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Köhler resigns post as IMF's Managing Director to accept nomination for German presidency

On March 4, Horst Köhler announced that he had accepted a nomination for the presidency of the Federal Republic of Germany and, effective immediately and in accordance with IMF rules, that he had tendered his resignation as head of the IMF. Köhler, who is 61 and had served nearly four years of his five-year term as the IMF's Managing Director, indicated that he was accepting the nomination with "a laughing and a crying eye"—honored by his nomination and yet finding it hard to leave an institution that he had fully expected to continue to serve and for which he had great and continuing regard.

Köhler told reporters that he had not sought the office of the presidency nor did he see it as an appointment that could "be planned in advance." But he expressed confidence that his own mix of national experience—as president of the German Savings Bank Association and as deputy minister of finance—and international experience—at the European Bank for Reconstruction and Development as well as at the IMF—left him well positioned to "contribute to what Germany needs right now"—namely, help in readjusting its

role in Europe and in the world, creating a strong economy, and developing "a good understanding of the Germans in the world and of the world in Germany."

Köhler said that he was leaving the organization with the "deepest appreciation of its integrity and its dedication to helping its members." Asked by reporters to reflect on his biggest achievement in office, he indicated that while any response just now would be "a bit premature," he was proud that during his tenure the IMF had opened up further—listening to others, developing a "learning culture," and drawing lessons from experience. He also cited the IMF's crisis prevention and management roles, which, in recent years, have helped the global economy recover from a major deterioration.

Köhler, who very recently returned from a two-day trip to Brazil, was also asked about his discussions with President Luiz Inácio Lula da Silva. The substance of



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From left: IMF Managing Director Horst Köhler greets Mari Alkatiri, Prime Minister of the Democratic Republic of Timor-Leste; on route to Africa; and responding to reporters at his farewell press conference.

those talks, he suggested, will not be affected by the selection of a new managing director. Referring to leaders in the region like President Lula da Silva, he said that they don't need to be lectured about what is right for their people. What they need is "appropriate support at the appropriate time," adding that he favored a rethinking of the instruments that the



Children welcome Köhler to Bamako, Mali, during his February 2001 visit to sub-Saharan Africa.



Köhler with Bono during the 2000 Annual Meetings in Prague, Czech Republic.

IMF employs to prevent crises. In his view, the international community should provide "timely and proactive support and help" to countries that have "the right intentions, the right policy in place," but suffer international financial and economic setbacks that are not under their control.

In his parting comments to reporters, Köhler also called upon the international community to be "more creative" and to search for "more financing room for infrastructure investment." While growth is not everything, he said, "without growth you end nowhere." Sustained growth requires sustained development based on investment in infrastructure.

And finally, asked to speculate on his successor, Köhler demurred. The decision on a new managing director, he said, "should be discussed within the Executive Board of the IMF and with the shareholders of this institution." ■

The full text of IMF Press Release No. 04/43 on Köhler's resignation and the transcript of his press conference are available on the IMF's website (www.imf.org).

Role and selection of IMF Managing Director

The Managing Director is the IMF's chief executive officer, serving as head of the institution's approximately 2,700 staff, and as chair of the 24-member Executive Board, which conducts the IMF's day-to-day business.

The procedures for selecting a Managing Director are set out in the IMF's Articles of Agreement (its charter). Article XII, Section 4, states simply that "the Executive Board shall select a Managing Director who shall not be a Governor or an Executive Director." This

leaves considerable discretion to the Executive Board on how to carry out the actual selection with an important objective being selection by consensus. When Horst Köhler was appointed as Managing Director in March 2000, the dean (the longest serving member) of the Executive Board conducted informal straw polls to gauge support among member states for the different candidates (besides Köhler, two other candidates had been formally nominated). Executive Directors elected by constituencies of countries were not allowed to split their vote, and therefore had to reach an internal consensus within their own constituencies before casting their votes.

Is Belgium's economic strategy up to the challenge?

Belgium has one of the most generous welfare states in Europe. Per capita income is among the highest in the world, and the poverty rate is among the lowest in industrial countries. But like most other European countries, Belgium is confronted with the challenge of maintaining its high level of public service and extensive social safety net in the face of an aging population. An increasing pension burden, higher health costs, and the prospect of a shrinking workforce are compounding the problem. The government is counting on lower public debt and interest payments to pay for the additional demands on the welfare state over the next 50 years. But is this a viable strategy? Luc Everaert from the IMF's European Department looks at the challenges facing Belgium.

So far, the government's strategy has met with success, though not without costs in terms of economic performance. Historically, Belgium's welfare state has been associated with high fiscal deficits and rapidly accumulating public debt. Even as recently as the early 1990s, budget deficits of 10 percent of GDP were not uncommon. Following a recession in 1993, public debt peaked at a staggering 138 percent of GDP. Since then, this ratio has fallen steadily to about 100 percent—a remarkable achievement. No doubt, a cyclical recovery in the mid-1990s and declining inflation helped. But it was Belgium's steadfast commitment to the Maastricht Treaty goals (particularly the fiscal deficit limit of 3 percent of GDP) and to the Stability and Growth Pact (requiring budget balance over the economic cycle) that did the trick. To accomplish the required deficit reduction, taxes were raised and noninterest spending was curtailed. As a consequence, the noninterest budget surplus (also known as the primary surplus) averaged 6.5 percent of GDP over the past seven years. Such an achievement would be deemed impossible in most parts of the world.

Still, while debt dynamics are now favorable, these efforts have taken their toll, and Belgium is not out of the woods yet. The high tax burden and generous social safety net have dampened long-term economic growth. And following years of strict budget discipline, policymakers are feeling the pressure from pent-up spending needs and demands for tax cuts.

Taxes and transfers discourage work

Taxes and transfers affect the choices people make. Overtaxing capital induces businesses to relocate—

with adverse consequences for growth. Work is also taxed at a high rate. In Belgium, the average person earning €100,000 takes home only €51,000. This does not encourage work in the formal economy.

The counterpart to high taxes is extensive transfers that benefit almost everyone. At the same time, however, these transfers raise the wages that people are willing to work for in the formal economy. Some transfers are particularly detrimental to the labor supply. Publicly sponsored early retirement schemes, previously seen as a socially expedient solution to the unemployment problem, are still pervasive. Even today, they are sometimes granted to “facilitate” industrial restructuring.

But even apart from such schemes, it often does not pay to work a full career in Belgium. The penalties for taking early retirement are small, and it is therefore not surprising that only one in four persons aged 55–64 works and that the overall share of the active population in employment is one of the lowest in the Organization for Economic Cooperation and Development.

