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# Conference Focuses on Implications of EMU For Europe and the World Economy

*Following is a summary, prepared by the IMF Research Department, of the conference on European economic and monetary union (EMU) and the international monetary system, co-sponsored by the Fondation Camille Gutt and the IMF in Washington and held on March 17–18.*

EMU is likely to start as scheduled on January 1, 1999, most participants at the EMU conference agreed, even though some risk of a postponement remains if key countries are unable to satisfy the Maastricht treaty criteria on the basis of 1997 data. Sounding a cautionary note, however, Klaus Regling of the German Finance Ministry stressed that legal concerns and a skeptical German public tightly constrained his government's ability to proceed to EMU on time if there were significant slippages from the reference values (convergence criteria) stipulated in the Maastricht treaty. IMF Managing Director Michel Camdessus (see page 102), Jacob Frenkel of the Bank of Israel, and Paul Volcker of James D. Wolfensohn Inc. (see page 104), pointed to risks inherent in any postponement, given the uncertainty that a delay would create. Participants also generally agreed that the euro would most likely be a strong currency, backed by a monetary policy oriented toward price stability and by conservative fiscal policies, as required by the Stability and Growth Pact. They wondered, however, whether EMU would generate greater exchange rate movements, and some participants pointed to the dangers of instability resulting from a European central bank (ECB) less concerned about the exchange rate. Others cited the potential consequences of a sharp shift of portfolios out of the U.S. dollar and into euro-denominated assets. Several participants stressed the difficulties of managing a single currency in the context of inadequate labor market flexibility and uncoordinated national fiscal policies.

Key questions considered at the conference were the prospects for international economic policy coordination—in particular, what EMU would mean for the policy coordination process of the Group of Seven (G-7) industrial countries—and how the IMF would need to adapt its procedures and relationships with its European Union (EU) members once the ECB had responsibility for monetary policy and the euro had replaced national currencies. Participants agreed that although a consensus existed on several broad issues, more work was needed to understand the implications of EMU for Europe and the world economy. Indeed, considerable uncertainty is likely to persist even after the start of monetary union, as countries are likely to join in stages and various structural changes might occur as a result of EMU.

## The Euro as an International Currency

The euro's attractiveness, participants generally agreed, was likely to be determined mainly by the macroeconomic policy stance in Europe and, in particular, by the success of the ECB in achieving low inflation. Participants agreed that the ECB would follow in the steps of the German Bundesbank in its dedication to price stability and would be independent of political interference, as provided in its statutes. Other elements are also likely to be important in affecting the international use of the euro, including the development of integrated, liquid, and efficient European financial markets. Use of the euro as a reserve currency is likely to evolve slowly, but the euro would begin as the second most important reserve currency and could, over time, rival the U.S. dollar. Ted Truman of the U.S. Federal Reserve Board argued that such a status would

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not, however, confer any special economic benefits on Europe—no more than has been the case for the U.S. dollar over the past 50 years.

*Will the Euro Be Strong?* Several participants focused on portfolio diversification as the primary factor influencing the euro's initial strength or weakness. George Alogoskoufis of the Athens School of Economics and the London-based Centre for Economic Policy Research (CEPR) and Richard Portes of the London Business School and CEPR argued that international investors would immediately want to hold more euro-denominated assets than were available. This gap between supply and demand would likely appreciate the euro, causing EMU countries to run a current account deficit. This, in turn, would increase the supply of euro assets over time, permitting a subsequent depreciation of the currency. Although taking a more nuanced view of the prospects for the euro to appreciate, C. Fred Bergsten of the Washington-based Institute for International Economics said that the European currencies were now overdepreciated (perhaps deliberately) against the dollar, making an appreciation appropriate. Despite his preference for exchange rate target zones for the major currencies, Bergsten stressed that uncertainty surrounding the implementation of EMU made target zones undesirable initially.

William R. White and Robert N. McCauley, both of the Bank for International Settlements, raised the contrasting possibility that the supply of euro assets might eventually increase more than the demand, which could lead to depreciation of the euro. Indeed, because of relatively underdeveloped European financial markets, the share of the world supply of assets in EU currencies falls well short of Europe's economic importance. This might well change with EMU, and in addition to redenomination of existing liabilities in EU currencies into euro, foreign issuers might want to borrow in euro if integrated European financial markets meant efficiency gains and, hence, lower borrowing costs. White and McCauley—as well as Gary Schinasi and Alessandro Prati, both of the IMF's Research Department—saw the introduction of the euro as a potential driving force for increased securitization, creation of a liquid EMU-wide money market, and development of more integrated and liquid bond markets.

*Paul Volcker (left), C. Fred Bergsten, and First Deputy Managing Director Stanley Fischer confer during a break at the EMU conference.*

*Volatility.* Even a strong euro might be subject to considerable volatility, according to several participants. One influence would be the more closed nature of the European economy than that of any single country. As Jean Pisani-Ferry of Centre d'Etudes Prospectives et d'Information Internationale pointed out, however, Europe is already closed, and a core group of European Monetary System (EMS) countries already effectively operate like an exchange rate bloc. The issue is whether the ECB would pay more or less attention to the exchange rate than the Bundesbank. Pisani-Ferry and his co-authors argued that the ECB will pay less attention, and, hence, EMU may increase the volatility of the real effective exchange rate vis-à-vis the dollar in response to shocks, but only moderately. Others maintained that, given the paucity of EMU-wide economic indicators at the start of EMU and the practical challenges involved in devising new monetary policy operating procedures, the ECB may have little choice but to place greater weight on the exchange rate in the early stages of EMU.

Another potential aspect of exchange rate volatility is the relationship between the EU countries adopting the euro and those not joining EMU. A successor to the exchange rate mechanism (ERM) of the EMS has been designed to link the "ins" and the "outs"—termed the ERM-2. This mechanism would involve wide bands and the proviso that exchange market intervention should not endanger the price stability objective of the ECB. Realignments would be jointly decided, done in time to prevent "one-way bets" from developing, and be small enough so that new central rates would be within the old bands of fluctuation. Paul De Grauwe of the University of Leuven and CEPR argued that although the above features—and the achievement of a considerable amount of economic convergence—would deter speculation and make less likely the type of crisis that occurred within the ERM in 1992–93, other features might make the ERM-2 vulnerable. In particular, the Maastricht treaty's fiscal criteria might make these countries vulnerable to shifts in market sentiment, especially if they have high debt levels. For example, a country whose commitment to entering EMU was thought to be flagging might pay higher interest rates on its debt, widening the budget deficit and setting in motion a self-fulfilling spiral. According to Fabio Ghironi of the University of California, Berkeley, and Francesco Giavazzi of Università

Bocconi and CEPR, volatility could be minimized by including as many countries as possible in EMU.

*Use of the Euro as Official Reserve Currency.* Several participants pointed to the attractive features of the euro as a reserve currency, although such use would develop gradually. At the outset, in fact, EMU would lessen the importance of European currencies in world reserves. Paul Masson and Bart Turtelboom, both of the IMF's Research Department, pointed out that intra-EMU holdings of the currencies to be replaced by euro would no longer be international reserves. Moreover, the bulk of reserves outside the EU are held by East Asian countries, which are unlikely to want to use the euro as an exchange rate anchor, so substitution of dollars by euro is likely to involve gradual portfolio diversification.

Bergsten, Alogoskoufis, and Portes argued that, over time, the euro should rival the U.S. dollar as a reserve currency. The euro's reserve currency status would be based on a wide economic area with an overall current account surplus and would develop as a vehicle for invoicing trade and facilitating foreign exchange transactions. At the same time, the potential for a shift out of dollar reserves was not seen as a major concern.

