, 2004

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What, then, is the explanation for the recessions that followed many of the 1990s devaluations? Researchers have paid a great deal of attention—and in Frankel’s mind appropriately so—to the balance sheet effect. This is a problem of “mismatch” between the currency in which a country’s debts are denominated and the currency in which its firms earn revenue. Domestic banks and firms had large debts denominated in foreign currencies, particularly in dollars, which they might have been able to service at

the previous exchange rate, but which they had trouble servicing after the price of foreign exchange went up sharply. The results were layoffs and bankruptcies.

### How to mitigate the contraction

How might debtors mitigate contractionary currency crashes? It is not enough to instruct firms to avoid dollar debts or to hedge them, because international investors are not very interested in lending to these countries in their own currencies anyway, for under-

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
(million SDRs)				
<b>Stand-By</b>				
Argentina	September 20, 2003	September 19, 2006	8,981.00	4,810.00
Bolivia	April 2, 2003	December 31, 2004	128.64	26.80
Brazil	September 6, 2002	March 31, 2005	27,375.12	10,175.48
Bulgaria	August 6, 2004	September 5, 2006	100.00	100.00
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Croatia	August 4, 2004	April 3, 2006	97.00	97.00
Dominican Republic	August 29, 2003	August 28, 2005	437.80	306.46
Gabon	May 28, 2004	June 30, 2005	69.44	41.66
Paraguay	December 15, 2003	March 31, 2005	50.00	50.00
Peru	June 9, 2004	August 16, 2006	287.28	287.28
Romania	July 7, 2004	July 6, 2006	250.00	250.00
Turkey	February 4, 2002	February 3, 2005	12,821.20	907.20
Ukraine	March 29, 2004	March 28, 2005	411.60	411.60
Uruguay	April 1, 2002	March 31, 2005	1,988.50	279.60
<b>Total</b>			<b>54,545.58</b>	<b>19,291.09</b>
<b>EFF</b>				
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	250.00
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
<b>Total</b>			<b>794.40</b>	<b>373.73</b>
<b>PRGF</b>				
Albania	June 21, 2002	June 20, 2005	28.00	8.00
Armenia	May 23, 2001	December 31, 2004	69.00	9.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	38.61
Bangladesh	June 20, 2003	June 19, 2006	400.33	251.83
Burkina Faso	June 11, 2003	June 10, 2006	24.08	17.20
Burundi	January 23, 2004	January 22, 2007	69.30	42.90
Cameroon	December 21, 2000	December 20, 2004	111.42	31.83
Cape Verde	April 10, 2002	April 9, 2005	8.64	2.49
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Congo, Democratic Republic of	June 12, 2002	June 11, 2005	580.00	53.23
Dominica	December 29, 2003	December 28, 2006	7.69	4.71
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	June 4, 2004	June 3, 2007	98.00	84.00
Ghana	May 9, 2003	May 8, 2006	184.50	105.45
Guyana	September 20, 2002	March 19, 2006	54.55	37.06
Honduras	February 27, 2004	February 26, 2007	71.20	50.86
Kenya	November 21, 2003	November 20, 2006	175.00	150.00
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	9.56
Lao People's Democratic Republic	April 25, 2001	April 24, 2005	31.70	13.58
Madagascar	March 1, 2001	March 1, 2005	91.65	22.70
Malawi	December 21, 2000	December 20, 2004	45.11	32.23
Mali	June 23, 2004	June 22, 2007	9.33	8.00
Mauritania	July 18, 2003	July 17, 2006	6.44	5.52
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Mozambique	July 6, 2004	July 5, 2007	11.36	9.74
Nepal	November 19, 2003	November 18, 2006	49.91	42.78
Nicaragua	December 13, 2002	December 12, 2005	97.50	41.78
Pakistan	December 6, 2001	December 5, 2004	1,033.70	172.28
Rwanda	August 12, 2002	August 11, 2005	4.00	1.71
Senegal	April 28, 2003	April 27, 2006	24.27	17.33
Sierra Leone	September 26, 2001	March 25, 2005	130.84	28.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	29.40
Tanzania	August 16, 2003	August 15, 2006	19.60	11.20
Uganda	September 13, 2002	September 12, 2005	13.50	6.00
Zambia	June 16, 2004	June 15, 2007	220.10	137.56
<b>Total</b>			<b>4,499.95</b>	<b>1,974.91</b>

EFF = Extended Fund Facility.  
PRGF = Poverty Reduction and Growth Facility.  
Figures may not add to totals owing to rounding.  
Data: IMF Finance Department

Members drawing on the IMF “purchase” other members’ currencies, or SDRs, with an equivalent amount of their own currency.