Health care costs are escalating

Another looming issue is health care expenditure. Belgium's health care system delivers high-quality results: health outcomes are generally well above the average for industrial countries, access is relatively equal, and there are no waiting lists for treatment. The costs of the health care system are somewhat above the industrial country average, but in line with what could be expected on the basis of Belgium's per capita GDP.

Looking ahead, Belgium—like most other advanced economies—faces structural pressure to increase health care spending. Quite apart from the effect of population aging, which will have relatively trivial consequences for the budget, the pace of health care spending has exceeded expectations and budgetary norms. In response, the government has raised the growth norm to 4.5 percent a year in real terms for the next four years. While this norm stands a good chance of being adhered to, it accommodates



A metro train is arriving at Stockel Station in Brussels. Almost no one pays full fare when using public transportation, thanks to generous fare subsidies.





To make the authorities' strategy work, attention needs to be focused not only on controlling public spending per se but also on boosting medium-term growth. Here, labor market and pension reforms will be key.

the upward trend in health spending, thereby putting further strain on the budget.

This trend is not unique to Belgium. To a large extent it reflects a general increase in wealth, which translates into a larger share of household budgets being devoted to health care—either through individual spending on health or through increased spending by the state. A clear example of the former is the United States, where about 15 percent of income is devoted to health care—well above Belgium's 9 percent. Technological progress has also been associated with increasing, rather than falling, health care costs—a phenomenon that sets health care apart from most other sectors of the economy.

Is the government's strategy viable?

With life expectancy increasing and the population aging, public expenditure is expected to rise considerably. In fact, the projected aging-related increase in spending between 2000 and 2050 is about the same as the interest bill in 2000—about 7 percentage points of GDP. The government is planning to use this equivalence to solve the aging problem: it intends to drive the debt-to-GDP ratio to near zero by running large budget surpluses and use the resulting savings on the interest bill to fund the cost of aging.

Is this strategy feasible? While the math can be made to add up, the policy requirements are daunting: first, in the relatively near future, the budget will need to run substantial surpluses; second, in the medium and long terms, growth in health care spending must be brought down to half its current rate; and, third, labor market performance must improve. To make the authorities' strategy work, attention needs to be focused not only on controlling public spending per se but also on boosting medium-term growth. Here, labor market and pension reforms will be key.

Reforming retirement benefits

Public spending on early retirement programs amounts to about ½ of 1 percentage point of GDP. Since these programs reduce the number of available workers, they lower the productive potential of the economy and its tax base. Phasing them out would therefore not only reduce direct fiscal outlays but also benefit the budget indirectly by expanding the tax base. Making a fair decision about who is to retire when is technically more difficult, but it could be done. The decision would have to appeal to Belgian citizens' strong sense of equity and require careful explanation.

Even though they are difficult to quantify, the effects of a reform of early retirement benefits on fiscal policy and the labor market will undoubtedly be favorable.

But does Belgium also need a more wide-ranging pension reform along the lines of what has been done elsewhere in Europe? Probably not. Significant reforms were introduced in the 1990s, and Belgium's pension system is now one of the least generous by international standards. In addition, the framework for a funded private pension pillar (commonly referred to as the "second pillar") has been in place for some time now, and the number of participants in privately funded pension schemes is gradually rising.

Streamlining labor market policies

In Belgium, it is possible to receive unemployment benefits without ever having worked; one-third of all unemployed women are reportedly in this situation. Unemployment benefits are also paid to those coming straight out of school, thus contributing to the high incidence of youth unemployment. Moreover, unemployment benefits in Belgium are, in practice, largely open-ended (with some exceptions). Even though workers are eligible for benefits only if they are actively looking for a job, this condition is seldom enforced. Benefits are based on the previous working wage, subject to a cap, and remain at that level indefinitely. It is therefore not surprising that one in two unemployed Belgians has been so for more than a year.

Unemployment benefits have been extended to so many groups because of the perceived inadequacy of the social safety net for people who are truly unable to find jobs. An equitable solution could consist in requiring a work history to be eligible for unemployment benefits and in introducing phasing and a limit to the duration of unemployment benefits. Unemployment insurance features such as these are quite common in other advanced economies. Of course, the social safety net would need to be strengthened at the same time. But if properly designed, such a policy shift would have substantial net benefits for the budget and labor supply—without leading to an increase in poverty.

Successive governments have not only provided income support to those without work but have also actively assisted problem groups in finding employment. A variety of policies and programs has been put in place for this purpose, including training, employment subsidies, and public employment schemes. Belgium has more than 200 active labor market programs, all of which require budgetary outlays and relatively intense administrative follow-up.

Are these resources well spent? There is an emerging consensus that active labor market programs are of limited effectiveness in placing people in private sector jobs. Enterprise-specific training and targeted reductions in social security contributions and

taxes—both of which the government is pursuing—seem somewhat effective. But general classroom training and public employment programs, which are also prevalent in Belgium, appear to be of little value. Some observers even claim they have a negative effect because they make people unavailable for the private sector. Streamlining the many programs could lead to substantial budgetary savings. But even without savings, a reallocation of resources toward the most effective programs would improve the functioning of the labor market.

Health care sector must cap costs

Reforms will also be needed in the health care sector. Rising living standards, technological progress, and population aging will keep pushing up health care expenditure for the foreseeable future. Continuing spending at the current budget norm, or even at recent historic rates, is fiscally unsustainable: publicly funded health care costs as a share of GDP would rise rapidly and absorb most, if not all, of the savings that pension and labor market reforms could generate. The government is aware of the need to reduce spending growth in the health sector but, as experience in other countries has shown, there is no magic recipe for success. Lowering the spending norm will be a necessary first step, but it is unlikely to be sufficient. Mechanisms to increase all stakeholders' cost-consciousness will also be needed. In the end, while the public should be allowed to choose its desired level of service, it should also be made aware of the costs.

Creating a virtuous circle

If implemented, all of these measures would result in a substantial improvement in Belgium's fiscal position. But savings should probably not be used only to retire public debt. Belgium's tax burden is clearly too high; cutting taxes would deliver a significant boost to economic growth by encouraging more people to work and businesses to invest. Also, the fiscal gains from comprehensive reforms could result in savings beyond what is required for a long-term improvement in the budget position, thus creating considerable scope for reducing taxes. Most of the tax burden currently falls on labor, through social security contributions and income taxes, or on consumers (who already have their income taxed) through indirect taxes. Lowering this burden, with reductions targeted to those groups that face the highest tax rates, will create new jobs, one of the government's key objectives.

