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On leaving office, Fischer reflects on changes in IMF operations and future challenges

Stanley Fischer, IMF First Deputy Managing Director for the past seven years, stepped down from his position at the end of August. Fischer was appointed in 1994 to an initial five-year term and to a second term in 1999. He was previously the Killian Professor and head of the Department of Economics at the Massachusetts Institute of Technology. From 1988 to 1990, he served as Vice President for Development Economics and Chief Economist at the World Bank. Fischer recently spoke with the IMF Survey *about his experience at the IMF and the changes he has witnessed during his tenure.*

Fischer: "The development of the international capital markets...has been extremely important for the work of the IMF."

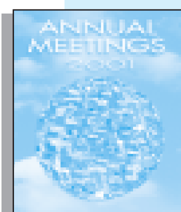
IMF SURVEY: Was any event during your service at the IMF truly unexpected?

FISCHER: Many events—but especially their scale—were unexpected. At the time I came to the IMF, I had no idea how severe the Mexican crisis would be, even though my friend Rudi Dornbusch had already predicted Mexico would be forced to devalue. In 1994, I would not have thought that the Asian countries could experience a major crisis of the type that occurred in 1997–98; even seen from 1996, although we had some well-founded fears about Thailand, the extent of the Asian crisis was unexpected. So was the extent of the contagion after the Russian crisis. When we divided up country responsibilities among the IMF's three Deputy Managing Directors in September 1994, I happened to choose among my countries three in Asia: Indonesia, Korea, and Thailand. So you might think that I had real foresight, but it was purely accidental.

IMF SURVEY: Changes in the global economy have had a profound effect on the way the IMF does business. What have been the biggest changes since the breakup of the Bretton Woods system in 1973?

FISCHER: The development of the international capital markets, and of emerging markets as a class of countries, has been extremely important for the work of the IMF, not least because so many *(Please turn to the following page)*

Annual Meetings to take place on September 29–30



The Executive Directors of the World Bank Group and the IMF have agreed to consolidate the joint fifty-sixth Annual Meetings of the Boards of Governors on September 30. The meetings of the IMF's International Monetary and Financial Committee and the World Bank–IMF Development Committee will be held on September 29 (see IMF Press Release No. 01/35, August 14).

The decision to consolidate the meetings was made following consultations with the U.S. government, the host for the meetings. In a statement, the World Bank and the IMF said that they fully shared the interest of the U.S. authorities in ensuring the conduct of all essential business with the least possible disruption to the people who live and work in Washington, D.C. Executive Directors said they would conduct all of the necessary business of the meetings during the two-day period (see IMF News Brief No. 01/77, August 10).

Fischer reviews his eventful seven-year tenure

(Continued from front page) crises have been associated with this development. The integration of the transition economies into the international economy certainly kept us busy in the 1990s. And we made important changes in the way we work with our poorest members.

From the IMF's viewpoint, these last seven years were the period in which the organization became transparent, and that is probably one of the most important things that ever happened to it.

IMF SURVEY: What is the significance of the new International Capital Markets Department [ICMD]?

FISCHER: The ICMD reflects a recognition that the IMF has to understand on a daily basis what is happening in the international capital markets and has to stay absolutely up-to-date with developments in those markets. Not only is the ICMD designed to perform surveillance on a continuous basis, it should also help member countries access the international capital markets safely, at an appropriate speed: the IMF needs to help its members deal with those markets, to minimize the risks and maximize the benefits that arise from them.

Fischer: "The word 'bailout' is misleading, not least because we make loans, not gifts, to our members."

IMF SURVEY: How has the IMF's financing role evolved since 1994? Is the era of large-scale bailouts over?

FISCHER: The word "bailout" is misleading, not least because we make loans, not gifts, to our members. We are trying to make the international capital markets safer and also to strengthen the economies that are accessing them. If this is done well, there should be fewer crises. But we will never get rid of crises entirely. The move to flexible exchange rates has helped, but—as we're seeing now with Brazil and Turkey—countries with flexible rates can still have difficulties and may need to borrow from the IMF. Still, they are less vulnerable, and we should therefore see fewer crises, and probably on a smaller scale, than before.

There is a serious question about the scale of IMF lending. We judge the size of a package against the quota, or shareholding, of the country that receives it. But quotas were set up to deal with current account problems, and while 300 percent of quota is a big number when dealing with a current account problem, it can look less impressive when a country is confronting a capital account crisis. Even so, it might be that we have the right scale of lending, taking moral hazard and other factors into account. But I'm not certain that the way we judge the size of packages in this era of massive capital flows and potentially rapid reversals is correct. We need to consider that issue; even more important is the question of whether the international legal framework for countries to deal with unsustainable debt situations should be changed.

IMF SURVEY: How successful has the transition process been, and how have the outcomes differed among the transition economies?

FISCHER: Some countries have done very well; some have done less well; some have done badly. Russia is now growing and pursuing a consistent market-oriented reform process. I've done a fair amount of work with colleagues in the IMF, particularly with my Advisor Ratna Sahay and Carlos Végh, formerly of the Research Department, on what worked and what didn't work. The answer seems to be that it worked pretty much as we thought at the beginning it would work; namely, countries needed to stabilize the macroeconomy and undertake pro-market structural reforms if they were to secure strong and sustainable growth in living standards.

The transition experience also raised an important set of political economy questions. Particularly, what will induce a country to pursue the path of reform? Those questions are much harder to answer. Most countries that have a prospect of joining the European Union seem to have had more focus to their reform efforts. It's probably harder for the others. Being a modern economy and looking forward to higher growth in the future is a bit of an abstract goal relative to the prospect of getting into Europe.

IMF SURVEY: Is there a direct relationship between democracy and economic progress?

FISCHER: The question of the relationship between democracy and economic progress has been much studied. In the mid-1980s, everyone was saying that international experience proves that democracies aren't good for development. "Look at Chile," they said. But that was fallacious. Chile was the one example supporting that view; there were at least twenty countries where dictators were making a complete mess of the economy. Now that Latin America has gone in a democratic direction—and you see the same in eastern Europe—I'm more and more impressed that it's the democracies that have done rather well in economic reform. The econometric results are more subtle but point in the same direction. It's frequently harder to negotiate with democracies, because the authorities have to worry about getting policies and programs through the legislature. But once they do, reforms tend to stick better.

IMF SURVEY: The IMF has moved heavily into assisting the poorest countries through the Heavily Indebted Poor Countries Initiative and the Poverty Reduction and

Growth Facility. Should we be in this business? Is it possible to measure concrete progress?

FISCHER: The IMF specializes in macroeconomics and structural issues related, or essential, to macroeconomic outcomes. I don't see how we could fail to be involved in poor countries that need macroeconomic help; they are our members. The notion that they belong to some other institution if they are poor is patronizing and wrong. Their macroeconomic problems are real, and they're not very different from those of other countries. So we need to have the capacity to help these countries, and I'm glad we have concessional loans that they can afford.

On the question of measuring progress, there is an emphasis on the need for quantitative indicators of economic progress in poverty reduction strategy papers. Per capita GDP growth and poverty rates are the most traditional indicators. But there are others, including life expectancy, school attendance, literacy, and inoculation rates. One striking fact that emerges from the human development indicators in the UNDP's *Human Development Report* [see *IMF Survey*, August 13, page 272] is that even in countries where per capita GDP has been declining, some of the social indicators are improving, including the health-related ones. So it is possible to take a broad-ranging look at what is happening and see whether there's progress.

IMF SURVEY: What is happening with the U.S., European, and Japanese economies?

FISCHER: The IMF's considered judgment is reflected in the *World Economic Outlook*, which will be out soon. Over the past six months, we've downgraded our growth estimates for Europe and Japan, but not for the United States. It's hard to predict turning points in growth, but U.S. growth must be close to beginning to turn. It's hard yet to say whether what's happening in Europe is just a slowdown or something worse.