*The Euro and Financial Markets.* Several participantssaw the introduction of the euro as a catalyst for the development of integrated money and bond markets in Europe. The disappearance of intra-European exchange rates would increase the focus on credit risk in the government bond market. Similarly, the euro would likely lower the cost for private borrowers of raising capital without bank intermediation, which would spur the corporate bond market. How far and how quickly these markets will change will depend on regulatory developments and changes in investor attitudes. Takatoshi Kato of the Japanese Ministry of Finance and Ted Truman stressed that these developments in European markets would be welcome because they do not make other markets less transparent or liquid. Moreover, as Masashiro Kawai of the University of Tokyo noted, parallel moves in Japan toward deregulation of financial markets as well as expansion of trade with Asia might well make the yen more prominent as an international currency; it was by no means certain that the relative importance of the yen would decline after EMU.

Even without EMU, technological progress and regulatory changes are already forcing a rationalization of European banking systems. White and McCauley and Schinasi and Prati noted that the euro's arrival will heighten competition among banks themselves and between banks and alternative sources of funds.

## International Economic Policy Coordination

The creation of EMU would have generally positive effects on neighboring countries, provided that the euro is stable and neither too strong nor too weak. Euro volatility, however, would have negative effects on neighboring countries. Participants expressed the hope that European integration would increase cooperation between the EU and neighboring countries and that the euro might become an important pole for exchange rate stability. In particular, countries of Central and Eastern Europe and the Mediterranean might limit their exchange rate fluctuations against the euro as part of a transition to membership in the EU—a possibility suggested by Geörgy Szapary of the Bank of Hungary. However, Hervé Carré of the European Commission argued that these countries should not prematurely adopt a pegged rate until convergence had been achieved. He noted that ERM-2 was designed for existing EU countries—which in most cases were close to qualifying for EMU—and not for the countries of Central and Eastern Europe, which were much farther away.

*Over time, the euro could rival the U.S. dollar as a reserve currency.*

As for relations with the African CFA franc zone, Carré argued that EMU would not cause any substantive change, except for the replacement of a peg against the French franc with one against the euro. He and several other participants viewed the arrangement as a budgetary agreement involving the French treasury, rather than a monetary arrangement that would involve the European institutions. This contention was challenged, however, by Bernd Goos of Germany's Bundesbank, who suggested that the CFA franc zone was an exchange rate arrangement and therefore needed to be addressed by the EU's Council of Economic and Finance Ministers (ECOFIN).

*Coordination Among Major Currency Blocs.* Several participants expressed concern that EMU might make Europe inward-looking and less interested in international policy coordination. In addition, the Maastricht treaty raised complicated issues of responsibility for international economic policy and of EU representation in international forums. The ECB had clear responsibility for monetary policy, and ECOFIN for formal exchange rate agreements, in addition to providing general orientations for exchange rate policy. There was a gray area between them, which might make the ECB reluctant to venture into agreements where jurisdiction is unclear.

While acknowledging the problem of representation, Paul Masson argued that in a situation of considerable uncertainty concerning the economic structure—knowledge of which was essential to carrying out an intermediate targeting framework, whether for money or inflation—the ECB might be receptive to

international coordination initiatives. In this context, the ECB would not be indifferent to the value of the exchange rate of the euro and might want to ensure exchange rate stability to enhance its credibility and convince public opinion that the euro would be neither too strong nor too weak.

Fred Bergsten argued that EMU should in effect lead to a replacement of the G-7 by a "group of three" for economic and monetary issues. For that to occur, however, Europe would need to have a clear counterpart to the ECB for fiscal policy and exchange rates. Bergsten was concerned that in the absence of such a counterpart, a situation of "benign neglect" would prevail. Such a situation would be dangerous, because in case of a crisis, a sufficiently rapid and effective response might not be put in place.

## IMF Regional Surveillance Considers EU-Wide Issues

While Article IV consultations remain the principal instrument of IMF surveillance over member country policies, the rapid integration and globalization of world financial markets and the progressive shift in policy formulation to a supranational level have increased the importance of IMF regional surveillance. Such surveillance has focused on the formulation of common economic policies at the regional level, effects of one member's actions on others within the region, and the impact of common external shocks.

In addition to examining preparations for European economic and monetary union (EMU), a regional perspective was reflected in the IMF's coverage of economic developments in the African CFA franc zone in the aftermath of the January 1994 CFA franc devaluation and the link between members' policies and regional monetary objectives. A regional perspective also figured prominently in discussions of the challenges facing transition economies. And IMF staff consultations with members of the Eastern Caribbean Monetary Union have assessed the appropriateness of financial policies in the context of common shocks.

Over the course of the 1990s, the IMF has expanded its coverage of EMU issues from a regional perspective. A key element of this effort has been the periodic Executive Board discussions on EMU, against the background of regular staff contacts with European Union (EU) institutions, and an expanded treatment of EMU matters in the World Economic Outlook exercise. These discussions have dealt with the progress of potential EMU members in meeting EMU convergence criteria—as spelled out in the Maastricht treaty—as well as the policy framework related to the transition to monetary union. A number of themes have emerged from the analysis:

- Most EU countries have brought inflation to low levels, providing a helpful starting point for a single monetary policy directed at low inflation.
- The fiscal discipline required by the Maastricht treaty is warranted in light of the need to reduce debt levels and prepare for future demographic pressures. Rapid fiscal adjustment, if credible to markets, would raise growth over the medium term, while short-run adjustment costs would be modest. EU-wide fiscal consolidation also is likely to have limited demand effects outside Europe, although individual non-EU countries with strong trade ties to the EU could be affected to a greater extent.
- The narrowing of interest differentials in Europe and the progress made with inflation convergence and fiscal consolidation reflect growing confidence that monetary union will begin in 1999. A key challenge is to maintain, and indeed strengthen, confidence—both in the EMU process and in a continued commitment to convergence in countries seeking to become members.
- Further action is needed to make European labor markets more flexible. Once the exchange rate instrument is given up, labor market rigidities will impair the ability of individual countries to adjust to shocks. Moreover, the persistence of high structural unemployment could complicate implementation of stability-oriented macroeconomic policies.

At the same time, bilateral Article IV consultations have also addressed EU-wide issues, and discussions have frequently provided regional perspectives. For example, reports have provided cross-country comparisons of labor costs and participation rates, overall fiscal spending and revenue as a share of GDP, and the cost of government social programs as indicators of progress countries have made in opening markets, removing structural distortions, and improving the efficiency of government involvement in the economy.

Looking ahead, the establishment of the euro for a group of EU members will have far-reaching implications for the international monetary system and, consequently, for IMF surveillance. Monetary union will entail a substantial shift of authority from the member states to EU institutions in the area of monetary and exchange rate policy. An assessment of monetary and exchange rate policies for the euro area as a whole will be essential for a complete picture of economic developments and prospects for individual members of the euro area. Given the systemic importance of the future euro area, the IMF will also need to focus on the impact of euro-area policies on other IMF members.

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## The IMF and Its EMU Members

Although EMU will not affect the rights and obligations of members under the IMF's Articles of Agreement, the transfer of monetary policy responsibilities to the ECB and the replacement of existing European currencies by the euro raise a number of issues for the IMF. These include how surveillance would be carried out, whether and how IMF resources should be made available to EMU members, how IMF quotas might be affected, whether the SDR would need to be redefined, and how the euro would be used in IMF operations.