Taking advantage of the synergies between fiscal consolidation and labor market reform would do more than just trigger a virtuous circle on public debt dynamics. Combined with tax cuts, it would also be likely to set in motion a virtuous growth circle, with positive feedback on public finances. Provided that reforms are implemented soon, Belgium should be able to maintain its high level of income and its welfare accomplishments—including an accessible and equitable health care system. ■

Copies of IMF Country Report No. 04/48, *Belgium: Selected Issues*, are available for \$15.00. Please see page 79 for ordering details.

Available on the web (www.imf.org)

Press Releases

- 04/37: IMF Completes First Review Under Tanzania's PRGF Arrangement and Approves \$4.2 Million Disbursement, February 25
- 04/38: IMF Managing Director Horst Köhler's Statement During His Visit to Korea, February 26
- 04/39: IMF Managing Director Horst Köhler to Visit Brazil, February 26
- 04/40: IMF Staff Statement on Bolivia, February 27
- 04/41: IMF Completes Fifth Review Under Ethiopia's PRGF Arrangement and Approves \$15 Million Disbursement, March 1
- 04/42: IMF Managing Director Horst Köhler's Remarks Following His Visit To Brazil, March 1
- 04/43: IMF Managing Director Horst Köhler Resigns Following Nomination as German President, March 4
- 04/44: IMF Completes Third Review Under the Democratic Republic of the Congo's PRGF Arrangement and Approves \$39 Million Disbursement, March 4

Note: PRGF = Poverty Reduction and Growth Facility

Public Information Notices

- 04/12: IMF Concludes 2003 Article IV Consultation with Kuwait, February 25
- 04/13: IMF Concludes 2003 Article IV Consultation with Belgium, February 27
- 04/14: IMF Concludes 2003 Article IV Consultation with the Republic of Palau, March 2
- 04/15: IMF Concludes 2003 Article IV Consultation with the United Kingdom, March 5

Speeches

- "Northeast Asia: Seizing the Opportunities of Globalization," Horst Köhler, IMF Managing Director, International Conference on a New Vision and Strategy Under Changing Leadership in Northeast Asia, Seoul, February 27
- "Perspectives for Economic Integration in Central America," Markus Rodlauer, Senior Advisor, IMF Western Hemisphere Department, 40th Anniversary of the Central American Monetary Council, Tegucigalpa, Honduras, February 27

First steps taken to update national accounts manual

On February 16–20, the IMF's Statistics Department hosted the first in a series of meetings to discuss updates to the *System of National Accounts 1993*. The manual sets standards for the measurement of GDP and serves as a reference guide for most economic and financial statistics. Impetus to update it stems from changes in the economic environment over the past decade, advancements in methodological research, and efforts to further harmonize various macroeconomic statistics.



From left to right: Jan Heller (Czech Statistical Office), Irena Tvarijonavičiute (Statistics Lithuania), Brian Newson (Eurostat), Neil Patterson (IMF), Brent Molton (Bureau of Economic Analysis, United States), Chellam Palanyandy (Department of Statistics, Malaysia), Agustín Carstens (IMF), Carol Carson (IMF), and A.C. Kulshreshtha (Central Statistical Office, India).

Among the participants were (left) Peter Harper (Australian Bureau of Statistics), and Jacques Magniez (Institute Nationale de Statistique et des Etudes Economiques, France).



Over the course of the weeklong meeting, experts from 16 countries and representatives from the IMF, Eurostat, the Organization for Economic Cooperation and Development (OECD), the United Nations, and the World Bank conferred on a large number of proposed changes. Most of these changes originate from three sources:

- the so-called Canberra II group, which is working on recommendations for the treatment of issues related to capital and the new economy;
- the current revision of the *Balance of Payments Manual*, which is bringing a number of issues to the fore—especially those related to innovations in financial instruments; and
- the recently created international task force on public sector accounting, in which the IMF has the lead.

Adoption of these proposed changes is expected to directly benefit IMF analysis and policy advice. In an address to participants, IMF Deputy Managing Director Agustín Carstens noted the importance of these issues to the IMF and underscored how vital good-quality national accounts—in particular sound data on economic growth—are for assessing the effects of policies. He suggested that countries may need more thorough updates of their national accounts than the usual revisions achieve. He likened revisions to the type of maintenance that keeps an old plane in the

air but does not bring it up to modern standards. And antiquated systems of national accounts, he added, can miss important developments, such as the new economy.

Indeed, issues related to the new economy were well represented on the agenda. The experts took up specific proposals and reached consensus on how to improve the recording of transactions related to research and development and discussed the recording of e-commerce.

Participants also agreed on how to deal with employee stock options. Significant progress was made on several other proposals, notably improvements in recording of developments in the insurance industry. Under current guidelines, the recorded output value of insurance services drops when major disasters occur—something that many participants viewed as unfortunate because it is in these circumstances that the insured benefit from the protection that insurance provides.

The full work program of the update of the *System of National Accounts 1993* runs through 2007 and will entail numerous consultations with regional and professional organizations. Publication of an updated manual is scheduled for 2008. More information about the manual and the update can be found at <http://unstats.un.org/unsd/nationalaccount/Programs.htm>. ■



Among the participants from the IMF Statistics Department were Adriaan Bloem (left) and Neil Patterson.

Interview with Ricardo Hausmann

Does currency denomination of debt hold key to taming volatility?

What is volatility? For Harvard University's Ricardo Hausmann, it is deep uncertainty about the future course of fundamental economic variables. It is a situation in which, to borrow a maxim from baseball's Yogi Berra, "the future is no longer what it used to be." In economics, the textbook reaction to volatility is to insure against risk or, if you can't do that, borrow in bad times and save in good times to smooth out the good with the bad. In reality, though, many developing countries experience dramatically higher volatility and struggle to devise adequate coping mechanisms. In an interview with the IMF's Alicia Jimenez, Hausmann explores this phenomenon and discusses some possible strategies to reduce volatility.

JIMENEZ: What are the chief effects of excess volatility?

HAUSMANN: Empirical evidence suggests that excess volatility is bad for growth, bad for investment, and bad for the poor. Because the poor are typically less able to cope with high volatility, volatility tends to increase poverty and worsen income distribution. In terms of educational achievements, data at both macro and micro levels suggest that during shocks children leave school, lose time, and often don't return after the shock is gone. Education is but one example. There is convincing evidence that excess volatility is bad for all the important dimensions of development we care about.

JIMENEZ: You suggest that there is a relationship between volatility in macroeconomic policies and volatility in macroeconomic outcomes. How does this correlation work?