It is clear, though, that this is turning out to be a longer growth slowdown than was thought nine months ago, and that we're in a period of uncertainty. You can paint a downside scenario pretty well, but you can't paint a massively positive upside scenario. You can see things going somewhat better, but there's no big recovery scenario in anyone's computer. I expect we'll turn around by the end of this year, but it's not guaranteed.

IMF SURVEY: Are the crises this year in Argentina, Brazil, and Turkey different from the crises of the 1990s?

FISCHER: The Brazil crisis is different in that it's happening to a country with a flexible exchange rate, and the IMF is ready to move in advance of the crisis with precautionary lending. In Turkey, we're dealing with the aftermath of a crisis related to a fixed exchange rate, so it's more like the earlier crises.

If we are in a better position now than we were earlier—and I think we are—it's because financial systems are much strengthened around the world, and because far fewer countries have pegged exchange rates. As a result of that, and of the revolution in transparency and information provided to the markets, there is probably less contagion going on now than there would have been in the past. What we're seeing from Argentina is very clear contagion to Brazil, but more sporadic contagion elsewhere. There are good reasons to hope that contagion in the system is more limited now. But we should be very cautious: it's hard to be sure about the likely extent of contagion if and when the next shock hits the international capital markets.

IMF SURVEY: Is it realistic to expect that ever-greater transparency will finally silence the IMF's critics? Is this even desirable?

FISCHER: No, we'll never silence our critics, nor, as you suggest, would that be desirable. The IMF is important—it is the principal agency, along with the World Bank, that helps countries in economic trouble. That involves making policy choices. Policy choices are never absolutely clear: we're bound to make mistakes, and there are bound to be critics. We are where the action is, so we will attract the critics—they're not going to go off and criticize some agency that has nothing to do with the issues at hand. We need to have that examination, even though it may be painful. So we can't, and in any case we shouldn't try to, silence the criticism.

IMF SURVEY: What will be the next great challenges for the IMF and the international monetary system?

FISCHER: We're dealing seriously with most of the challenges that we can see, although progress on private sector involvement in crises and reducing the volatility of international capital flows has been disappointing. The backlash against globalization is a major challenge that has to be dealt with, and somehow we're going to have to find ways of turning the situation around in our poorest member countries, many of them in Africa. But there will undoubtedly be challenges arising from future shocks that we did not anticipate. In that regard we can take comfort from history because, if there's one thing the IMF is good at, it's responding to challenges. When our critics complain that we constantly reinvent ourselves, it's another way of saying that, as the world changes, so do we.

IMF SURVEY: During your career, you have had experience in both the academic and theoretical world and in the real world of practical application. Has the change from theoretical modeling to practical application changed your approach to problem solving?

FISCHER: Experience must have changed my approach, because after seven years I feel more confident about dealing with real-world problems—including

The backlash against globalization is a major challenge that has to be dealt with.
—Stanley Fischer

crises—than I did at the beginning. But I can't quite pinpoint what it is that I learned.

Much of what one learns in academic life is not only very useful, but close to essential, in dealing with the problems that come up in the IMF. Everyone should know the basic core of macroeconomics and international macroeconomics. But there's also a lot of other material—including the game-theoretic literature on policy—that is very useful. I've been impressed and surprised that I sometimes find myself drawing on material that I was convinced had no real-world relevance when I first studied it.

A key difference from the textbooks is figuring out how to deal in complicated situations with live human beings: how they're going to react, what is driving them, what matters to them, which incentives they will respond to, and how. Yet those judgments have to be made all the time, not only about the policymakers and the public in our member countries, but also within the IMF.

When I first arrived, I found it hard to get used to the fact that if I held a meeting, there had to be a conclusion at the end of it—we had to decide one way or the other what to do. In my previous life in academia, you could just say things were unclear and leave it at that. In the IMF's work, we have to decide what to do even when there is uncertainty about the outcome—but of course the decision has to take into account the uncertainty about the outcome.

IMF Survey: Is there anything else you'd like to tell us about your time at the IMF?

Fischer: Yes, what a wonderful time I've had, what a wonderful experience it's been, and how grateful I am for having had the privilege of having this opportunity. The staff of the IMF is superb, and this organization works extraordinarily well. I couldn't imagine an organization that operates more rapidly in responding to crises or in dealing with problems as they arise. Somehow, the combination of the Board, the staff, and the management works extraordinarily well. I often wonder what drives the culture of this institution and the people in it—it's pride in what they do, it's the belief and knowledge that what they do is important, it's ability—the people are excellent. But there's something more, which I can't quite define. And the IMF is not even very large. It's a great surprise to people that we have a staff of just 3,000, given all the things that we do. I couldn't have had a more interesting time, I couldn't have worked with better people, and I'm very grateful. ■

Offshore financial centers

IMF, with other agencies, helps countries raise supervision standards, improve financial stability

In July 2000, the IMF Executive Board asked IMF staff to extend its work on members' financial sectors to include offshore financial centers through a voluntary program of assessments. Since then, IMF staff have visited 19 offshore financial centers and conducted three IMF-led assessments. The first assessment, on Cyprus, has been published and is available on the IMF's website. Stefan Ingves, Director of the IMF's Monetary and Exchange Affairs Department (MAE); and Huw Evans, Team Leader, Special Financial Supervisory Issues Section, MAE, spoke with the IMF Survey *about the IMF's experience so far with offshore financial center assessments and plans for the future.*

Ingves: "As capital flows between countries have increased, so, too, has the need to supervise banks and other financial sector activities."

IMF Survey: What is an offshore financial center?

Ingves: People have been trying for a long time to come up with a workable definition of offshore financial activities. Briefly, an offshore financial center is a place where most of the business is conducted with parties outside the region or country in which the center is based.

IMF Survey: What are the inherent dangers of these offshore financial centers? Why is there a need to assess and monitor their activities?

Ingves: When offshore financial centers began evolving, the need to monitor their activities was not all that important because very small sums of money passed through them. However, as capital flows between countries have increased, so, too, has the need to supervise banks and other financial sector activities. This holds true as well for the business conducted within the offshore centers. Today, almost all major world players have subsidiaries or affiliates in these centers, so a very substantial part of the business is passing through these channels. If the rules and regulations governing these centers are lax, passing money through them is a way of escaping national rules and regulations. And that's detrimental to the international financial system as a whole. So there is a serious need to follow closely what is going on in these centers.

IMF Survey: What is the rationale for addressing these issues at an international level and, in particular, what is the IMF's role?

Ingves: Supervisory agencies around the world have been dealing with these issues and discussing them among themselves for many years, but the process has often been slow, especially the attempt to get the supervisory agencies in the offshore financial center countries more involved.

These issues are now being discussed in a number of international forums in the hopes of speeding up the process. There are at least three separate aspects of the problem—money laundering, taxation, and financial regulation. The Financial Action Task Force, for example, was set up to deal with the legal and criminal implications of money laundering, which is a worldwide problem not confined to offshore centers only. The Organization for Economic Cooperation and Development has been concentrating on tax evasion, tax competition, and differences in tax laws between jurisdictions.

The IMF's work in the area of offshore financial centers is a natural extension of our work helping members strengthen their financial systems. Many of the offshore financial centers are also IMF members, so it makes sense for us to look into the supervisory aspects of their financial activities.

Now, if you are looking at financial stability from a national perspective—and most of the business of these offshore centers is being conducted with noncitizens—then the national aspect of sizable offshore financial center activity may not be all that important. But given the links between countries and the IMF's concerns about financial stability, our involvement is unavoidable.