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**Prakash Loungani**  
Associate Editor

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standable reasons. The short-run solution is for countries to adjust promptly, rather than procrastinate. When foreign investors lose their previous enthusiasm for financing a country's current account deficit, the national policymakers must decide whether to adjust or to wait. Typically they wait. As a result, even countries that had previously managed to keep dollar-denominated debt relatively low tend to switch the composition of their debt toward that currency during the year or so preceding the ultimate currency crash.

A prime example is Mexico during the course of 1994. International enthusiasm for investing in Mexico began to decline after the beginning of that year, but the authorities clung to the exchange rate target and delayed adjustment in hopes that conditions would improve. During much of the year they ran down reserves. An important second mechanism of delay was to placate nervous investors by offering them Tesobonos (short-term dollar-linked bonds) in place of the peso bonds (Cetes) that they had previously held. It seems likely that the magnitude of the Mexican recession in 1995 stemmed not just from the adverse balance sheet effects that have been so frequently noted, but particularly from the adverse *shift* in balance sheets that took place during the course of 1994. A third mechanism of delay was a shift toward shorter maturities. And the fourth was an explicit commitment to defend the peg.

These tactics are part of a strategy that is sometimes called "gambling for resurrection." What they have in common, beyond achieving the desired delay, is helping deepen the crisis, if it comes. It is harder to restore confidence after a devaluation if reserves are near zero and the ministers have lost personal credibility. Further, if the composition of the debt has shifted toward the short term and toward the dollar, then restoring external balance is likely to wreak havoc with private balance sheets regardless of the combination of increases in interest rate and currency depreciation. The lesson, according to Frankel is to adjust sooner rather than later—but this is something, he admits, that is easier said than done.

### Trade openness helps

One final question concerns the wisdom of pursuing trade integration. Broadly speaking, there are two opposing views. One holds that a highly integrated



Frankel: To help mitigate contractionary currency crises, countries should adjust promptly rather than procrastinate.

economy is more exposed to shocks coming from abroad. The other holds that countries that are open to international trade are *less* vulnerable because when the ratio of trade to GDP is high, it is easier to adjust to a cut-off in international financing.

Frankel subscribes to the second view. He points out that since the emerging market crises of 1994–98, economists have increasingly emphasized the contractionary balance sheet effect: if the country's debts are denominated in foreign currency, the balance sheets of the indebted banks and corporations are

hit in proportion to the devaluation. If the economy is starting from a high ratio of trade to GDP, the necessary devaluation need not be large, and therefore the adverse balance sheet effect can be correspondingly modest. But if the economy is not very open to trade to begin with, the necessary devaluation and the resulting balance sheet impact and recession will both be large. In Frankel's view, trade protectionism does not "shield" countries from the volatility of world markets as its proponents might hope. On the contrary, less trade openness leads to greater vulnerability to sudden stops and currency crashes. Openness is the only variable that is virtually always statistically significant.

### Lessons to take away

Many of the currency crises of the past 10 years have been associated with output loss stemming from the contractionary effects of a devaluation, the most problematic being the balance sheet effects. How can countries minimize vulnerability to sudden stops, devaluations, and associated economic contractions?

In the shorter term, countries must keep balance sheets strong by avoiding a shift to short-term dollar debt as a means of procrastinating. Adjusting promptly after inflows cease is better than procrastinating. And in the longer term, greater openness to trade reduces vulnerability to both sudden stops and currency crashes and may be the more robust option, politically as well as economically. ■

The full text of Jeffrey Frankel's lecture is available on the IMF's website at <http://www.imf.org/External/Pubs/FT/staffp/2004/00-00/arc.htm>.