HAUSMANN: Policies and outcomes are deeply intertwined. In a typical industrial country, the volatility of fiscal revenues and spending implies a fiscal balance that can have an unexpected deviation, or "surprise," of about 1 percent of GDP a year. In a developing country, it is more like 3 percent of GDP a year. Now in industrial countries, the financial system is about 100 percent of GDP on average, so a typical fiscal shock is about 1 percent of a financial system. In developing countries where the financial system may be more like 20 or 30 percent of GDP, a 3 percent of GDP shock represents something like 10 to 15 percent of the financial system.

It is thus much harder for a developing country's financial system to cope with a fiscal shock. The monetary disturbance it will generate would be much larger,

probably too large to be digested purely at home without major macro disruptions. In these circumstances, it is going to be so much more important that developing country governments develop the capacity to address the effect of shocks by borrowing abroad. If they cannot, these shocks can create enormous pressures on monetary policy and lead to inflation and exchange rate instability.

This is one example of how, in developing countries, the interaction of risks with limited financial markets can multiply volatility, while an industrial country would be in a position to cope with it relatively easily.

JIMENEZ: Why do developing countries lack the mechanisms to cope with volatility? How can they create them?

HAUSMANN: The absence of coping mechanisms has to do with incomplete and weak insurance and financial markets. There is a potential vicious circle, too, because high volatility may make it harder for these markets to develop.

To begin to remedy this, we have to better understand the sources of volatility. In some countries, it may be that budget institutions don't ensure a stable and sustainable management of government spending and borrowing. Governments end up spending whatever they can collect or borrow. In good times, they can spend a lot, but in bad times, both revenues and lending dry up, forcing them into a fiscal contraction that aggravates the already difficult situation.

In other countries, the story might be financial. Increasingly, I also believe that the nature of international finance—the inability of countries to maintain access to international capital markets in bad times—forces both governments and households to cut back spending when things are bad, hence aggravating recessions.

I am also exploring the idea that greater financial frictions may arise from weaknesses in property rights and bankruptcy procedures. To the extent that investment is riskier because of these weaknesses, volatility will cause low investment, and low investment will increase volatility. The result is a vicious



Hausmann: "The presence of foreign currency debt makes monetary and exchange rate policy more rigid and less stabilizing and makes fiscal risks larger."

circle whose underlying, amplifying cause may be weaknesses in domestic institutions.

JIMENEZ: What should countries do to lower volatility?

HAUSMANN: That is a bit of a puzzle. Some recommendations are very uncontroversial. Better institutions, property rights, and bankruptcy procedures are things you want regardless of whether they lower volatility. Better fiscal management and financial policies are uncontroversial, too.

I am exploring two more controversial areas. One is the possibility that countries may be in a “volatility trap.” High real exchange rate volatility makes investment in exportables riskier because profits in this sector are very sensitive to the level of the real exchange rate. But countries that have a smaller export sector will have more volatility in the real exchange rate. Hence, you get this vicious circle. To pull countries out of this predicament, it may be necessary to devise interventions that socialize the real exchange rate risk borne by exporters.

The second area that I am exploring relates to the inability of most countries to borrow internationally in their own currency. This makes international finance less stabilizing than the textbooks suggest. I have been thinking about how international financial institutions could help in this regard. At present, the international financial institutions are part of the problem: the World Bank lends in U.S. dollars and the IMF lends in SDRs; they do not lend in local currency. In bad times, countries’ real exchange rates depreciate, making it harder to service these loans: bad times are made even worse, and this aggravates volatility.

Now, the World Bank justifies its dollar-based lending on the grounds that the dollar is the currency in which it can borrow in capital markets. However, the International Development Association and the IMF’s Poverty Reduction and Growth Facility don’t have to go to capital markets to borrow; they are funded with grants from member countries. They could, in principle, lend that money whichever way they want and according to the principles and rules they want to adopt.

In research I have done with Roberto Rigobon, we suggest that the World Bank and the IMF are wasting a huge opportunity for risk sharing among poor countries and that the world would be better off if these entities lent in consumer price indexed (CPI) local currency terms. It would be better for each borrower and probably for the IMF and for the World Bank, because the cash flows that they expect to get would be more or less the same, but the debts would better track each country’s ability to pay.

JIMENEZ: How would industrial countries react?

HAUSMANN: This proposal is in everyone’s interest. It doesn’t involve changing the grant component of these loans; it would essentially involve risk sharing among poor countries. It’s easier to implement than trying to change private capital markets, which would entail decisions by millions of individual investors. In this regard, my colleague Barry Eichengreen and I have also suggested that the World Bank should attempt to develop an international market in a basket of inflation-indexed developing country currencies to allow it to lend in each country’s CPI-indexed local currency.

JIMENEZ: What are the main components of a macroeconomic policy response to a volatile economy?

HAUSMANN: In a volatile economy, it’s not just policy that has to respond differently; a different institutional setup is needed. We used to think in terms of what to do if there were a positive or a negative shock. The question now is what to do if you don’t know what the shock is going to be. How do you prepare yourself structurally to cope with surprises?

The more volatile the economy is, the more precautionary the policy stance needs to be. More volatile countries have to target a lower average level of debt, a higher precautionary level of fiscal savings, and more liquidity in the fiscal and external accounts. They need to impose higher capital adequacy and liquidity requirements on banks in order to cope with the underlying volatility of deposit demand, interest rates, and asset values. And they need to consider very seriously their exchange rate arrangements.

The research that I and others have done suggests that the presence of foreign currency debt makes monetary and exchange rate policy more rigid and less stabilizing and makes fiscal risks larger. That is why I have concentrated so much effort on analyzing the consequences of the currency denomination of national debt and the need to change the structure of international markets. I increasingly believe that, to a large extent, the transmission mechanisms that make volatility so hard to manage have to do with incompleteness in international financial markets, and I do believe that there is an active agenda for the international financial institutions to help develop those markets. With a more complete set of market instruments, countries will be in a better position to cope with volatility.

JIMENEZ: Have some countries dealt well with excess volatility, and, if so, how did they do it?

To a large extent, the transmission mechanisms that make volatility so hard to manage have to do with incompleteness in international financial markets, and I do believe that there is an active agenda for the international financial institutions to help develop those markets.

—Ricardo Hausmann

HAUSMANN: The principal success stories are countries like Canada and Australia—countries that have significant commodity-based exports subject to large terms of trade volatility. They have been able to cushion their domestic economies from these shocks by actively using a floating exchange rate regime with countercyclical monetary policy and by passively employing a countercyclical fiscal policy.