EVANS: Hundreds of billions of dollars are passing through these centers, so although most of the centers themselves are very small in terms of population, the actual amount of financial activity going on is very large and is of concern to many people around the world.

IMF SURVEY: What is the benefit to developing countries and emerging markets of more rigorous supervision of offshore financial centers?

EVANS: Adverse consequences of inadequate supervision can be felt in developing countries as well as anywhere else. See, for example, what happened in the BCCI and Meridien cases. I've heard real concerns expressed by developing countries that have financial institutions in some poorly supervised offshore centers.

INGVES: We now have more countries buying into the process of improving supervision and regulation.

EVANS: We also have pretty full buy-in from the offshore financial centers themselves, all of which have indicated they want to achieve international standards of financial supervision. We have met with virtually every one of them and have completed three reports—Cyprus, Gibraltar, and Panama—and we have published the report on Cyprus (see box, this page).

INGVES: It's important to keep in mind that this whole process will go on for quite some time. It is one thing to send a mission for a few weeks to take a look at what is going on. But that just produces a snapshot of things at a given moment. It will actually take some time to improve supervision, change the laws, and do all the things you normally do in countries when you have decided to change something.

IMF SURVEY: What is involved in an IMF assessment?

INGVES: First, an assessment won't happen unless a country agrees to have us come in. We have views about where it would make sense to go, and we discuss these with members and come up with a work program. So far, it has always been possible to agree on a program.

EVANS: The discussions are not about *whether* the IMF should be involved but *when*: when we should come and what kind of assessment would be most helpful to the country or offshore financial center.

INGVES: Also, there is an ongoing discussion about what it would make sense for us to do, which depends a lot on the nature of the financial business in these countries. We have also held meetings with many offshore financial centers to explain what we do.

EVANS: We want people to understand what an assessment means, what kind of help we can give them, and over what sort of time frame. Then they can consider the timing that would suit them best.

INGVES: We have found this approach very helpful as a way of building consensus and getting a general buy-in to the process. In the early days, many people asked what the IMF was doing, why we were doing it this way, or what these standards and regulations were that they suddenly had to comply with. But these concerns can normally be addressed in preliminary meetings.

EVANS: Some of these concerns can also be allayed through the short- and long-term technical assistance that we are able to give the offshore financial centers.

Evans: "Adverse consequences of inadequate supervision can be felt in developing countries as well as anywhere else."

Financial assessment of Cyprus is first to be published

At the invitation of the Governor of the Central Bank of Cyprus, the IMF in March 2001 assessed the extent to which the Cypriot supervisory arrangements for the offshore financial sector complied with certain internationally accepted standards. The assessment concentrated on the supervision of the offshore banking center and on the provision of company services to the international business companies registered in Cyprus. An IMF-led team, including supervisory experts from Germany and Jersey, carried out the assessment.

The subsequent report found that the Cypriot offshore sector is not large in comparison with some other offshore centers and that the services provided are more restricted than in many other offshore centers. The report concluded that supervision was generally effective and thorough, though there was some scarcity of resources. It also described the many legislative changes being made by the authorities to bring Cyprus in line with the European Union, as the country prepares itself for accession. The report also notes that Cyprus has licensed institutions from countries often regarded as high risk and that continued vigilance and high standards of supervision are required.

The Central Bank of Cyprus published the report, which can also be found on the IMF website (www.imf.org/external/np/ofca/ofca.asp).

IMF Survey: Does the technical assistance come from the IMF or from other agencies?

Ingves: It's a joint exercise. The expertise we have is leveraged through all the work we do with cooperating institutions: central banks and supervisory agencies that lend us their experts. Without their help, it would take us almost forever.

Evans: A substantial part of an assessment team will be experts on the regulation and supervision of institutions—both onshore and offshore—from cooperating institutions around the world. They are already playing a key part in providing the necessary expertise.

IMF Survey: Is money laundering an area in which the IMF has experience?

Ingves: Technical assistance in supervision is not new for us. What is new is how to deal with the supervisory aspects in regard to money laundering. This issue has been on the agenda for many years, and it tends to pop up when there are serious cases of misbehavior. These cases can seriously affect the public perception of a financial center.

Evans: Money laundering is a concern in all markets; it is a particular danger in large markets where laundering activities can pass unnoticed among the billions or trillions of dollars traded. The IMF has been asked to intensify its activities to help counter money laundering, and we will do that both on- and offshore. But we're not the police trying to catch criminals, and we have no intention of getting involved in law enforcement.

IMF Survey: What are the offshore financial centers themselves doing to improve their financial supervision?

Evans: In the past year, in particular, we've seen efforts in many offshore financial centers to strengthen the laws and to increase the number and skills of financial supervisors. But, of course, as Stefan said, raising standards takes time. First you have to decide what to do, which usually involves updating, extending, and improving your laws. Then you need to put more supervisors with updated skills in place. Further, you have to make sure that everything is working and that supervisors have the necessary independence and legal backing to support their efforts. Any financial supervisor will tell you that this is a matter of years, not months.

IMF Survey: Is it realistic to expect smaller jurisdictions to raise their financial supervision to international levels?

Evans: It depends. Some jurisdictions are upgrading their laws and their supervisory resources. Some small jurisdictions with limited resources would be best advised to limit the extent of business that they supervise. In other instances, there may be a case for regional supervision—for example, the Caribbean.

IMF Survey: More countries with offshore financial centers seem to be requesting assessments. Will the IMF be involved in this activity for several years to come?

Ingves: Absolutely. A year and a half ago we had a lively debate about whether this was the right way to go. Now the issue is how we factor these assessments into our work with countries on their financial sectors. It's on the way to becoming a regular part of our business. ■

For further information on the IMF's work with offshore financial centers, please see the following papers by IMF staff: *Offshore Financial Centers (OFCs): Note for the IMF Executive Board*, which can be found on the IMF's website (www.imf.org/external/np/mae/oshore/2001eng/062901.htm).

Köhler to recommend increase in Argentina's Stand-By credit

IMF Managing Director Horst Köhler informed the IMF's Executive Board on August 21 that he was prepared to recommend an augmentation of Argentina's current Stand-By credit by approximately $8 billion, to about $22 billion from the present $14 billion.

"Of the total amount that would be added to the current Stand-By credit, approximately $5 billion would be made available upon Executive Board approval of the augmentation, and the balance of $3 billion would be added to future disbursements under the program," Köhler stated. "The authorities are also considering the possibility of a voluntary and market-based operation to increase the viability of Argentina's debt profile. As these discussions bear fruit, IMF management would be prepared to recommend bringing forward the remaining $3 billion under this augmentation to support such an operation."

IMF News Brief No. 01/81 also noted that "the Argentine authorities have committed to strengthening fiscal adjustment and to ensuring that the fiscal adjustment is sustainable over the medium term, through full implementation of the 'zero-deficit' law approved by the Argentine congress on July 29. An important undertaking in the program is the introduction of legislation to reform Argentina's revenue-sharing arrangements with the provinces, which have been a significant source of rigidity and inefficiency in public finances.

"A strengthening of tax administration by the authorities is expected as part of Argentina's aggressive efforts to address fiscal imbalances. Other reforms under the government's program include measures in the reform of the state and the strengthening of the public banks.

"The Executive Board is expected to consider the augmentation in early September when it conducts its review of Argentina's performance under the current arrangement."

The full text of News Brief No. 01/81, as well as an earlier related press release (01/3) and news brief (01/71), is available on the IMF's website (www.imf.org).

Country circumstances should determine how IMF conditionality is applied to privatization

Privatization has emerged as an important issue in recent discussions about the conditionality the IMF attaches to the country programs for which it provides support. On July 12, the IMF's Fiscal Affairs Department and Policy Development and Review Department, in collaboration with the World Bank, cohosted a seminar on privatization, program design, and conditionality. The purpose of the seminar, which drew on the experience of IMF and Bank staff members as well as outside observers, was to discuss the incorporation of privatization in IMF-supported programs and to develop practical guidelines in light of the Executive Board's recent review of conditionality.