Both Jacques Polak, former Director of the IMF's Research Department, and Niels Thygesen of the University of Copenhagen and the Centre for European Policy Studies stressed that surveillance could well be more relevant in the context of a complicated transition to EMU of a subset of EU countries and of the establishment of the ERM-2 arrangement. Clearly, IMF surveillance should involve the ECB. This would require formulation of modalitites for consultations with the ECB as well as with national authorities, who retain responsibility for other macroeconomic policies. In addition, Jacob Frenkel stressed the importance of enhanced IMF surveillance of financial markets and capital flows.

The issue of possible use of IMF resources generated much controversy. Polak argued that, although they were unlikely to draw on IMF resources, individual EU countries might nevertheless be somewhat more likely to come to the IMF after EMU, since monetary bailouts and EU balance of payments assistance would not be forthcoming. Polak also maintained that a member country would still have a balance of payments, and hence the criterion of balance of payments need would still be relevant under EMU.

## Transition to EMU

Although the conference focused on the international monetary system after EMU, the issue of the transition to EMU was discussed at a final round table. The participants had differing views of the extent to which transition would proceed smoothly and of the possible pitfalls in the early years after the start of EMU.

Xavier Larnaudie-Eiffel of the EU Commission noted the progress made in ensuring a smooth transition and in giving legal certainty to the euro when it is created, including outside the EU. He emphasized that the selection of qualifying countries would be part of a transparent process and subject to clear criteria.

Klaus Regling reiterated the German position that the Maastricht criteria would be applied strictly, pointing to the need to satisfy German public opinion that monetary union would ensure stability. Since many countries are still above the deficit criterion, stronger fiscal measures are needed. In Regling's view, given the use of "creative accounting," there was no more room for interpretation in meeting the criteria. He could not exclude the possibility that Germany might not qualify, which might therefore lead to postponement.

*Takatoshi Kato (left), Ted Truman, Stanley Fischer (moderator), Jacob Frenkel, and Mervyn King participated in the round table on European monetary integration and the international monetary system.*

Lars Heikensten of Swedish Riksbank and Paul Jenkins of the Bank of Cananda highlighted some dangers associated with the transition. Heikensten was skeptical that EMU would operate smoothly with rigid labor markets and was concerned that EMU might not be a good thing for Sweden if it faced asymmetric shocks. Nevertheless, staying out could pose problems, since the Swedish financial sector would begin adopting the euro in any case, and volatility of the exchange rate against the euro might pose significant problems.

## Preparing for EMU

Although the conference did not provide definitive answers to all the important questions concerning EMU and the international monetary system, it clarified some issues and identified areas for further work. In general, participants expected that the timetable for EMU would be respected, and that the euro would be associated with good anti-inflationary performance and a credible European central bank. As a result, the euro should become an important international currency, second only to the U.S. dollar, and, over time, perhaps a rival to it. EMU might, however, be associated with increased exchange rate volatility, and it would be important to facilitate, and, indeed, enhance international economic policy coordination. In this regard, IMF Managing Director Camdessus has called for the IMF's greater involvement in analyzing equilibrium exchange rates and advising EU governments in the run-up to EMU and during its early years. ■

# EMU and the Euro: Ensuring a Successful Launch

*Following are excerpts of a speech by Managing Director Michel Camdessus at the EMU conference on March 18.*

European economic and monetary union (EMU), and the economic convergence it has inspired, is certainly one of the most important and promising developments in the international monetary system in recent decades. For prospective members, the drive toward EMU has provided strong incentives to strengthen domestic economic policies and to begin addressing deep-rooted structural problems. For the European Union (EU) as a whole, EMU will help reinforce monetary stability and cement economic integration. And for the world, EMU holds out the promise of a strong new pillar for the world monetary system.

Why is EMU so important? Certainly, Europe will reap a number of economic benefits from the introduction of a sound common currency. A common currency will lower transaction costs, reduce exchange risk, stimulate competition, and facilitate the broadening and deepening of European financial markets. It will also cement a larger economic space better able to face external challenges be more impervious to adverse external shocks.

But clearly, there is more to EMU. Indeed, EMU is the crowning achievement of four decades of European economic integration. Seen from this perspective, EMU is, above all, an essential building block in Europe's growing political unity. Certainly, important work still lies ahead. Nevertheless, the conditions for EMU's successful start are already largely in place.

*Managing Director Candessus (left) greets Baron Godeaux, Chairman of Fondation Camille Gutt, which co-sponsored the EMU conference.*

*First*, across Europe there is a remarkable consensus on the approach to macroeconomic management: namely, that monetary policy should be directed to price stability; that budgetary policy should aim toward medium and long-term fiscal sustainability; and that structural reform—especially labor market reform—has an essential role to play in achieving sustained, noninflationary growth and promoting job creation.

*Second*, most EU members have achieved a high degree of macroeconomic convergence. Inflation in the 15 members of the EU—now projected at 2 ¼ percent in 1997—is lower than at any point in the last 35 years. Equally striking is the unprecedented narrowing in the dispersion of inflation. All EU members, except Greece, are expected to have inflation below 3 percent this year and to be in compliance with the reference value in the Maastricht treaty.

Important progress has also been made in the fiscal area. EU-wide, the general government deficit is projected to be 3¼ percent of GDP in 1997—that is, 3¼ percentage points of GDP below its 1993 peak. Over 2 percentage points of this adjustment is expected to occur in 1996–97, with almost three-fourths of it representing a strengthening of the underlying fiscal position. Among the countries aiming to participate in EMU from the beginning, virtually all are projected to satisfy, or come close to satisfying, the treaty's 3 percent fiscal deficit ceiling.

*Third*, solid institutional arrangements are being put in place to ensure the euro's credibility. The Statute of the European Central Bank [ECB] guarantees the bank's independence and gives clear priority to low inflation in the conduct of monetary policy. Moreover, the Stability and Growth Pact, with its early warning system and various procedures for enforcing appropriate fiscal adjustment, lays out a strong framework for maintaining budgetary discipline after January 1999.

## Finishing the Job

It is time to put to rest any lingering doubts about the future of EMU and to finish the job that is so close to completion. For 1997, countries must concentrate on fulfilling their Maastricht commitments, especially deficit reduction. This is the only way to dispel concerns that the desire to begin EMU on time could take precedence over economic fundamentals.

Although meeting the 3 percent of GDP ceiling will not be easy, in most cases, it is feasible. Certainly, this year's budgetary outturn will be influenced by the pace of economic activity in Europe, which has not been as strong as desired. However, there are good grounds for believing that growth will be stronger this year than last and that countries' budgetary positions will improve.

But what if growth turns out to be weaker in 1997 than currently projected? In more normal circumstances—especially where countries were already making a substantial fiscal effort—there would be good rea-

son to allow automatic stabilizers to work. However, the preparations for EMU make the issue more complex. In fact, if slippage in meeting fiscal goals increased market concerns that EMU would be postponed, the consequences could well be more damaging for economic growth than additional fiscal restraint. Under these circumstances, if there were a need to support economic activity—while inflation remained subdued and fiscal consolidation was proceeding—an easing of monetary conditions might be considered. Certainly, the more credible countries' fiscal efforts were, the more scope there would be to pursue such a course.

In the final analysis, however, the most important thing is to ensure that the underlying pace of fiscal consolidation is adequate, and above all, that countries' commitments beyond 1997 are consistent with the Maastricht treaty. In the meantime, markets need reassurance that the process will be managed in a steady and harmonious way.

## Long-Term Adjustment Requirements

Europe's adjustment task also has an important medium-term dimension. On the fiscal side, the need to meet the longer-term challenges arising from aging populations and to provide a reasonable amount of scope to accommodate periods of sluggish growth calls for gradually reducing cyclically adjusted budget deficits to near zero and perhaps, in some cases, turning deficits to surpluses.