Australia doesn't get into trouble despite having a large foreign debt, very few international reserves, and a significant structural deficit in its current account—three things that would scare most finance ministers in developing countries. Why is that? Because, in essence, its foreign debt does not involve a net currency exposure—it is de facto in domestic currency. Fluctuations or risks in Australia's exchange rate are shared with its creditors, and there is consequently less risk at home. Most emerging markets can't do this, and that is why they need more reserves, less foreign debt, and much smaller current account deficits. This is probably the best they can do, but by so doing, it will make it harder for them to smooth shocks, and hence they would at best be much more volatile than Australia. But it is still an open question why successful countries are so hard to emulate. It's not because successful countries sacrifice more, it is because they achieve more with less pain.

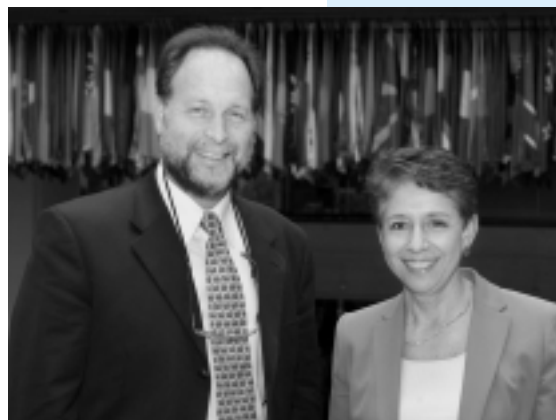
JIMENEZ: How would you compare Chile, for example, with Australia?

HAUSMANN: Chile is well managed and has less external debt than Australia, extremely large international reserves, and very little public debt. It's been a star pupil and a leader in reform. But when the East Asian and Russian crises came, Chile went into recession and Australia did not, even though the shocks they received were somewhat similar. The hard question is why was one of the best managed emerging markets unable to emulate Australia or Canada during this period? I believe it is related to the fact that Australia can borrow abroad in Aussie dollars and Chile cannot do so in pesos.

JIMENEZ: Do you see any correlation between corporate governance and volatility?

HAUSMANN: Obviously, bad corporate governance makes financial markets less effective and may prevent investment and amplify volatility. However, it is very important to think of two-way causality. In an environment of low volatility, it is easy to abide by contracts because the environment people have in mind when they sign a contract is more or less the environment in which they execute that contract. The greater the volatility, the more unexpected the

environment, and the more reasons, for example, to have renegotiations after a contract is signed. And while a weak institutional environment seems to be related to high volatility, the direction of causality is not clear. It may very well be that higher volatility makes it harder to develop strong institutions because following the rules becomes harder when current conditions differ dramatically from those that were envisioned when the rules were adopted.



JIMENEZ: What would you like to see IMF economists keep in mind with regard to volatility?

HAUSMANN: When you go to a country, try to understand the sources and the potential amplifiers of volatility. Take a good look at the structure of financial markets, the nature and denomination of accumulated debts, and the potential access to finance in difficult times. Also take a look at the nature of domestic financial markets and the risks involved in the structure of the fiscal accounts, and try to come up with suggestions that allow a better distribution of the risks and, ideally, a better internationalization of risks.

Most countries are unable to follow Australia's example and share the risk with their foreign creditors, and that inability keeps too much of the risk at home. I would urge these countries to explore avenues in which risk can be better managed and shared with others. ■

Alicia Jimenez with Hausmann. In Hausmann's view, many countries cannot share risk with their foreign creditors and thus "keep too much risk at home."

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
March 1	1.62	1.62	2.14
March 8	1.61	1.61	2.13

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).

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

Data: IMF Finance Department

Parliamentarians urged to take more proactive stance on development

Under the aegis of the Parliamentary Network on the World Bank, approximately 190 legislators from over 80 countries gathered in Paris on February 14–16 to discuss a wide range of development issues. This fifth annual meeting of the organization, which also drew government officials, civil society organizations, and representatives from the World Bank and the IMF, focused on rising concerns over the prospects for meeting the United Nations' Millennium Development Goals (MDGs); continued frustration with trade and market access; the importance of improving the accountability of the international financial institutions; donor policies; and efforts to strengthen the role of parliamentarians in promoting development.



Listening to the proceedings are (left) Joseph Henry Mensah, Member of Parliament from Ghana, and Agustín Carstens, IMF Deputy Managing Director.

The significant role that parliaments can play in a range of economic and social issues has not been lost on the IMF. The IMF has expanded its outreach to parliamentarians (see *IMF Survey*, November 17, 2003, pages 343–44) and for the past few years has been working closely with the Parliamentary Network on the World Bank through participation in its annual conferences (see *IMF Survey*, March 31, 2003, page 89), regional meetings, and field visits.

In remarks to participants, Agustín Carstens, IMF Deputy Managing Director, emphasized that his organization has attached increased importance to a continuing and expanding dialogue with parliamentarians—a point that was also made by Pierre Duquesne, France's Executive Director at the World Bank and the IMF. Carstens noted that this greater attention to the role of legislators reflected, in part, increased openness and transparency at the IMF, but it was also indicative of the increased attention being paid to national ownership of reforms.



European Commissioner for Agriculture Franz Fischler (left) makes a point at the session on international trade. With him on the dais is Malian Commerce and Industry Minister Chogul Maiga.

Duquesne underlined that the Executive Boards are more and more responsive to the necessity of taking into consideration the economic policies of countries covered and their desire to have regular and various relations with parliaments. In this context, he drew participants' attention to the recent report by the Working Group of IMF Executive Directors on Enhancing Communication with National Legislators and invited their comments. That report, which, among other recommendations, calls on the IMF to make a greater effort to enhance the dialogue with legislators, can be found at <http://www.imf.org/external/np/ed/2004/ecnl/index.htm>. Comments on the report are welcome by April 30, 2004.

Worries about financing development

Amid deepening concern that many countries are not on course to reach the MDGs by 2015, James Wolfensohn, President of the World Bank, suggested that the international community seems to be losing its way on this initiative. He pointed out that although annual global spending on defense stands at \$1 trillion and agricultural subsidies or equivalent total \$300 billion, only \$55 billion is spent on development aid. "What is needed," he said, "is not just a bold push here and there but a concerted and deep-seated insurgency on behalf of development and peace." Parliamentarians in particular were urged to play a greater role in monitoring their country's progress in attaining the MDGs.

Eveline Herfkens, the UN Secretary-General's Executive Coordinator for the Millennium Development Goals Campaign, encouraged parliamentarians to discuss these goals with their ministers of finance to find ways to raise needed revenues. She acknowledged that there was "serious skepticism" among taxpayers in industrial countries about boosting official development assistance. According to Herfkens, the prevailing view seemed to be: "Why should middle-class taxpayers finance the elites of developing countries?"