In opening remarks, IMF Managing Director Horst Köhler noted the timeliness and relevance of the seminar, given ongoing IMF reforms and the emphasis on streamlining conditionality. On privatization, Köhler was convinced that private sector activity is indispensable for growth and for improving welfare over the long run. Nonetheless, privatization should not be seen as a rigid ideology, because it is up to individual governments to make decisions about social organization. Thus, while privatization is often the preferred route, the best way to convince governments is through consultation and persuasion. Collaboration between the IMF and the World Bank is particularly important, he said, because the privatization process is a microeconomic issue and therefore falls more within the World Bank's area of responsibility and expertise than the IMF's.

Privatization and program design

In a presentation on the fiscal and macroeconomic implications of privatization, Jeffrey Davis of the IMF's Fiscal Affairs Department noted that privatization proceeds should be transparently channeled through the budget and not into extrabudgetary funds, and they should be considered as financing in the fiscal accounts. Privatization proceeds, he added, should preferably be used for debt reduction, and any spending should be restricted to high-return projects and should also be consistent with macroeconomic objectives. He noted that privatization was correlated with better macrofiscal outcomes, including higher growth and lower unemployment (at least in the aggregate). Programs should estimate privatization proceeds cautiously, he said, and adjusters should be used to ensure that any excess privatization proceeds are saved.

Even though the evidence showed privatization improved enterprise and macroeconomic performance and enhanced government credibility, according to John Nellis, formerly with the World Bank, it remains a difficult, contentious, and unpopular action. The answer to this conundrum, he suggested, is that privatization involves trade-offs, including between multiple government objectives and between different segments of the population. In his view, efficiency and market structure are more important than revenue generation. Also, both speed and preparation are important, and technical assistance should be used to attain high-quality, yet fast, results. A regulatory framework needs to be in place before, or—at a minimum—in parallel with, privatization, particularly in the case of utilities, he emphasized. It is also important to ensure free entry to the market—perhaps as important as privatization itself.

Providing a summary of findings from the academic literature, William L. Megginson of the University of Oklahoma said the evidence shows that privatization improved performance. This improvement was evident even when the government retained a majority stake, provided the company was allowed to operate commercially. Also, sales prices tended to be higher when a regulatory regime was in place.

Privatization-related conditionality

Timothy Lane of the Policy Development and Review Department reviewed the state of play in the IMF's ongoing review of conditionality. He noted that, in deciding when and how to apply conditionality to privatization, one must bear in mind that the macroeconomic consequences of privatization depend considerably on how it is carried out. In particular, the transparency of the process and the corporate governance structure, degree of competition, and labor market restrictions newly privatized enterprises will face are very important. For this reason, notwithstanding the belief that privatization is generally beneficial, it is not always clear whether these benefits will materialize under the actual circumstances in which privatization takes place—which often include poor governance and weak administrative capacity.

A related issue, Lane said, is the question of ownership: if the authorities are not committed to the goals of privatization, they may either drag their feet on implementation or implement in a way that frustrates these goals. These considerations should be taken into account in deciding whether to attach conditionality to privatization in a particular instance. These considerations also pose the question of whether conditionality should specify how privatization takes place or just the outcome: the importance of the process for the macroeconomic benefits would argue for the former, but if the IMF tries to specify the process in too much detail, this may be seen as intrusive and weaken ownership.

Davis: Privatization proceeds should be transparently channeled through the budget and not into extrabudgetary funds.

Lane: The macroeconomic consequences of privatization depend considerably on how it is carried out.

Havrylyshyn: Strong ownership ensures success in privatization-related institutional reforms.

Basu: In general, IMF conditions were policy-based whereas Bank conditions were results-based.

Oleh Havrylyshyn of the European II Department noted that moving toward privatization conditionality that is based on process, rather than on time or other targets, helps. This shift started many years ago, for example in Bulgaria and Romania, though the results varied. How much success is a result of better design of conditionality, and how much of stronger ownership is difficult to assess. Strong ownership, he said, ensures success in privatization-related institutional reforms—for example, in the judicial system (as in Lithuania)—while devoting large resources may not achieve results if there is lack of ownership. A good regulatory framework helps ensure the sustainability of reforms, as was true for Moldova, while allowing privatized enterprises to "capture" the regulators leads to failure, as happened in the energy and railroad sectors of several countries.

Havrylyshyn suggested that two important issues in designing privatization conditionality are that it needs to be clear that privatization is critical for the program, and that more flexibility is needed in this area than in the design and monitoring of conditionality in other areas. In general, he felt it was undesirable to set targets for the number of enterprises to be privatized, total privatization revenue, or the timetable, although he said that indefinite delays should not be permitted. In establishing a competitive market environment for privatized enterprises, liberal entry to and exit from the market are crucial, he stressed. When dealing with natural monopolies, regulation must be part of the privatization program.

IMF–World Bank collaboration

There was a frank discussion on the cooperation between the World Bank and the IMF on privatization issues. Speaking from the perspective of the World Bank, Nemat Talaat Shafik said there was a need to better understand the political economy aspects of creating a robust market structure and to address distribution issues up front. Frequently, she noted, differences between the Bank and the IMF come down to speed, with the IMF often aiming for quicker results.

Looking at Bank-IMF collaboration from the IMF's side, Anupam Basu of the African Department used the experience of trying to privatize the public groundnut company in Senegal as an example of cases where the process needed to be strengthened. The decision to privatize this company had been made explicit in the policy framework paper as far back as 1995, he said, but the opposition of certain groups, a lack of satisfactory bids, and the need to take broader liberalization measures had delayed its implementation. Indeed, by 2000, the objective had become a "future milestone."

On the basis of this example, Basu saw a need to review the Bank's usual practice of waiting until countries were ready to implement policies without tracking developments closely in the meantime. He noted, for example, the lack of financial analysis and infrequent auditing of companies put forward for privatization and suggested conducting periodic profit and loss assessments for these companies. There were also, he indicated, differences in the way the IMF and the Bank set structural conditions and in the extent to which nonobservance of these conditions affected aid inflows. In general, IMF conditions were policy-based whereas Bank conditions were results-based. In addition, when IMF conditions were not met, failure to complete a program review could lead to a drop in financial support from various sources. In the case of the World Bank, a loss of financial support as a result of poor policy implementation in a particular sector would be much more limited, as financing would continue to be provided to the country through loans in other sectors. Where there has been a reversal of measures (the delay in privatizing the public groundnut company in Senegal was a prime example), he noted it would be helpful for the World Bank to provide an analysis of the underlying causes.

More generally, Basu emphasized that it was essential to improve Bank-IMF collaboration in this area because World Bank advice had a macroeconomic impact.

Members' use of IMF credit
(million SDRs)

	During July 2001	January–July 2001	January–July 2000
General Resources Account	**1,306.46**	**10,679.11**	**2,204.03**
Stand-By	1,306.46	10,567.99	1,542.71
SRF	578.40	4,585.68	0.00
EFF	0.00	111.12	661.32
CFF	0.00	0.00	0.00
PRGF	**108.14**	**411.03**	**221.92**
Total	**1,414.60**	**11,090.14**	**2,425.95**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
August 13	3.42	3.42	4.02
August 20	3.37	3.37	3.96
August 27	3.39	3.39	3.99

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?2001).

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

Data: IMF Treasurer's Department

There was a need for a shared analysis of objectives and greater clarification from the Bank side as to what kind of sectoral reforms were needed in countries.