Likewise, both EMU and the need to accelerate growth in Europe call for much more vigorous structural reform, particularly in labor markets and related social policies. As regards EMU, it is widely recognized that greater labor market flexibility is needed to allow economies to adjust to asymmetric shocks. But persistently high unemployment associated with labor market rigidities could undermine the credibility of the euro as a stable currency, if markets believe that such rigidities will make it difficult to pursue prudent macroeconomic policies.

In this connection, EMU must not be saddled with the political blame for necessary, but unpopular, measures to rein in government spending, reform social welfare programs, and remove other structural impediments to growth. National authorities need to make it clear to the public that the policy reforms they are undertaking are, above all, good for their own countries—not simply good for EMU.

All countries have a strong interest in seeing that EMU gets off to a good start, even those—or perhaps I should say, *particularly* those—that are not among the first participants. Indeed, those initially outside EMU may benefit most from a solid euro zone, since it is they who would have the most to gain from increased market confidence as their performance converges with that of EMU members. Thus, later entrants must also help ensure that EMU begins on time, and with an appropriate initial size—but most important, that it begins on a sound economic footing. The essential thing is that a clear road map be established for them to join as soon as possible thereafter.

## Implications of EMU for the World

The euro will clearly become a major pillar in the international monetary system. Naturally, this will be an important innovation in the system; hence, it is essential for the rest of the world, as well as for Europe, that the transition be managed well.

*The euro's position will depend on the strength of its domestic economic foundations.*

At this point, it is very difficult to predict just how the euro will fit into the constellation of other reserve currencies. However, we can safely assume that its position will depend largely on the strength of its domestic foundations—that is, on the continued macroeconomic convergence of its member countries, the pace of structural reform, the depth and breadth of euro-denominated financial markets, and the degree of political cohesion among EMU members on key policy issues.

## Role of the IMF

The IMF has learned a lot since 1978 [the inception of the European Monetary System]. We have learned how to recognize misalignments; how to correct them and what this implies in terms of international dialogue and cooperation. Thus, we are equipping ourselves to play the role we could be called upon to carry out.

We are mindful of the hesitations of key players to ask us for assistance in this area. But key players are mindful also of the systemic consequences of their actions, and they are certainly as concerned as we are by the fact—as many speakers have reminded us—that incidences of misalignment could become more frequent and more damaging in a bipolar or tripolar world.

If such misalignments do occur, let us hope that the expertise of the IMF will be properly used and that the IMF will be called upon to do its job—that is, to "provide the machinery for consultation and collaboration on international monetary problems." I have no doubt that we will enjoy the full cooperation of the current and future European authorities in developing a constructive dialogue on the potentially difficult issues we may face. Concentrating early enough—and openly enough—on these issues, with the technical support of our professional staff and the contribution of all its members, will be essential in ensuring that EMU and the euro achieve their full potential.

# Implications of EMU for the IMF

*Following are excerpts of remarks by Philippe Maystadt, Belgian Deputy Prime Minister and Minister of Finance and Foreign Trade, and Chairman of the IMF Interim Committee, delivered at the EMU conference on March 17.*

The creation of EMU will be a remarkable development in international relations and is without precedent in the IMF's history. The challenge today is to fully grasp the external implications of this development for both the international monetary system and the IMF.

## Implications for IMF Membership

I believe that EMU members will opt to remain individual members of the IMF, rather than choosing to merge into a single IMF member with a single quota. The main reason for retaining individual IMF membership is that EMU will imply only a limited transfer of decision making at the supranational level. The transfer of competence will mainly concern the Union's monetary policy, which will be the exclusive responsibility of the European Central Bank (ECB), and its exchange rate policy, which will be in the hands of the Council of Economic and Finance Ministers (ECOFIN) and the ECB. EMU member states retain ultimate responsibility for other economic policies, however. For this reason, a number of them may wish to maintain a close relationship with the IMF.

Another important consideration is that a decision to merge EMU members into a single IMF member with a single quota would imply a loss of national sovereignty. I doubt that it would be easy to reach consensus among EMU members on this possibility.

## Volcker Hopes for Renewed Cooperation In the Wake of the Euro's Creation

*Following is a summary of remarks made by Paul A. Volcker of James D. Wolfensohn, Inc., at a dinner gathering of participants in the EMU conference on March 18.*

"A common currency area is an appropriate and crowning development for the European Community, [as it] would begin to justify institutionally the new nomenclature of the Community as the European Union," said Paul Volcker at the EMU conference. The economic benefits of a common currency would be real, said Volcker, and given the desire for a true "single market," exchange rate stability was necessary.

The EU was entering into the most sensitive and delicate stage of the transition amid difficult economic circumstances—notably, prolonged economic sluggishness and high unemployment. These conditions were complicating efforts of EU members to meet the Maastricht treaty's budget and debt criteria. Such efforts, in the short run, Volcker cautioned, would dampen economic expansion and could thus undermine the project. Any derailment of the common currency union would be unfortunate given the progress already made toward convergence on the "more critical price stability criteria," said Volcker, and the increased recognition throughout Europe of the importance of economic restructuring to achieve greater flexibility and competitiveness.

In addition, although both monetary and fiscal policy would, as many believe, be further constrained for some time ahead—fiscal policy to meet the stability criteria, and monetary policy as the European central bank strives for full credibility—postponement or abandonment of currency union could be used as an excuse for looser policies, invoking "strong and disturbing" market reactions.

The prospective European central bank was unprecedented and a "unique enterprise," said Volcker: independent countries would be ceding monetary sovereignty to a jointly sponsored entity, without a parallel governmental body with which the central bank would interact. Hence, the ECB amounted to "the extreme of formal central bank independence." But, Volcker did not believe that any central bank could operate entirely outside a political context; sooner or later, "it must be able to justify its policies to the general public and to political leaders." Volcker sympathized with the establishment of an intergovernmental council as a forum in which the ECB could communicate its policy decisions and hear the concerns of governments.

While Volcker cited some concern about the dampening impact of monetary union on the global economy, a failure to move ahead could have equally restraining effects—in the form of exchange market disturbances and renewed uncertainty about domestic policies. Furthermore, he added, "slow growth in Europe need not and should not mean a general recession."

### Longer-Term Consequences Of a Single Currency

The euro's long-term consequences depend on several uncertain variables, Volcker said. In time, though, the euro's creation should encourage "more competitive, flexible, and liquid financial markets," and the euro could, other things being equal, come to be seen more on a parity with the U.S. dollar as a reserve and trading currency. Much will depend on "other things" as yet

Also, retaining the status quo would be in line with the IMF's Articles of Agreement, which require that membership be available to countries individually. The Articles would have to be amended if EMU members opted for single membership.

Retaining the status quo will not, however, make it easy to solve the issues that will arise with the introduction of the euro. The IMF's Articles are based on the norm that a member is a country with a currency of its own. There are precedents of monetary and currency unions, but this will be the first time that the single currency of a group of IMF members will most likely emerge as a major international currency. EMU will have a global impact and raise systemic policy issues.

### Implications for the SDR

According to the principles for valuing the SDR, adopted by the IMF's Executive Board in 1980, the SDR basket includes the currencies of the five IMF members with the largest exports of goods and services. Since 1980, the SDR basket has included the U.S. dollar, the deutsche mark, the Japanese yen, the French franc, and the pound sterling. With the creation of EMU, it is likely that at least two of these currencies will disappear. The currency composition of the SDR will therefore need to be reviewed.