Several parliamentarians indicated that what was needed to achieve the MDGs was political will. Bert Koenders, chair of the Parliamentary Network on the World Bank, noted that many well-intentioned initiatives collapse for lack of political will and that parliamentarians can bring a much-needed ingredient to the mix—namely, political capital.

Financing was also a key concern, and participants received an update on several major bilateral

efforts. Richard Morford, International Outreach Director of the Millennium Challenge Corporation, underscored that the new U.S. initiative—its Millennium Challenge Account—would depart from previous development assistance efforts and focus on countries that govern justly, invest in their citizens, and encourage economic freedom. Paul Boateng, Chief Secretary of the U.K. Treasury, restated his government's commitment to a proposed new international finance facility that aims to raise \$50 billion for development—an initiative that received the support of Francis Mer, France's Minister of Economy, Finance, and Industry, at the Paris meeting. More generally, Mer called for innovative ways of financing development and announced a conference in Paris on that topic on April 8.

Speaking to participants via teleconference, Brazil's President Luiz Inácio Lula da Silva outlined his government's Zero Hunger effort—a homegrown family stipend program launched in January 2003 to provide grants to poor families in return for their commitment to enroll in health and nutritional programs and send their children to school. So far, he said, the program has benefited about 3.6 million families and would reach an estimated 11 million families by the end of his term. President Lula da Silva also lamented the excessive focus in the international agenda on security issues and called for a global movement that would bring together trade unions, nongovernmental organizations, parliamentarians, and others to fight hunger and poverty.

Expanding role for parliamentarians

At present, Koenders observed, many countries adopt their poverty reduction strategy papers without the formal approval of their parliaments. For all the talk about consultation, not nearly enough actual participation takes place. Indeed, nongovernmental organizations are typically more active than elected officials in the formulation of these strategy papers. He decried this circumvention of the political process and urged parliamentarians to become more proactive. Parliamentarians won't win elections based on their work on poverty reduction strategy papers, Koenders acknowledged, but it is critical, as representatives of the people, that they be involved in developing and monitoring their country's poverty reduction efforts.

Several members of parliament also underscored their unhappiness over the continued lack of developing country access to industrial country markets and detailed the damaging impact that industrial countries' agricultural subsidies can have. Chogul

Maiga, Mali's Minister of Commerce and Industry spoke about the plight of his country's cotton sector, noting that what was once a source of wealth has become a burden largely because of trade-distorting agricultural subsidies. Franz Fischler, Commissioner for Agriculture for the European Union (EU), countered that while the EU is committed to restarting the Doha Round of multilateral trade negotiations, it wanted to see those discussions take a broad look at all forms of export support, including export credits, monopolies, and differential tax systems. He added that the objective of the Doha negotiations is to tackle the farm subsidies that distort trade the most, not do away with farm policies.

There were also calls for the international financial institutions to be held more accountable to their member countries. Alex Wilks, Coordinator of the Bretton Woods Project, argued that it is important for parliamentarians to know what positions their countries' Executive Directors take on the Boards of the IMF and the World Bank. It is also important, he said, that parliaments know this in real time and not years later as is currently the case. He also urged parliamentarians from both industrial and developing countries to be more proactive in the process of selecting new heads of the IMF and the World Bank. There had been some suggested tweaking of the system in 2001, he said, but more needs to be done. ■

Sabina Bhatia
IMF External Relations Department



Speaking via direct video link, Brazilian President Luiz Inácio Lula da Silva addresses conference participants.



From left, World Bank and IMF Executive Director for France Pierre Duquesne and World Bank Vice-President for External Affairs, Communications, and UN Affairs Ian Goldin listen to French Finance Minister Francis Mer's keynote address.

The main sessions of the conference were recorded and can be seen at <http://www.pnowb.org/>. For the full text of Agustín Carstens's remarks at the conference, please also consult <http://www.imf.org/external/np/speeches/2004/021504.htm>.

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Proceed with care in reforming global financial system, Aizenman urges

In the wake of the 1990s' experience with economic and financial crises, there has been considerable debate about the reforms needed to make the global financial system more stable. A key area of contention is the role played by financial liberalization. In a February 23 seminar at the IMF Institute, Joshua Aizenman, professor of economics at the University of California at Santa Cruz, examined the complex trade-off between liberalization's adverse intermediate effects and its more arguable long-run benefits. He cautioned that successful reforms will need to factor in market imperfections.

On balance, is financial liberalization good or bad? In truth, we may not yet have the tools to do a definitive cost-benefit analysis, Aizenman suggested. There is "solid evidence," he said, that the fragility induced by financial opening increases the chance of a financial crisis. The proof that there is a positive correlation between financial opening and long-run growth—as Ross Levine and others have argued—was more tenuous, although financial opening could lead to higher growth, in part by encouraging a more efficient allocation of investment. Moreover, empirical studies provide little guidance on how to weigh potential costs against potential benefits. Any estimate of this balance would depend critically on an appropriate time horizon and an evaluation of the counterfactual. For example, what would have happened to the Korean economy had the country not liberalized financial flows during the 1990s?

Improving the trade-off

The key challenge for policymakers is to figure out how to supplement financial opening with policies that could diminish short-term volatility without undercutting prospects for higher growth over the long term, Aizenman said. Numerous reforms have been proposed to reduce the incidence or alleviate the costs of financial crises. Among those that have focused on crisis prevention, Aizenman cited the Meltzer Commission recommendation that the IMF limit its lending to those countries that have been pursuing "appropriate" policies and have satisfied predetermined criteria; the Basel II Accord, which strengthens capital adequacy standards; Chilean-style capital controls (taxes on short-term inflows); varied efforts to design "crisis insurance"; incentives to move from debt financing to equity financing; and attempts to design a crisis warning system based on statistical

indicators of vulnerability. Among the reforms that seek to strengthen crisis management and mitigate its costs, Aizenman mentioned proposals to develop international bankruptcy-style procedures or work-out mechanisms and the addition of collective action clauses and/or rollover options to loan agreements.

Beware of unintended consequences

Which types of proposals hold the most promise? According to Aizenman, reforms must address the fundamental forces that lead to excessive exposure and crisis. He warned that changes in policies can affect incentives and budget constraints facing debtors and creditors, altering the nature of economic relationships—in effect, what has come to be called the Lucas critique (based on a seminal 1976 work by Robert Lucas, who first pointed out that new policies alter the behavior of agents, thereby modifying observed correlations). Unless reforms are designed with these potential effects in mind, Aizenman said, they "may lead to disappointing results at best, and welfare reduction at worst."