Responding to Basu, Michael Klein of the World Bank said there had been a number of instances of successful collaboration between the two institutions on privatization. However, the lack of a mandate in the World Bank to conduct systematic surveillance had hampered its analysis. Klein took issue with the contrast drawn by Basu between the enforcement of World Bank and IMF conditionality, saying it was overdone in the case of privatization. Since IMF program reviews and the associated disbursements were often held up as a result of delays in policy implementation, de facto IMF conditionality had become floating conditionality. Finally, he acknowledged the need for better coordination between the two organizations in this area.

Conclusions

Although participants saw privatization as clearly beneficial, the seminar revealed a range of views on how prospective benefits could best be achieved, with some speakers emphasizing that the consequences of privatization depend on how, as well as whether, it is implemented. Thus, the process by which privatization is accomplished—including the transparency of the process—and the environment in which the privatized enterprise will operate are important. Several participants stressed the need for hard budget constraints on the privatized enterprise and for freedom of exit, as well as entry. Others, however, warned that worrying about such issues could become an excuse for delay and stressed that privatization is usually beneficial even if it does not happen under ideal circumstances.

One key theme was the need to differentiate the way conditionality is applied to privatization, depending on the circumstances of the country. When there is a hemorrhage from the budget caused by financial imbalances at state-owned enterprises, privatization conditionality is absolutely essential and should take the form of performance criteria and even prior actions when country finances are threatened. When the primary objectives are longer term—for example, in the case of transition economies—more flexibility is justified, and the implementation of conditionality could be monitored in the context of program reviews focusing, in particular, on the process and eschewing explicit targets for timetables, numbers of enterprises sold, or revenues. In many middle-income countries, capital markets are more likely to play a key disciplining role, and IMF efforts should thus be tilted toward advice rather than conditionality.

The discussion of Bank-IMF collaboration highlighted the need to strengthen collaboration to address the different time frames under which both institutions often work. This was seen as particularly important in cases in which quick action on privatization was critical for fiscal sustainability. Closer coordination and a clear understanding of the objectives and constraints of each institution were seen as essential given these differences. It was agreed that a process needs to be set up to guide Bank-IMF coordination and help set priorities and clarify further the responsibilities of each institution. ■

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Interview

Calomiris commends recent IMF reforms but urges further rethinking of policies, facilities

The International Financial Institution Advisory Commission, set up by the U.S. Congress and headed by Allan H. Meltzer of Carnegie Mellon University, issued its report on the role and effectiveness of the IMF and the multilateral development banks in April 2000. In the intervening months, a number of its recommendations have been absorbed in the IMF's ongoing efforts to adapt to a changing global economy. In some areas, however, debate continues over both the role of the organization and the modalities of certain reforms (see also remarks by Mark Allen on page 288).

Following is an interview by Prakash Loungani with Charles Calomiris, a member of the Meltzer Commission and a professor of finance and economics at Columbia University's Graduate School of Business. Calomiris was visiting the IMF in mid-June to give an IMF Institute course on emerging financial markets.

Calomiris: "There will always be an IMF...So why don't we just try to make it work better?"

LOUNGANI: Some members of the Meltzer Commission were reportedly in favor of abolishing the IMF. What's your view?

CALOMIRIS: There will always be an IMF. And a majority of the Meltzer Commission agreed there were bona fide reasons to have an IMF. So why don't we just try to make it work better? This institution already starts from a pretty strong position in terms of having well-stated objectives and skilled economists who understand incentives and mechanism design. I am also very impressed by [IMF Managing Director] Horst Köhler. I don't agree with him on everything, but he certainly seems to have a good sense for the right objectives.

LOUNGANI: IMF First Deputy Managing Director Stanley Fischer said recently the biggest change he's seen at the IMF in his years here is that we used to publish virtually nothing and now we publish virtually everything. Would you agree? Is the IMF a lot more open?

CALOMIRIS: Certainly, there's no question about that. And my understanding is that Stan Fischer made a strong personal commitment to make that happen. But there's one area where the IMF still needs to be more open—the Executive Board's decisions need to be transparent and explained better. I support a policy of explicit recording and publishing of the Board's votes. Is it really acceptable these days for a taxpayer-funded institution to operate with the kind of hidden processes that the IMF's Board has used through the years? You could also move ahead on this front by making decisions based more on rules than on the exercise of discretion. If people see the institution more or less following rules they've already been told about, openness does not end up becoming such a big issue.

LOUNGANI: The Meltzer Commission was critical of the IMF's accounting practices. Has your view changed since talking to our Treasurer's Department about changes we've made?

CALOMIRIS: Yes, I was very impressed by the changes made in the reporting of the IMF's finances. They are definitely a move in the right direction. What's even more heartening is that the people in the Treasurer's Department say they aren't done yet. I think the critiques from the Meltzer Commission and others helped nudge along a process of reform that was already under way.

LOUNGANI: What about the streamlining of our lending facilities? Does that broad direction appeal to you?

CALOMIRIS: Oh, absolutely. Consolidating the lending facilities, increasing incentives for early repayment, trying to raise the interest rates at which you lend, all that makes sense to me. It's fair to say, though, that all the real consequences of these changes remain to be demonstrated. Another problem is that your lending rates haven't been increased as much as they should; they should be geared not to the lending countries' cost of funds but to the borrowing countries' (pre-crisis) cost of funds. Still, the streamlining of facilities does represent progress. And my sense from conversations with senior people at the IMF is that they want to move more in that direction, and that's very constructive.

LOUNGANI: But you're not a fan of one of our facilities—the Poverty Reduction and Growth Facility. Why?

CALOMIRIS: Because I find it difficult to defend poverty reduction as a core mission of the IMF. Why should the IMF be so involved in it? That's what we have development banks for. I realize problems facing countries are intertwined, particularly in much of Africa. No one would be so naïve as to say that macroeconomics in Africa is unrelated to war and disease and other such causes of extreme poverty. But don't we need to approach such problems with a different skill set than the one with which we approach monetary and fiscal and banking system problems? We should reform and recapitalize the development banks so that they can do more for these countries. It's pretty clear that if they were reformed, the development banks could stand to have a much larger capital base and they could substantially increase their role in poverty reduction. The Meltzer Commission—even

though we want to see regional development banks take the lead in providing much of poverty assistance—argued that the World Bank would have to play a key role in African assistance for a while because the African Development Bank might not right away have the resources or the institutional structure that would allow it to operate effectively.

Loungani: You've been a critic of many earlier programs in Argentina and Turkey that the IMF has supported. Let's take Argentina first. What don't you like?

Calomiris: Argentina needs reform a lot more than it needs funding. There are hard reforms ahead in the labor market, in trade, and in government expenditures —particularly in co-participation policies. I believe there would have been greater progress on these reforms without the Argentine government's access to the multilateral institutions' funding and imprimatur and, thereby, without the easier access to global capital markets. The buildup in sovereign debt since 1996 as a consequence of that access has been very great, and my view is that the IMF allowed itself to condone this loss of fiscal discipline. Part of the story in Argentina is one of reform fatigue. You could look at Argentina in the early part of the 1990s and say, "things have gone well." You had the setting up of the currency board, the privatizations, and the banking sector reforms, which I was involved in personally. Now comes the hard part of solving the political economy problems of how to rein in the unions, how to change the labor laws, how to end protectionism and have real free trade, and how to change the revenue-sharing and expenditure-sharing policies between the central government and the regions. People argue that the agreements with the IMF buy time to carry out these reforms. But is more time good? Does more time make it more likely that you are going to have reform? Time also removes pressure. In Argentina, the pressure for reform has been reduced.

Loungani: Why are you critical of Turkey's program?