The introduction of the euro in the SDR basket will also raise questions of principle and measurement, which will be indirectly related to a fundamental issue—the place of the euro in the international monetary system and its relative position vis-à-vis the dollar.

### Implications for IMF Surveillance

Assuming that EMU participants remain IMF members, the IMF will need to maintain its bilateral (Article IV) consultations with each of these countries.

unknowable: specifically, whether internal stresses, sluggish growth, the fiscal impact of aging populations, and the cost of social programs will lead to persistent European fiscal deficits and raise doubts about the priority of price stability, or whether broader markets, needed economic restructuring, and enhanced competitiveness will improve both the stability and attractiveness of the euro.

What should we be doing, Volcker asked, to help ensure that the euro will support rather than undercut international economic cooperation? A successful euro would, at its core, reduce instability of exchange rates and volatility of financial markets by eliminating a number of important currencies. But will the euro's creation tend to stabilize trans-Atlantic and trans-Pacific exchange rates and capital flows? The textbook possibility, said Volcker, is that the currencies of the United States and European Union would move in a relatively narrow margin, and that relative competitive positions and price levels would change slowly and predictably. The resulting small and gradual changes in equilibrium exchange rates would allow cyclical fluctuations in interest rates to be accommodated by relatively small adjustments in spot and forward exchange rates. On the other hand, the experience of the early 1970s showed that the exchange rate between the dollar and the yen—the world's two largest economic powers—was notoriously unstable.

Volcker cautioned that if markets sensed that governments and central banks were neglectful—benignly or otherwise—of the desirability of exchange rate stability, "huge amounts of capital could be easily mobilized to ride a trend." And it may then be even more difficult to find a forum for international decision making and to achieve political consensus. As for domestic monetary policies, Volcker added, it is uncertain whether a truncated Group of Seven—shrunk to three, with authority largely independent of finance ministries—would ease international policy coordination in pursuit of international objectives. It was clear, however, that Europe would have no central fiscal authority to act as a counterpart to the ECB, which would complicate coordinated decision making. This, Volcker suggested, given the size of the major currency zones, could weaken the influence of the IMF in its objective to enhance international cooperation. And it could reinforce the difficulty of any kind of flexible management of fiscal policy.

*The euro should encourage more competitive, flexible, and liquid financial markets.*

Even if concerns about the instability of the dollar/euro/yen exchange rates are borne out, said Volcker, the situation would still be preferable to one with multiple European currencies. At the same time, the three main currency blocs could become insulated and isolated, which would dampen enthusiasm for further liberalization or for leveling the playing field for trade, investment, and services. Volcker concluded with the hope that the three poles of economic and financial power—Europe, the United States, and Japan—would find it in their mutual interest to work more closely together, and with the IMF, in determining and defending a range of equilibrium exchange rates. He pinned this hope on the belief that the euro could become the impetus for renewed thinking on the international front.

In the context of these consultations, however, EMU will have to be taken as a fact.

Pursuit of these bilateral consultations will allow the IMF to remain well informed about the economic situation in EMU members and to give advice in such areas as medium-term fiscal consolidation and social security reforms, and thus to promote sound economic policies and stronger economic performance. But such surveillance will have to be supplemented by consultations between the IMF and the main European institutions with responsibilities in economic and monetary policymaking. Therefore, suitable arrangements will need to be established, including the following:

• The IMF will need to consult closely with the ECB on *monetary policy* issues.

• The *exchange rate policy* of the EMU will be a joint responsibility of the ECOFIN and the ECB. Nevertheless, EMU members, in accordance with their general obligations under the IMF's Articles of Agreement, will have to collaborate with the IMF and other members to "assure orderly exchange arrangements and to promote a stable system of exchange rates."

*IMF Deputy Managing Director Alassane Ouattara (left) and Philippe Maystadt at the EMU conference.*

• EMU members will have to engage in consultations with the IMF on the *policy mix* of the euro zone.

• The ECOFIN and the ECB will have to decide about EMU *representation* at meetings of the IMF's Executive Board when issues relevant to the EMU are discussed.

## Access to IMF Resources

Will EMU members still be entitled to use the IMF's resources? Will it be possible for the IMF to provide financial assistance to the euro area as a whole?

Although it can be argued that a request by EMU members to use conditional credit from the IMF is unlikely, these are valid questions because they relate to the need to preserve the general rights of IMF members as well as the capacity of the IMF to provide a safety net for countries and currencies in difficulty.

If, on the one hand, the IMF should decide that it could not assist EMU members in a manner consistent with the Articles of Agreement, this would limit the general rights of EMU members and the fundamental principle of equal treatment for all members.

If, on the other hand, a broad interpretation of "balance of payments need" were accepted and the IMF could provide financial assistance to individual EMU members, the question would then arise whether it would be possible for the IMF to assist the euro area as a whole if EMU as a single entity could not be a member of the IMF.

The question of access to IMF resources is closely related to the implications of EMU for the architecture of the international monetary system. Indeed, with the advent of the euro, the international monetary system will probably move from a U.S. dollar-denominated system to a new system with two or three reserve currencies—the dollar, the euro, and the yen. The IMF will have the major responsibility of overseeing the orderly transition to this new system. This means that the IMF will need to review the mechanisms of surveillance of the international monetary system and reassess its financial relations with the three reserve currencies. In particular, it is essential for the IMF to provide a safety net against the risks of excessive exchange rate fluctuations, not only with regard to the dollar and the yen—as is currently the case because the countries that issue those currencies are IMF members—but also with regard to the euro, even if EMU does not became a single-entity member of the IMF.

## Preparing for EMU

Neither the Maastricht treaty nor the IMF's Articles of Agreement provide all the answers to some important questions. I would like, therefore, to make the following suggestions:

• The IMF should take all the necessary steps to be ready in time to welcome the euro as the new currency of a group of its members.

• A "working method" needs to be agreed on to deal with the questions that will require consultation and resolution at the international level.

The model that the European Union has adopted to establish its monetary union does not fit in perfectly with all the existing arrangements and practices that have been developed over the years to allow the IMF to carry out its mission. Without denying the potential difficulties, however, I am confident that the ability the IMF has shown in the past to adapt to changing circumstances and the willingness of the European Union to be an effective and responsible actor on the international stage will allow the necessary consensus on suitable arrangements to be reached in due time. ■

# Are Europe's Social Security Finances Compatible with EMU?

As the deadline set by the European Union (EU) draws near for economic and monetary union (EMU), several current and prospective EU members face the prospect of not being able to meet some of the criteria laid down in the 1991 Maastricht treaty. The treaty prescribes limits on the overall deficit and gross debt of general government—including social security institutions—that must be met or approached at a satisfactory pace before the final stage of the EMU. According to a new IMF Paper on Policy Analysis and Assessment, *Are Europe's Social Security Finances Compatible with EMU?* by George Kopits, the financial imbalance of social security institutions in several EU members may be an impediment to their meeting these requirements.