A good example of how the Lucas critique could come into play is in the area of transparency. While acknowledging that a minimum level of transparency is needed for financial market operations, Aizenman cautioned that stiffer transparency requirements may lead to more creative accounting rather than fewer crises. Verification that standards are being met is "costly and fuzzy," and, "frequently, it takes a major crisis to force the 'real books' to open." A vicious cycle could be induced, whereby enhanced standards lead to more creative accounting, a crisis exposes new loopholes, standards are changed accordingly, and so on.

Such a dynamic could undermine proposals that rely on improved transparency, such as those that restrict crisis lending to countries that have satisfied certain predetermined criteria (notably the Meltzer Commission recommendation and efforts to develop crisis insurance). It may also lead to a new form of moral hazard in which countries that perform well according to preset indicators are expected to be safer, as they would be bailed out in the event of a crisis. Indeed, Aizenman asked, "what should be done in the case where, in the aftermath of a crisis, we learn that some of the criteria were met only superficially?"

There is also reason to be wary about an increased focus on vulnerability indicators as this could lead to

Verification that standards are being met is "costly and fuzzy," and, "frequently, it takes a major crisis to force the 'real books' to open."

—Joshua Aizenman

incentives to distort them, Aizenman said. And there is no assurance that tracked indicators, which reflect experience with past crises, will perform adequately in future under changed policy environments.

Aizenman suggested that effective reforms will also need to be time-consistent. Consider the case where crisis lending is prohibited unless certain pre-crisis conditions have been met. In the throes of an actual crisis, is a prohibition against lending credible if conditions were not satisfied but contagion is a key concern?

And, Aizenman added, there are inevitably political economy ramifications. For example, experience has indicated that a low ratio of international reserves to short-term debt has been associated with a higher incidence of crises in recent years. The instinctive reaction would be to advise countries to increase this ratio to lower their risk of crisis. Yet in countries where there is political instability—for example, where there is a risk that opportunistic administrations might “loot” the treasury to favor narrow interest groups—the optimal amount of international reserves should actually be lower than in countries not subject to such instability. In this instance, targeting a higher ratio of reserves to debt could actually reduce welfare rather than increase it.

More prudent measures

“There are good reasons to support both more effective crisis management and more prudent ex ante allocation of credit,” Aizenman concluded. But given market imperfections, such as costly verification, incomplete insurance markets, and political economy factors, no solution is likely to be “first best.” In his view, a mix of “second-” or “third-best” solutions will be required. More prudent regulations may reduce the incidence of insolvency but cannot eliminate liquidity crises. And crisis management proposals, which may include postcrisis lending, will not eliminate incentives to undertake excessive risk.

In terms of preventing crises, institutions have a key role to play in creating the rule of law and in ensuring a low level of corruption and good contract enforcement. A number of studies examining financial liberalization have shown that countries with weak institutions are more vulnerable to crisis, while countries with strong institutions are more likely to enjoy higher growth. Both findings suggest, he said, that in financial liberalization the sequencing of reforms matters.

There are other unilateral steps that countries can take to lower the risk of crises, reduce their severity, and speed recovery. Developing countries would do well to adopt more flexible exchange rate regimes,



although there may not be “any smart choice that will avoid a crisis” and factors deeper than exchange rate rigidity may be at play. Countries should also strengthen financial systems and fiscal policy, beware of overborrowing, and reduce external overexposure by moving from debt financing to equity financing when feasible.

In the developed countries, Aizenman saw merit in exploring deeper insurance markets as a way to deal with terms of trade volatility; encouraging the use of collective action clauses; and adopting improved minimum capital requirements. In Aizenman’s view, international financial institutions could also do more to enhance country efforts. And, while being mindful of the dangers of “transparency creep,” they should continue to improve transparency standards for macroeconomic policies and for financial and corporate sectors.

In closing, however, Aizenman said he was not convinced that “all crises are bad.” In some cases, a crisis has been the catalytic event that spurred reforms and ultimately led to dramatic improvements in economic performance and social welfare. Typically, these were reforms that had not been implemented earlier owing to political constraints. Indeed, many countries that have experienced occasional crises have grown faster, on average, than countries that have had smoother credit conditions. ■

Patricia Reynolds
IMF External Relations Department

Aizenman:
Given market imperfections, the search for better crisis prevention and management tools is likely to yield a mix of second- or third-best solutions.

Photo credits: Denio Zara, Padraic Hughes, Eugene Salazar, and Michael Spilotro for the IMF, pages 65–66, 70–73, 77–78, and 80; Gerard Cerles for AFP, page 67; Jacques Collet for AFP, page 68; and World Bank, European Vice-Presidency, pages 74–75.

Interview with Arvind Subramanian and Xavier Sala-i-Martin

Tackling the natural resource curse: An illustration from Nigeria

It is well documented that most countries do not benefit from their natural resource endowments, largely because of poor revenue management. Nigeria falls squarely into this category. Between 1970 and 2000, the country's poverty rate—measured by the

share of the population subsisting on less than \$1 a day—increased from close to 36 percent to just under 70 percent. This translates into a staggering increase in the number of poor from about 19 million in 1970 to 90 million in 2000. In a recent IMF Working Paper, Xavier Sala-i-Martin (professor of economics at Columbia University) and Arvind Subramanian (Division Chief, IMF Research Department) identify and quantify the impact of the natural resource curse in Nigeria and propose a solution. Christine Ebrahim-zadeh of the *IMF Survey* spoke with them.



Subramanian: "The government should directly distribute all, or a large fraction, of the revenues that it obtains from oil directly to the people."

IMF SURVEY: Why is the natural resource curse occupying the attention of policymakers?

SUBRAMANIAN: This issue is topical and pressing. The natural resource curse was the subject of a recent workshop organized by George Soros's Open Society Institute and held at Columbia University, where a group of economists, political scientists, lawyers, policymakers, and representatives of civil society gathered to discuss ways of overcoming it.

One outcome of the workshop was to commission a project that would involve the compilation of a handbook of best practice. This handbook would cover the entire cycle of resource exploitation—from exploration to government expenditure of the revenues derived from the resource. It would provide guidance to governments on how to proceed with the exploitation of a natural resource in a manner that maximizes the benefits derived from it.

There was a shared sense at the workshop that any effort to address the curse should focus equally on the role played by foreign companies that helped exploit the resource. These companies should be subject to best practice in terms of contracting, procurement, and the transparency of their operations.

The resource curse is also in the news because of a number of other developments. The World Bank, for example, is carrying out a review of its own project

lending policies with regard to extractive industries. Civil society groups have taken strong positions on this, arguing, for example, that the Bank should cease lending to extractive industries in developing countries. Oil is also being discovered in a number of important geostrategic locations, such as the former Soviet republics. And, of course, recent events in Iraq have refocused attention on the role of oil in Middle Eastern countries.