Calomiris: I believe that Turkey still has more foreign exchange reserves than its total foreign debt exposure. So I find it difficult to think that external sustainability is the main problem. The main problem seems to be one of internal sustainability, credible fiscal policy, ensuring good governance, and keeping politics out of business. So the real question is: Should the IMF offer loans to countries as an inducement to get them to carry out such internal reforms? Does that work? Will it work in Turkey this time after numerous previous attempts? What's happening here is that the Group of Seven is providing fiscal subsidies to a politically important country using the IMF. I just don't think that this model of what the IMF should be doing is right. If the program fails, some people will again fault the technical competence of the IMF's programs rather than the inadvisability of using IMF money and advice to carry out internal reforms.

Loungani: Let's close by discussing our facility of the future, the CCL [Contingent Credit Lines] Facility. What do you think of it?

Calomiris: A facility based on the idea of prequalification—ex ante conditionality—is something that the Meltzer Commission was in favor of as well. But it concerns me that the CCL Facility remains unused and is structured in a way that it may not be used much in the near future. Having many lending facilities lowers the attractiveness of the CCL; eventually it seems to me you'd want to have one lending facility rather than multiple pockets that countries can draw from, each with its own multiple rules. Countries shouldn't be able to arbitrage across different kinds of lending facilities—that undermines the whole purpose of setting conditions, whether ex post or ex ante conditions. And the facility should be a reliable source of credit, something like a line of credit from a bank. Countries should, if they meet certain (pre-)qualifications and subject to regular review, know that the money is going to be there when they need it and at the terms set in advance. The way I read IMF discussions is that you do want it to be along these lines but there's also going to be a review of whether the country was an innocent victim. That makes it a somewhat less reliable source of credit from the country's point of view.

Calomiris (with Prakash Loungani): "Not everything has to be invented from scratch...; the IMF could learn more from the way private contracts are written."

I've also floated the idea of having a CCL Facility with multiple tiers, where as countries improve they see the advantages of access to a larger amount of potential liquidity on cheaper terms. I understand that designing these facilities correctly is not a simple matter, and I'm very sympathetic to the need for refinements. But not everything has to be invented from scratch based on long negotiations within the IMF; the IMF could learn more from the way private contracts are written. Not to mimic them exactly, but there are a fair number of examples of liquidity assistance provided in private markets.

Probably the simplest example, which goes back 30 years, is credit lines for commercial paper issuers, which are designed to deal with potential liquidity crises that might shut down the commercial paper market. These were designed after the Penn Central crisis of 1970. The goal was to prevent a Penn Central crisis from ever happening again by making it clear that there was liquidity assistance. And so far it's worked. There hasn't been another Penn Central crisis.

Isn't it interesting? The private markets experienced a commercial paper crisis in 1970, decided they could

come up with liquidity lines to prevent financial crises from happening, and did so immediately, and we've not had a crisis since. So, can't we learn a little bit or benefit from the way that those facilities are designed or, generally, how other bank lines of credit are designed? They require borrowers to make certain warranties in advance, to agree to certain covenants. There is ongoing monitoring to make sure the borrowers' warranties are true and the borrowers' covenants are being enforced properly. And subject to that and subject to no very sudden adverse change in circumstances, borrowers have access to credit lines. Why is that not a good model for the IMF? It seems to me that it would be. ■

Mark Allen

IMF fosters international cooperative assistance to allow markets to work properly

Following are edited excerpts of remarks delivered at the Midwest Economics Association meeting in Cleveland, Ohio, this spring by Mark Allen, Deputy Director of the IMF's Policy Development and Review Department, on the role of the IMF.

Allen: "We do not live in a world where countries can be treated like minor banks or enterprises and allowed to collapse."

The IMF has always seen preventing crises—and managing those that it couldn't prevent—as a critical part of its responsibilities. The Latin American debt crisis of the 1980s and its aftermath were a typical instance of this. But the crises of the 1990s have been something different. They have been remarkable for their suddenness and virulence, and for the sharp upsurge in public and academic examination of the IMF they have triggered. This scrutiny is entirely appropriate. As the central monetary institution of the global economy, the IMF should be subject to scrutiny. One criticism is that we apply the wrong remedies in individual countries; the other, broader criticism is that IMF activities actually cause crises by making the international financial system more fragile.

Moral hazard

The broad criticism—the moral hazard criticism—argues that the IMF, by providing insurance to feckless countries, encourages private markets to lend more than is prudent, because the markets know the IMF will make them whole in the event of a crisis. This, in turn, say critics—such as those on the Meltzer Commission—leads to more crises and a more unstable international monetary system.

In truth, all insurance is prone to moral hazard. So the question for a public provider of insurance, such as the IMF, is how the costs of moral hazard compare with the benefits of intervention. How large, in reality, are the moral hazard effects of the IMF's activities? The Meltzer Commission report states that it is impossible to overestimate the costs of moral hazard, but hard evidence is scanty and in fact indicates the costs are pretty small. The IMF's advances to its member countries are a small fraction of the private market claims on those countries. If markets think the IMF is going to bail them out, there must be a collective delusion concerning how many claims a single dollar can satisfy.

Indeed, while the availability of IMF money may have some effect on, say, Argentine spreads, the high spreads in that country reflect lender recognition of a high risk of default. Those who gambled on the "moral hazard play" in Russia lost a lot of money when the ruble collapsed. In addition, econometric analysis shows the possible size of the moral hazard effect must be small. So, while the moral hazard hypothesis is an interesting one, there is no evidence to support it. One might just as well recommend barring automobile insurance on the grounds that a lack of insurance will spur people to drive more safely and thus reduce the accident rate.

Interconnected prosperity

Also, consider the benefits of the IMF's support for countries' adjustment efforts. We do not live in a world where countries can be treated like minor banks or enterprises and allowed to collapse. Our prosperity is too interconnected. The true motivation for creating the IMF was not to establish a system of fixed exchange rates but to ease the adjustment effort in countries, recognizing that distress in one economy causes distress in others. The lessons of the Great Depression and World War II remind us that economic distress can give rise to international frictions and, ultimately, war.

Cooperative assistance among nations to help countries emerge from their difficulties makes sense on three counts. First, prosperous partners bring prosperity. There are few gains to be had from trade if trading partners are flat on their backs. Second, economic distress generates international political tensions and floods of migrants. And, third, there is the moral imperative to help fellow humans in distress. I do not put this forward as an idealistic or sentimental gesture. This is the real world in which the IMF operates.

IMF and capital markets

The IMF now functions in, and must adapt itself to, a new world of global capital markets. With the cost of crises so large, the return on crisis prevention becomes very high as well. One element in the IMF's crisis prevention work is the new Contingent Credit Lines Facility. This facility is designed to provide sub-

stantial insurance to a country to ward off the spread of crises—or contagion—should the markets become nervous. To qualify, countries must have sound policies, no balance of payments need absent a crisis, healthy financial systems, high standards in such areas as the provision of data and financial institution regulation and supervision, and good relations with their creditors. Once a country has qualified, it can then draw substantial amounts of money immediately if a crisis breaks out.

While we have our eyes on several countries, so far we have had no applicants, and it is worth looking at the reasons why this may be so. The first concern is the market's potential reaction. Professor Allan Meltzer has suggested that the market would reduce spreads for countries with a contingent credit line. The reality is that countries fear markets will interpret their application as a sign of concern about vulnerability.

A second concern for possible users of the facility is who the other members of the club will be. Each country aspires to have its reputation enhanced when it joins a select club. The authorities of one country, now borrowing at 100 basis points, have expressed concern about being in a club with other countries that the market is charging 350 basis points. Then there is the fear of being thrown out of the club. If a country's policies cease to meet with approval, for whatever reason, and the country is declared no longer eligible, it may face a negative credit shock at the worst moment. The IMF believes that all these problems can and will be overcome, but they reflect some of the complexities inherent in the reform suggested by the Meltzer Commission.