## Trends in Social Security Finances

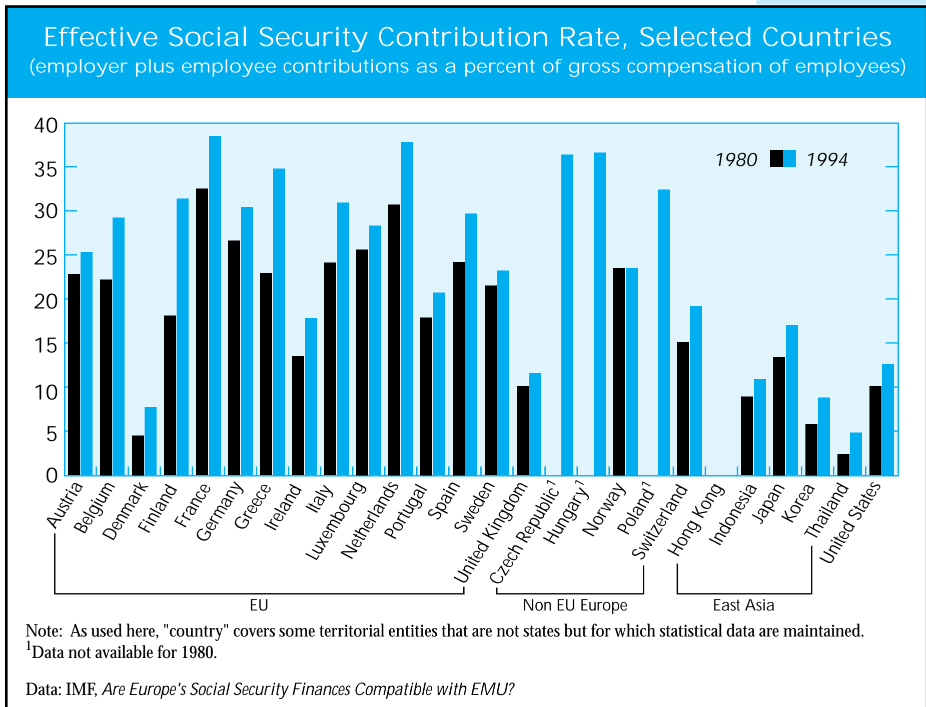
During the postwar period, in nearly all industrial countries, pay-as-you-go public pension systems—supported by favorable demographic developments—yielded considerable surpluses that encouraged the expansion of defined benefits. By the late 1970s and early 1980s, however, financial pressures began to emerge, following drives to broaden coverage and ease eligibility for benefits, accompanied by increased longevity and declining fertility. Most European countries avoided deficits in the social security funds through a steady increase in payroll tax rates (see chart). In a few countries, since the mid-1980s tax increases were accompanied by a slowdown or reversal in the expansion of benefits. Nevertheless, various dysfunctional features of social security schemes—for example, easy eligibility for pensions or use of sick pay to contain unemployment—remained.

*Pensions.* Most pension reform measures adopted since the mid-1980s were aimed largely at marginally improving the cost-effectiveness of existing pay-as-you-go, defined-benefit programs. These measures included raising the effective retirement age through, for example, modest increases in the standard retirement age or the minimum service period, cutting replacement rates slightly through stricter benefit indexation or using a reduced proportion of earnings or longer service periods to compute the pension base, and tightening special pension benefits somewhat.

*Health Care.* Many of the health reform measures were experimental and of relatively limited extent. Cost-containment efforts were focused on the supply of, rather than the demand for, services and benefits; for example, greater reliance on global budgets to limit hospital expenditures, reduction in excess hospital capacity and development of outpatient and other alternative care, and competitive managed-care schemes.

*Unemployment Insurance.* A few countries rationalized unemployment insurance by limiting assistance to frictional unemployment (that is, for individuals shifting between, or looking for new jobs) while treating structural unemployment mainly with active labor market programs.

Although clearly moving in the right direction, the social security reform measures adopted so far—given their rather modest scale and the need to phase them in over a prolonged period—do not, according to Kopits, appear sufficient to cope with the dramatic aging that will be experienced in the future in most of Europe. Indeed, with unchanged policies, an expected doubling of the old-age dependency ratio within the next four decades will substantially increase social security entitlements. In the health-care area, this trend is compounded by technological developments whose immediate effect will be to increase costs.




Note: As used here, "country" covers some territorial entities that are not states but for which statistical data are maintained.
[1]Data not available for 1980.

Data: IMF, *Are Europe's Social Security Finances Compatible with EMU?*

## Deficit Criterion

A key condition for participation in EMU is that by the end of 1997, the overall deficit of the general gov-

ernment—excluding receipts from privatization—should not exceed 3 percent of GDP. Under the recently agreed Stability and Growth Pact, EU members participating in EMU will be further committed to maintaining the financial position of the general government close to balance or surplus over the medium term; failure to remain within 3 percent of GDP could result in a significant financial penalty.

As a major component of the general government, social security finances—despite their extrabudgetary status—have a direct bearing on the ability of EU members to approach the medium-term fiscal balance target. Although, since 1992, each government has pursued a convergence plan to meet the deficit ceiling, the actual role of social security operations within the plan has been mixed.

*Globalization will impose the hardest constraint on further payroll tax rate increases.*

Notwithstanding past savings on the benefits side and prevailing high contribution rates, three EU members (Ireland, Italy, and Spain) continue to experience significant deficits in the social security accounts. Four other countries (Austria, Denmark, Finland, and Greece) would show social security imbalances in the absence of sizable budgetary transfers. Arguably, without such explicit or implicit social security imbalances, some of these countries could already have met the 3 percent deficit ceiling by 1996.

Among the countries that have applied for EU membership, the Czech Republic, Hungary, and Poland show substantial deficits and high contribution rates, reflecting deep-seated distortions in virtually all social security programs—inherited in part from the pretransition period. For these countries, overhaul of social security is likely to be a critical step for joining the EU, even before participation in EMU.

Although most EU members are poised to meet the deficit ceiling, some members risk failing it because of endemic—explicit or implicit—social security imbalances. In the short run, deficits in the social security accounts may be accommodated with expenditure cuts or tax increases elsewhere in the government. Over time, however, it will become increasingly difficult for most countries to continue to abide by the deficit ceiling, let alone the medium-term balance or surplus target envisaged under the Stability and Growth Pact, without comprehensive social security reform.

### Debt Criterion

Another important requirement for EMU participation is that the gross debt—less proceeds from privatization—of general government not exceed 60 percent of GDP. Although, in principle, this criterion should be fulfilled by the end of 1997, in fact, a participating country must make reasonable progress toward reducing its debt outstanding toward the ceiling. The debt limit has been broadly met in five EU members (Finland, France, Germany, Luxembourg, and the United Kingdom), and the debt ratio has been judged to be diminishing at a satisfactory pace in two (Denmark and Ireland). In Belgium, Greece, and Italy, however, the debt stock exceeds 60 percent of GDP by a wide margin. In general, for most EU members, it is plausible to assume that—on the basis of a medium-term fiscal consolidation strategy that targets primary surpluses (measured in percent of GDP) in excess of the difference between the interest rate and growth rate—the debt criterion would be within reach, were it not for the likely deterioration in social security finances.

With current policies, the dramatic rise in old-age dependency ratios will be reflected in widening deficits, because the marked rise in pension and health-care expenditures will have to be financed from a shrinking payroll tax base of a reduced workforce. For at least five EU members (Belgium, France, Portugal, Spain, and Sweden), the present value of net unfunded pension liabilities surpasses the value of GDP, reflecting a considerable additional burden on future generations. In addition, under conservative assumptions about health-treatment costs (assumed to grow at the same rate as GDP), by 2030, yearly health-care expenditure is projected to rise 1½ to 2½ percentage points above the present 6–7 percent of GDP. Again, in the absence of deep reform, the debt criterion will not be sustainable in the long run.

### Implications for Reform

The expansion of European social security systems has been financed to a large extent with high and rising payroll taxes. This approach was facilitated by the administrative ease of withholding such taxes at their source. But, as Kopits notes, it may be difficult to increase payroll taxes further in the face of mounting resistance—in particular from organized labor and the business sector—because of the adverse effect of these taxes on employment and competitiveness.