IMF SURVEY: Why are some countries subject to the natural resource curse and some not? How does it manifest itself?

SALA-I-MARTIN: Based on cross-country evidence, we found that the natural resource curse is intrinsic to most countries with oil or minerals—that is, owning such resources depresses long-run growth. But countries that are rich in other natural resources, such as agricultural products and commodities, are not subject to the curse. Also, and more important, the curse works by destroying domestic economic and political institutions. The presence of oil or minerals gives rise to rent seeking and corruption, which adversely affect the climate for investment and growth.

But the deeper sense in which natural resources impede the development of institutions is that they minimize the two-way interaction between the state and its citizens. Political scientists and economic historians have emphasized this effect. Governments that have easy recourse to oil rents do not need to promote wealth creation that they can subsequently tax; in turn, citizens have less incentive to hold governments accountable. Historical experience suggests that institutional development is impeded because of this disconnect between governments and their people. Our research is interesting also because it suggests that other effects that are commonly thought to be associated with owning natural resources, such as revenue volatility or currency overvaluation, are less important in contributing to lower long-run growth.

IMF SURVEY: What is the IMF's policy prescription for preventing or addressing the curse?

SUBRAMANIAN: I am not sure that the IMF has a specific policy prescription for preventing or addressing the curse. The IMF routinely asks for better fiscal policy and better management of oil revenues—which, in this case, means saving during revenue upsurges to stabilize the economy as well as saving for

the future when the resource is expected to be depleted. In some instances, such as Kazakhstan, the IMF has promoted or agreed to the creation of special oil funds. Although varying in detail, oil funds are an attempt to separate and render transparent some or all of the revenues from oil, and the uses to which they are put. Research by the IMF Fiscal Affairs Department suggests that the experience with such funds has been mixed. The IMF is involved in some international initiatives, such as the Extractive Industries Transparency Initiative sponsored by the United Kingdom's Department for International Development, which aims to make oil companies and governments more transparent in transactions related to oil revenues.

IMF SURVEY: Why hasn't Nigeria benefited from its oil?

SALA-I-MARTIN: Nowhere are all the pathologies associated with oil as clearly manifest as in Nigeria. The Biafran war of secession—Africa's biggest civil war—in the late 1960s, which led to one million deaths, was in part an attempt by the eastern, predominantly Igbo, region to gain exclusive control over oil reserves. Nigeria has witnessed the assassination of two leaders, six successful coups and four failed ones, and 30 years of military rule. In past decades, Nigerian rulers may have plundered oil wealth to the tune of tens of billions of dollars. The explosion in windfall-financed government expenditures also provided increased opportunities for kickbacks. All of these factors have contributed to poor growth but also to staggeringly destructive development outcomes. Thus, oil, and the institutional deterioration that it has led to, has perhaps been the single most important cause of Nigeria's economic and political problems.

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Note: PRSP = Poverty Reduction Strategy Paper
 PRGF = Poverty Reduction and Growth Facility

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Thus, oil, and the institutional deterioration that it has led to, has perhaps been the single most important cause of Nigeria's economic and political problems.

—Xavier Sala-i-Martin

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IMF SURVEY: What is your proposed solution for countries at risk of the resource curse?

SUBRAMANIAN: Our proposal is very simple. The government should directly distribute all, or a large fraction, of the revenues that it obtains from oil directly to the people. To generate revenue to finance its expenditure, the government should rely on normal tax policy instruments—like in any non-oil country. The chief virtue of this approach is that it would minimize opportunities for corruption and misappropriation, because windfall revenue would stay out of the hands of public officials. It would also rectify the imbalance of economic and political power, which is strongly tilted in favor of the government and against the people in most oil-rich countries.

Of course, a number of practical design issues need to be addressed, such as who should get the money—adults, women, or households? How much of the revenue should be distributed? How should it be distributed? Answers to these questions will undoubtedly vary from country to country, but practical solutions can be found with some thought, ingenuity, and the involvement of domestic and international actors.

IMF SURVEY: How realistic is this strategy? What are its disadvantages?

SALA-I-MARTIN: There are two standard objections to this proposal: the risk of macroeconomic instability caused by the loss of revenue to the government; and the inefficiency involved in distributing revenues to the people only to then partially tax those revenues back to finance public investment and other sensible government expenditures.

Neither objection is really compelling. In terms of macroeconomic consequences, the proposal would essentially convert public windfall gains and losses from price volatility to gains and losses to households. Who is better at determining how much to save and spend—the people or the government? Now, in principle, an argument can be made that the government has a custodial role to play to smooth consumption and to save. But the choice almost always is whether the people or a weak or corrupt state would be better at these decisions. And the evidence clearly suggests that weak states do very badly in making these decisions. For example, a steel factory built by the Nigerian government has not produced a single ton of salable steel in nearly 40 years.

The second objection is that the proposal would be doubly wasteful because it would incur two sets of costs—first in distributing oil revenues and then in taxing these revenues to finance government needs. But we would argue that the efficiency costs are eclipsed by the benefits of encouraging public



Sala-i-Martin: "Ironically, good government and strong institutions require that the raising of public resources is costly."

scrutiny of government spending. Governments that derive revenues from natural resources like oil are in a dangerous supply-sider's paradise. That is, where the marginal cost of raising public resources is virtually zero, governments have little incentive to manage well, provide adequate public services, or respond to citizens. Nor do they have the incentive to invent and sustain the 'software' of market economies and good governments, such as institutions to protect property rights or manage redistribution conflicts. Ironically, good government and strong institutions require that the raising of public resources is costly.

IMF SURVEY: Do you see any hope of your proposal being put into action?

SUBRAMANIAN: The chances of our proposal being implemented are not bright because of a fundamental political problem. The people who are currently deriving economic and political power from access to oil revenues will fight the proposal tooth and nail. This suggests that some international intervention may be required to overcome this problem. Ideally, the chances of the proposal being implemented are greater where there is a big transition—some kind of "constitutional moment" in a country's history. For these reasons, we think that Iraq affords an excellent opportunity to implement the proposal. And once it is shown to be successful in one or more countries, the demonstration effect will lead people in other countries to lobby for it. ■

Copies of IMF Working Paper No. 03/139, "Addressing the Natural Resource Curse: An Illustration from Nigeria," by Xavier Sala-i-Martin and Arvind Subramanian, are available for \$15.00 each from IMF Publication Services. Please see page 79 for ordering details. The full text is also available on the IMF's website (www.imf.org).