IMF country information

Among the other recommendations of the Meltzer Commission is that the IMF provide reliable information on its member countries, because this information is a public good. The IMF does indeed provide the market with information, but why can the private market not provide it? Would countries not have an interest in providing accurate information and getting it certified by private sector accountants, who are concerned with their reputation? If the IMF is to do this as part of the international public sector, should there not be a domestic analogue? Why does the U.S. government not publish and certify information about banks and private firms? If the provision of information is left to the private market inside the United States, why should this not be the case for international data?

In this instance, the public good is not so much the provision of data but the setting and enforcing of standards. And it is this that is the job of the public sector. Governments have traditionally managed the infrastructure of markets, setting and enforcing standards. At the international level, the IMF is increasingly playing this role. We have become active in promoting the use of international standards in a range of areas. In this way the IMF is acting as its founders intended—as part of the structure of international cooperation needed for markets to work properly. ■

Available on the web (www.imf.org)

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News Briefs

01/77: World Bank/IMF Annual Meetings to Take Place Over Two Days Next Month, August 10 (see page 277)

01/78: IMF Continuing to Work with Argentina, August 19

01/79: IMF Executive Board Informally Discusses Argentina, August 20

01/80: Publication of First IMF Staff Assessment of an Offshore Financial Center, August 21

01/81: IMF Managing Director Prepared to Recommend Addition of $8 Billion to Argentina's Stand-By Credit, August 21 (see page 282)

01/82: IMF Managing Director Congratulates Korea on Early Repayment of 1997 Stand-By Credit, August 22

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"Turkey Is Recovering: A Commentary," Michael Deppler, *Financial Times*, August 14

IMF Financial Activities, August 24

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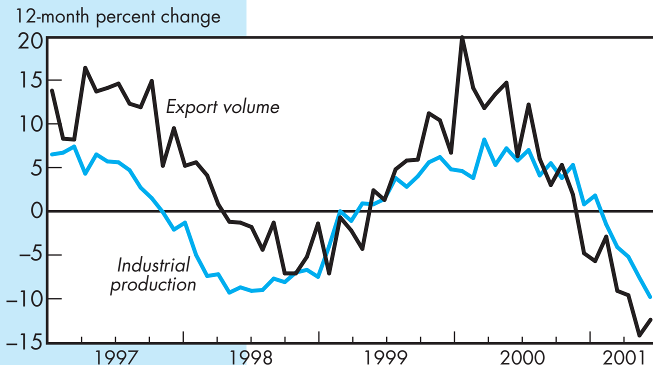
Deep-seated weaknesses

Decisive structural reforms offer key to restoring healthy growth in Japan

The modest economic recovery that appeared to be under way in Japan in early 2000 in the context of the buoyant global economy has now given way to renewed weakness. While real GDP grew by 1½ percent in 2000, the economy has slowed sharply this year as the high-tech-driven expansion succumbed to the U.S. and global electronics slowdown. Industrial production and exports have fallen by 9½ percent and 12½ percent, respectively, over the past year (see chart, this page); equity prices have declined by 32 percent to 17-year lows; the unemployment rate has risen to 5 percent; and deflationary pressures have continued, with underlying consumer prices currently declining by around ¾ of 1 percent (12-month basis) (see chart, page 292).

Export volume and industrial production



Data: WEFA, Nomura Database; and IMF staff estimates

In the face of the weakening economy, the Bank of Japan (BoJ) introduced a new monetary policy framework in mid-March. Under this framework, a quantitative target is set for current account balances (broadly equivalent to bank reserves) at the central bank. The target was initially set at ¥5 trillion, which was sufficient to bring overnight interest rates down to zero, and was increased to ¥6 trillion in mid-August as deflationary trends intensified. The BoJ also announced that it would step up its purchases of long-dated government bonds (so-called *rinban* operations) to support this higher target. The central bank has indicated that this policy framework will remain in place until year-on-year changes in the consumer price index, excluding perishables, have risen to zero or above.

Despite this easing, short-term prospects are bleak. The staff's current forecast sees the economy contracting by 0.2 percent in 2001, before returning to modest growth of 0.5 percent in 2002. But the downside risks are considerable. A slower than expected recovery in the U.S. economy and global electronics market, a further decline in equity prices, or a deterioration in consumer confidence could result in a deeper recession. Indeed, concerns are mounting that Japan may re-enter a cycle of slowing activity, rising bankruptcies, and a deteriorating banking system.

Government's reform agenda

Against this background, the new government of Prime Minister Junichiro Koizumi took office in April. Believing that "without structural reform, there can be no rebirth for Japan," the government has committed itself to addressing Japan's deep-seated economic problems. While the details are still being fleshed out, the reform program has three central pillars:

• ***Dealing with the long-standing weaknesses in the bank and corporate sectors.*** The centerpiece of the bank and corporate restructuring package is the removal of nonperforming loans to bankrupt and near-bankrupt borrowers from major banks' balance sheets within two years, and the removal of newly emerging nonperforming loans within three years of such classification. Bad loan disposal will involve assets being restructured or sold, through either out-of-court workouts or bankruptcy proceedings. A working group of bank and business representatives has recently issued draft guidelines, which will be finalized later this month, to guide the out-of-court workouts. Difficult loans that remain on banks' balance sheets at the end of the stipulated two- or three-year period will be sold to the Resolution and Collection Corporation for final disposal. The plans also call for a reduction in banks' significant exposure to equity price risk. To facilitate this process, the Banks' Shareholding Acquisition Corporation will be established to purchase equity from the banks. It will then repackage the equity into mutual or exchange-traded funds for sale to investors.

• ***Implementing structural reforms to create new employment and investment opportunities and raise productivity.*** In its "seven-point plan," released in June, the government highlighted a number of high-priority areas. These included regulatory reforms, tax reforms, and reforms of state-run corporations to improve competition and economic efficiency, promote business start-ups and the expansion of the information technology sector, and expand employment opportunities; social security reforms to restore confidence in the system and put its finances on a sound footing; and fiscal reforms (see below). The government's Council for Regulatory Reform has also called for deregulation to encourage greater private sector involvement in social service provision and measures to revitalize the real estate market.

• ***Undertaking fiscal reforms to rein in the large budget deficit and return the government's finances to a sustainable footing.*** The government has indicated that it believes that balancing the primary budget is a reasonable medium-term objective but has set no time frame for doing this. It has, however, committed itself to limiting

the issuance of new government bonds to ¥30 trillion in fiscal year 2002 (which runs from April 1, 2002, to March 31, 2003), and spending guidelines have been issued that represent an initial attempt to secure the cuts needed. If achieved, this target could result in a substantial fiscal contraction next fiscal year. The government has also announced its intention to end the practice of earmarking revenues for specific purposes (like road construction) and to shift greater responsibility to the local governments for their own financing.