In fact, Kopits observes, high payroll tax rates tend to compound the unfavorable effect of labor market rigidities and lower productivity on competitiveness in major European countries, when compared to their trading partners in North America and East Asia. The ongoing external liberalization in these countries—both within the single market and toward the rest of the world—is likely to pose an additional challenge to competitiveness. Ultimately, globalization will impose the hardest constraint on further payroll tax rate increases. Therefore, adjustment in social security finances will have to be undertaken primarily on the benefits side; indeed, a serious effort should be made to create room for reductions in social security contribution rates.

In the foreseeable future, Europe's social security institutions face relatively narrow room for maneuver. The financial position of these institutions is weak in several countries, and a further deterioration can be expected in virtually the entire industrialized region, mainly as a result of demographic forces. The policy goal of establishing EMU underscores these deficiencies and makes the need for corrective action even more compelling. For some countries, the situation can be characterized as a "wolf at the door," in the sense that social security deficits may be an impediment to entry into EMU. For a few economies in transition, even EU accession may be at stake. Remaining outside EMU would mean a loss of benefits anticipated from a favorable assessment by financial markets and from the ensuing expansion of trade, investment, growth, and, of course, employment.

More generally, the long-run outlook is akin to having "termites in the basement," because few EU members would be able to comply with the deficit and public debt ceilings, given mounting social security imbalances on the strength of population aging during the first half of the next century.

In view of the limits to payroll taxation (or rather, of the need for tax rate reductions) and the narrowing scope for significant cuts in discretionary budgetary outlays, the only viable option for most EU members is to avert these imbalances with a large-scale social security reform, focused mainly on public pension and health-care systems. Such an effort should begin with the eradication of all remaining dysfunctional features, including:

- low standard retirement age;
- early retirement schemes; and
- easy access to disability pensions and sick pay.

Removal of these features should strengthen work incentives and help ease the labor-market rigidities that partly explain the high structural unemployment in some European economies.

In addition, for *pensions*, steps toward placing the computation of benefits on a sound actuarial basis as well as a fair, yet realistic, indexation formula are necessary. Besides reforming the existing public pension system, consideration might be given—as is being done in some countries—to introducing a supplementary funded defined-contribution pension scheme, in combination with a minimum basic pension, subject to a means test.

*Health care systems* require thoroughgoing reform on both the demand and supply sides. Further cost-containment measures should include enhanced cost-sharing, effective provision of medical services, and effective provider payment systems. Rationalization of new technology and adoption of strict spending limits for certain services are inevitable. A level of basic health care could, of course, be made available free to low-income households.

Much like the selected mix between the solidarity and insurance principles for public pensions, the choices among rationing, regulation, and a market-based approach to health care should be the outcome of social consensus, to be reached on the broadest possible basis in each country. In any case, the solution adopted should allow for a decline in payroll tax rates and, if possible, for accumulation of an adequate level of contingency reserves.

Copies of IMF Paper on Policy Analysis and Assessment (PPAA) 97/3, *Are Europe's Social Security Finances Compatible with EMU?*, by George Kopits, are available for $7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org. The full text is also available on the IMF's web site (http://www.imf.org).

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# Camdessus Visits Russia

*IMF Managing Director Michel Camdessus visited Moscow on April 1–3, at the invitation of Prime Minister Viktor S. Chernomyrdin, to discuss the authorities' 1997 economic policy in the context of the medium-term strategy supported by IMF resources.*

On April 2, Managing Director Michel Camdessus termed the achievements in the last few years in the Russian economy "impressive." In a speech delivered at the Moscow Institute of International Affairs, he noted that inflation had been cut, the exchange rate stabilized, central planning abolished, two-thirds of the economy was now in private hands, trade barriers had been reduced, and the ruble was now traded freely and could be readily converted into foreign exchange.

Some people, said Camdessus, would point to the mass of unpaid wages and pensions, collapsing public services, decline in production, street protests, and increasing lawlessness and call it a "crisis." To them, Camdessus would say that the crisis has to do, in part, with the role of the state. "The state of crisis is a crisis of the state," he said, adding that "nobody has put that in a more striking way than President [Yeltsin] himself, who said: 'The state interferes in the economy where it shouldn't, while where it should, it does nothing.' "

Camdessus identified three key problems concerning the state that had to be addressed: growth, nonpayment of taxes, and corruption.

Russia's economic growth could be accelerated if the government completed the institutional reforms on which a thriving market economy depends, said Camdessus. These include a simple and transparent regulatory system; an effective legal and judicial system that protects property rights, enforces contracts, and helps create an atmosphere of law, order, and personal security; and a tax system that is simple and broad-based, with limited exemptions and fairly low and uniform rates.

The government must have the revenues to meet its obligations to workers, pensioners, and all who depend on government services, said Camdessus. Priority had to be given to changing the attitude toward nonpayment of taxes, beginning with the largest tax delinquents. There was an urgent need to broaden, simplify, and update the tax system and tax administration. Over the medium term, the goal must be to build a taxpaying culture based on voluntary compliance with transparent laws that are consistently applied.

An important element in the strategy, said Camdessus, was to fight corruption. Here, the challenge was to refocus the state's role in the economy on its basic tasks. This entailed removing unnecessary government regulations and controls, strengthening the legal system and the enforcement of contracts, reforming the tax system and the civil service, and establishing an arm's-length relationship between business and government.

Russia's future lies in the hands of its people and leaders, Camdessus emphasized. At the same time, he said, "this is also the time for [the IMF], as part of the international community, to go ahead with our support for the completion of Russian reforms—by continuing our friendly and constructive dialogue on policies; by extending, when needed, our technical assistance; and by resuming our financing and risking our resources once again in support of your economic program." Camdessus called on the Russian State Duma "to pass laws for the market economy, to ensure that the government's budget is realistic and ambitious on both the revenue and expenditure sides, and to lead a responsible debate in the country about economic policies and propriety in public life."

On April 3, Camdessus and Russian Prime Minister Viktor Chernomyrdin initialed a joint communiqué citing the progress achieved in finalizing Russia's economic program for 1997. ■

## IMF Asia and Pacific Regional Office To Open in Tokyo

On March 21, IMF Managing Director Michel Camdessus announced that the IMF's Regional Office for Asia and the Pacific will be located in Tokyo. The establishment of the office reflects the substantial, and growing, importance of the economies of the region in the global economy. Kunio Saito, a national of Japan, is the Director of the new office, which is expected to be open for business by late August.

Kunio Saito

According to Managing Director Camdessus, "The primary aims of establishing this office are to allow the IMF to develop closer ties with national policymakers in the region, who have been working increasingly through various regional policy forums toward greater policy coordination and cooperation, to monitor economic developments more closely, and to strengthen contacts with financial markets and the media in the region."

The staff of the Tokyo Regional Office will make frequent visits to other key cities in the region to keep in close contact with the region's financial communities and to facilitate information gathering and relationship building. The cost of the new office will be offset by savings in the IMF's expenditures elsewhere, Camdessus said.

**Photo Credits:** Denio Zara and Padraic Hughes.

# West Bank and Gaza Strip Needs to Attract Private Investment

Beginning in May 1994, the Palestinian Authority has gradually assumed responsibility for administering economic and social activities in the West Bank and Gaza Strip. To meet these responsibilities, the Palestinian Authority must establish and sustain an effective system of institutions. Wherever possible the Palestinian Authority has opted to adapt existing institutions, creating new institutions as needed.