Implementing the reforms

Over the past decade, expansionary macroeconomic policies and piecemeal structural reforms have not succeeded

Stand-By, EFF, and PRGF arrangements as of July 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By Arrangements				
Argentina[1]	March 10, 2000	March 9, 2003	10,585.50	5,774.97
Brazil[1]	December 2, 1998	December 1, 2001	13,024.80	3,554.05
Croatia	March 19, 2001	May 18, 2002	200.00	200.00
Ecuador	April 19, 2000	December 31, 2001	226.73	75.58
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Latvia	April 20, 2001	December 19, 2002	33.00	33.00
Nigeria	August 4, 2000	August 3, 2001	788.94	788.94
Pakistan	November 29, 2000	September 30, 2001	465.00	105.00
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Papua New Guinea	March 29, 2000	September 28, 2001	85.54	18.89
Peru	March 12, 2001	March 11, 2002	128.00	128.00
Serbia/Montenegro	June 11, 2001	March 31, 2002	200.00	150.00
Sri Lanka	April 20, 2001	June 19, 2002	200.00	96.65
Turkey[1]	December 22, 1999	December 21, 2002	15,038.40	6,903.82
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			**41,311.83**	**18,151.60**
EFF arrangements				
Bulgaria	September 25, 1998	September 24, 2001	627.62	0.00
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
FYR Macedonia	November 29, 2000	November 28, 2003	24.12	22.97
Indonesia	February 4, 2000	December 31, 2002	3,638.00	2,786.85
Jordan	April 15, 1999	April 14, 2002	127.88	91.34
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Ukraine	September 4, 1998	August 15, 2002	1,919.95	1,017.73
Yemen	October 29, 1997	October 28, 2001	72.90	26.40
Total			**8,696.57**	**6,231.39**
PRGF arrangements				
Armenia	May 23, 2001	May 22, 2004	69.00	59.00
Azerbaijan	July 6, 2001	July 5, 2004	80.45	72.40
Benin	July 17, 2000	July 16, 2003	27.00	16.16
Bolivia	September 18, 1998	June 7, 2002	100.96	37.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	16.76
Cambodia	October 22, 1999	October 21, 2002	58.50	25.07
Cameroon	December 21, 2000	December 20, 2003	111.42	79.58
Central African Rep.	July 20, 1998	January 19, 2002	49.44	24.96
Chad	January 7, 2000	January 6, 2003	42.00	20.80
Djibouti	October 18, 1999	October 17, 2002	19.08	13.63
Ethiopia	March 22, 2001	March 21, 2004	86.90	69.52
FYR Macedonia	November 29, 2000	December 17, 2003	10.34	8.61
Gambia, The	June 29, 1998	December 31, 2001	20.61	3.44
Georgia	January 12, 2001	January 11, 2004	108.00	90.00
Ghana	May 3, 1999	May 2, 2002	228.80	105.17
Guinea	May 2, 2001	May 1, 2004	64.26	51.41
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Honduras	March 26, 1999	March 25, 2002	156.75	64.60
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Lao People's Dem. Rep.	April 25, 2001	April 24, 2004	31.70	27.17
Lesotho	March 9, 2001	March 8, 2004	24.50	17.50
Madagascar	March 1, 2001	March 1, 2004	79.43	68.08
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2002	46.65	33.15
Mauritania	July 21, 1999	July 20, 2002	42.49	18.21
Moldova	December 15, 2000	December 20, 2003	110.88	92.40
Mozambique	June 28, 1999	June 27, 2002	87.20	33.60
Nicaragua	March 18, 1998	March 17, 2002	148.96	33.64
Niger	December 14, 2000	December 21, 2003	59.20	50.74
Rwanda	June 24, 1998	January 31, 2002	71.40	19.04
São Tomé & Príncipe	April 28, 2000	April 28, 2003	6.66	4.76
Senegal	April 20, 1998	April 19, 2002	107.01	28.54
Tajikistan	June 24, 1998	December 24, 2001	100.30	22.02
Tanzania	March 31, 2000	April 3, 2003	135.00	75.00
Vietnam	April 13, 2001	April 12, 2004	290.00	248.60
Yemen	October 29, 1997	October 28, 2001	264.75	94.75
Zambia	March 25, 1999	March 28, 2003	254.45	199.51
Total			**3,382.52**	**2,029.11**
Grand total			**53,390.92**	**26,412.10**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Treasurer's Department

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in reinvigorating the Japanese economy. These policies failed because they did not address the deep-seated weaknesses that are at the heart of Japan's economic problems—particularly the slow adjustment of the economy to the forces of globalization and technical change, which has impeded innovation and productivity growth, and the failure of the bank and corporate sectors to unwind the excess debt and capital built up during the bubble years. A sustained rebound in activity will remain elusive until these structural factors are decisively dealt with.

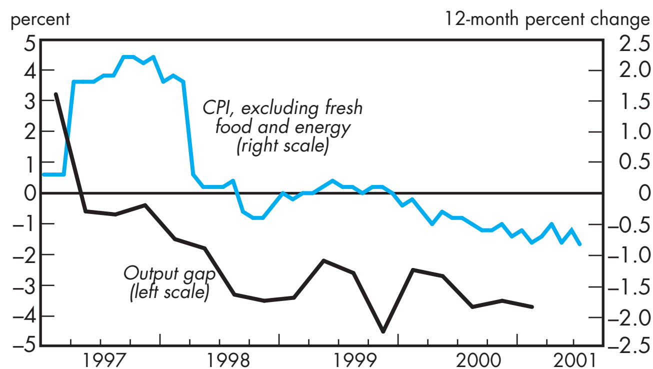
It is therefore important that the Koizumi government press ahead with its broad-based reform agenda. Delaying or watering down the reforms will simply prolong economic weakness and increase the risk of crisis, as the deep imbalances in the economy are not sustainable. However, in a number of important areas, the reform program will need further strengthening to fully deal with the outstanding issues. An appropriate handling of macroeconomic policy will also be essential given the current weak economy and the likelihood that the disposal of bad loans and corporate restructuring will negatively affect growth and employment in the short run.

The banking sector has appropriately been identified as a top priority, and the vigorous implementation of the announced policy package is essential. Additional measures, however, will be needed to ensure that the bad loan problem is fully recognized and dealt with, and that all deposit-taking institutions, not just the major banks, are covered by the reforms. Targeted public capital injections may be needed to offset the impact on bank capital from the more aggressive provisioning and loan disposal.

The program to accelerate banks' disposal of bad loans will be a success, however, only if it achieves deep restructuring in distressed firms and the prompt exit of nonviable companies. The final guidelines for debt workouts will therefore need to be strong enough to achieve a durable turnaround in corporate performance. Measures to strengthen the regulatory structure, reduce the role of public enterprises in the economy, improve corporate governance, increase labor market flexibility, and revitalize the real estate market will also be important to generate new investment and employment opportunities, and raise productivity growth over the medium term.

The government's focus on developing a credible medium-term fiscal consolidation strategy is essential to put its finances on a solid footing. Such a strategy should aim to establish a medium-term debt target, and the broad objectives and directions of tax, expenditure, and social security policies to back up this target. Detailed short-term fiscal targets could then be affirmed in annual budgets. When to start this process of fiscal reform, and how quickly to pursue it, are key issues, however. While establishing a credible framework for medium-term consolidation is important, the government should avoid an abrupt withdrawal of fiscal stimulus during the period of restructuring and weak economic activity. In this regard, there are welcome recent indications that the government will introduce a supplementary budget later this year to expand the social safety net to support workers who lose their jobs.

Output gap and core CPI



Data: WEFA, Nomura Database; and IMF staff estimates

With regard to monetary policy, the BoJ has taken an important step with its recent decision to raise its quantitative target and increase its purchases of government bonds. Further measures are still likely to be needed, however, and the effectiveness of policy would be enhanced if the BoJ clearly specified a reasonable time frame for eliminating deflation. The channels through which monetary policy operates in the current environment are likely to include the exchange rate, asset prices, and private sector expectations about the future course of prices. While easier monetary policy may cause some weakening of the yen, regional concerns about a weaker Japanese currency are likely to be markedly less than during the Asian crisis, given the adoption of flexible exchange rates by many countries and healthier external debt profiles throughout the region. ■

Tim Callen
IMF Asia and Pacific Department

This story is based on the IMF's recently concluded annual (Article IV) consultation with the Japanese authorities. For more details, please see the Public Information Notice (issued at the conclusion of the IMF Executive Board discussion of the Article IV consultation) and the staff report. Both are available on the IMF website (www.imf.org).

Correction

In the table on IMF Quotas that appears on page 5 of the *IMF Survey Supplement,* dated September 2001, Oman's quota as of August 15, 2000, should be SDR 194.0 million.

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