A new IMF report, *Recent Economic Developments, Prospects, and Progress in Institution Building in the West Bank and Gaza Strip*, discusses the Palestinian Authority's development strategy, economic and institution-building developments in 1996, and prospects for 1997. The authors—a staff team from the IMF's Middle Eastern Department—emphasize that although the West Bank and Gaza Strip economy is relatively free of major structural distortions, the Palestinian Authority still needs to put in place the necessary preconditions to attract investment and reduce the very high unemployment rate. Political uncertainties are key constraints to private investment, but the Palestinian Authority must also establish a transparent legal and regulatory framework.

## Background

The Palestinian Authority has gradually assumed responsibility for the economic management of most public sector functions in the West Bank and Gaza Strip. This challenge has been complicated by frequent border closures and increased political uncertainties that have reduced the number of Palestinians working in Israel, disrupted trade and public investment, and generally weakened confidence. As a result, during 1996 per capita income fell, unemployment rose to 34 percent, and only modest progress was made in developing the physical and institutional infrastructure. Overall investment slumped in 1996 to slightly more than 18 percent of GDP from 28 percent in 1992, with private investment collapsing to 10 percent of GDP from 25 percent.

The medium-term economic strategy of the Palestinian Authority is geared toward reducing unemployment. From 1967 until a few years ago, employment in Israel and in the Gulf states provided the principal impetus for income growth in the West Bank and Gaza Strip. Since 1992, however, these sources of employment have declined, with little prospect for an immediate recovery. With the labor force and population growing at an annual rate of 4 percent, the West Bank and Gaza Strip's unemployment problem will intensify, in the absence of strong economic growth. Future efforts to reduce unemployment will need to be linked to an expanded role for the private sector and export-led growth. The investment-to-GDP ratio must rise substantially from the current 18–19 percent to underwrite higher growth rates, but this will require an environment conducive to private sector investment and growth.

*Reducing unemployment requires a larger private sector role and export-led growth.*

To spur investment and savings, the Palestinian Authority is implementing structural measures in the fiscal, financial, external, and regulatory areas, although success will no doubt be affected by the political situation. The Palestinian Authority's plans also call for a substantial reduction in the recurrent deficit in 1997 and for small but rising surpluses thereafter. The improved fiscal position would allow for a domestic budgetary contribution to public investment and enable donor assistance to focus more on infrastructure building and other investment projects. Key steps to strengthen tax administration are planned as part of this initiative.

The economic agreements between Israel and the Palestine Liberation Organization in 1993–95, which culminated in the Interim Agreement of September 1995, largely regularized the existing trade regime of the West Bank and Gaza Strip, which is in a de facto customs union with Israel. Even if the Palestinian Authority were to exercise fully the flexibility allowed under the Interim Agreement for some of its traded goods, the trade regime would remain basically a customs union, mainly because low Israeli tariffs set the

### Selected IMF Rates

| Week Beginning | SDR Interest Rate | Rate of Remuneration | Rate of Charge |
|---|---|---|---|
| March 24 | 4.07 | 4.07 | 4.45 |
| March 31 | 4.06 | 4.06 | 4.44 |

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 U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 109.4 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171.
Data: IMF Treasurer's Department

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upper limit on the West Bank and Gaza Strip's tariffs. On the one hand, this trade regime, in the absence of border closures, gives the exports of the West Bank and Gaza Strip free access to the large Israeli market and allows the West Bank and Gaza Strip to derive the benefits of a relatively liberal trade regime. On the other hand, it obliges the West Bank and Gaza Strip to pursue a trade regime that might not be best suited to its economic circumstances and development strategy. It also ties the West Bank and Gaza Strip to the pace of trade liberalization under way in Israel.

## IMF Assistance

Because the West Bank and Gaza Strip is not a member of the IMF, IMF support is limited to providing technical assistance. The IMF, which sponsors a large program of technical assistance to the Palestinian Authority, has been helping to establish a modern revenue administration and create an efficient public expenditure management system. The IMF is also assisting the West Bank and Gaza Strip in meeting reporting requirements to other donors—particularly in the areas of revenue and expenditure developments and progress in building fiscal institutions. The IMF's technical assistance has also aided the Palestinian Monetary Authority in organizing and managing the Authority; strengthening bank licensing and supervision; administering a clearing and payments system; preparing draft banking legislation; and improving balance of payments statistics and national income accounts. In 1995–96, the scope of IMF technical assistance widened to include macroeconomic policy formulation. In this connection, IMF staff have helped the Palestinian Authority prepare its annual budget, monitor budgetary performance, report to donors, and mobilize external financial resources.

The World Bank has also been deeply involved in the West Bank and Gaza Strip in recent years and is currently a primary donor, disbursing about one-fourth of the $1.4 billion in total assistance extended since the signing of the Oslo agreements in 1993. World Bank activities include technical and advisory services and trust fund administration, in which the World Bank administers the transfer of donor contributions to the West Bank and Gaza Strip, the financing of investment projects, and coordination of donor activities.

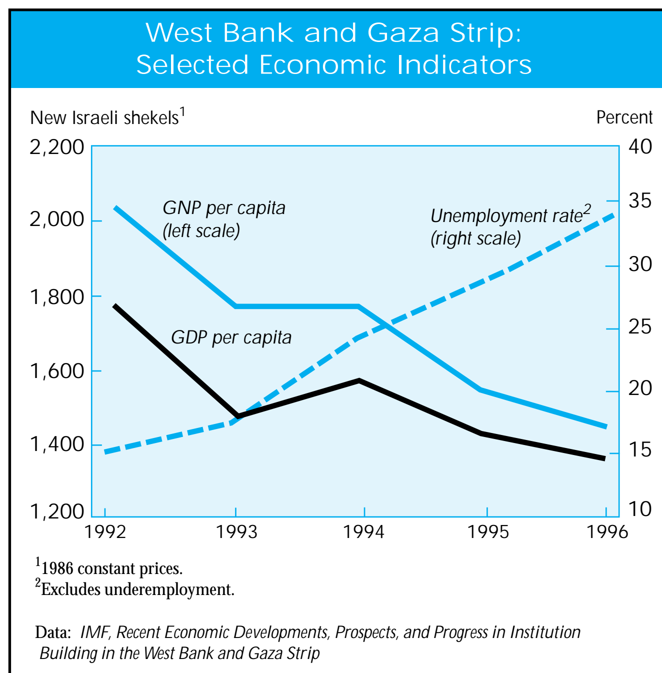
## Prospects for 1997

Assuming modest improvements in security and political conditions, the outlook for 1997 is for a moderate recovery in exports and private investment, coupled with an increase in the number of Palestinians working in Israel. Under such conditions, real GDP is projected to rise by 5–6 percent, and the unemployment rate to fall slightly. The draft budget aims to cut the recurrent deficit to the equivalent of 1.5 percent of GDP in 1997 from 3.5 percent in 1996.

To further boost private investment, the public investment program must be more effectively implemented over the medium term. To achieve the 1997 budget target, the authorities are taking steps to strengthen expenditure management and revenue collection. Employment for the rapidly growing labor force will need to be generated through export growth. Thus, it will be important for the Palestinian Authority to avoid distortions in price incentives, pursue the planned dismantling of import monopolies (the major structural distortion in the economy), and strengthen financial intermediation.

The Palestinian Authority is continuing to mobilize external resources from donors, but considerable follow-up will be required to ensure these pledges are translated into commitments and disbursements for specific investment projects in the public investment program. ■

Martha Bonilla
IMF External Relations Department




[1]1986 constant prices.
[2]Excludes underemployment.

Data: *IMF, Recent Economic Developments, Prospects, and Progress in Institution Building in the West Bank and Gaza Strip*

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