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Managing Director welcomes Korea's request for assistance. See page 371.

Five-Nation Tour

Camdessus Visits Southeast Asia, Addresses Issues Arising from Financial Crisis

Against the background of the financial turmoil in a number of Southeast Asian countries, IMF Managing Director Michel Camdessus made a "whistle-stop" tour of the region, from November 10–15, with stops in Indonesia, Singapore, Malaysia, Thailand, and the Philippines. Meeting with government and banking officials and the press, Camdessus spoke about the events leading up to the crisis, prospects for recovery, means to prevent or lessen the effect of future crises, and the contribution the IMF can make to help the region restore confidence and recover its strength. He emphasized that Southeast Asia's economies were ready for recovery, provided their leaders carried out tough reforms. Camdessus also discussed plans to develop a regional surveillance mechanism and a cooperative financing arrangement, which were the subject of a meeting of finance and central bank deputies in Manila on November 18–19 (see box, page 371).

Camdessus arrives at the parliament in Bangkok for a meeting with senior Thai officials.

Indonesia. Camdessus said in a press briefing in Jakarta on November 12 that he saw no sign that countries in Asia were pursuing a strategy of devaluing their currencies to boost exports. He thought that the market would continue to be volatile for a while, during which time market forces would rebalance the *(Please turn to the following page)*

Vancouver Communiqué

APEC Leaders Affirm IMF's Central Role in Region

Meeting in Vancouver, Canada, on November 24–25, leaders of the Asia-Pacific Economic Cooperation (APEC) economies addressed the continuing economic and financial turbulence in Asia and its impact on the global economy. They renewed their commitment to cooperative efforts to sustain prosperity and stability, stressed that the role of the IMF remains central in the global effort, emphasized their confidence in the dynamism and resilience of the region, and reaffirmed their conviction that open markets bring significant benefits and that continuing trade and investment liberalization will foster further growth. Highlights of the final communiqué follow:

• APEC and the world economy have a stake in seeing Asia make a quick and durable return to financial stability and restore healthy and sustained growth rates. The global dimensions of the new challenges to the international financial system require a new global response, with regional initiatives to complement and support these efforts.

• The fundamentals for long-term growth and the prospects for the region are exceptionally strong. The APEC leaders stressed that open markets will bring significant benefits and pledged to continue to pursue trade and investment liberalization that fosters further growth. Prudent and transparent macroeconomic and structural policies, human resource development strategies, and effective financial sector regulation are key, they said, to restoring financial stability and to realizing the region's growth potential.

• Noting the need to go further, the communiqué emphasized the importance of moving quickly to enhance the capacity of the international system to prevent or, if necessary, respond to, financial crises. On a global level, the role of the IMF remains *(Please turn to the following page)*

(Managing Director's trip: continued from front page) relative position of the currencies. "I believe this is a normal working of the market," he said, "and I see no reason to interfere with that." What is important, he said, is that governments make sure their macroeconomic policies are in line with the new exchange positions and that they establish an exchange rate regime compatible with the new market setting and with economic fundamentals and objectives.

The press briefing was held less than a week after the IMF Executive Board approved a $10 billion Stand-By Arrangement for Indonesia (see *IMF Survey*, November 17, page 353). If the necessary reforms—including a restructuring of the financial and banking sector, transparency and accountability in the budget, and deregulation and good governance—are implemented, growth might be slower over the next couple of years, but "Indonesia can come out of the crisis stronger, with much more sustainable conditions for long-lasting growth," he observed.

Camdessus greets Thai Prime Minister Chuan Leekpai (left) and Indonesian President Suharto (right).

Singapore. In a press briefing in Singapore on November 13, Camdessus said that the region's longer-term fundamentals remain basically favorable and that the underlying potential for growth is there. His optimism about Asia's long-term prospects was partly fueled by the readiness within the region to come up with financial support for faltering economies. But he warned that restoration of confidence takes time and he stressed the importance of regional cooperation and solidarity, especially for a "creditor" like Singapore.

Malaysia. Speaking at a press briefing in Kuala Lumpur on November 13, Camdessus observed that he came to Malaysia with a message of "prudent optimism." Given Malaysia's efforts to reduce its current account deficit and rein in credit expansion, while at the same time strengthening supervision of the banking sector, the country should be able to resist the turmoil and financial upheaval afflicting the region. Noting that the financial crisis in Asia had also affected markets in the United States and Europe, Camdessus said countries must be ready to react early; they must also always be ready to pre-empt financial crises with the right policy mix.

Thailand. Referring to the $17.2 billion assistance and reform package agreed with Thailand in August (see *IMF Survey*, September 17, page 283), Camdessus said in a press briefing in Bangkok on November 14 that the Thai program had a bumpy, hesitant start. But that was not because of the program itself nor its financing, but because of the country's shaky political situation at the time. In spite of the difficult political situation, the Thai authorities had moved forward with their reform program; Camdessus said that he would urge the IMF Executive Board to approve the second installment of the IMF's $4 billion loan—a move that would signal the IMF's faith in Thailand's economic reform.

Philippines. Speaking at a news conference in Manila on November 15, Camdessus noted that the Philippines had been less affected by the Southeast Asian crisis than others in the region mainly because of the quality and

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(APEC: continued from front page) central, the leaders said. They urged a rapid implementation of the Manila framework (page 371), which they said was a constructive, cooperative step to promote: financial stability; enhanced regional surveillance; intensified economic and technical cooperation to improve domestic financial system and regulatory capacities; the adoption of new IMF mechanisms on appropriate terms in support of strong adjustment programs; and a cooperative financing arrangement to supplement, when necessary, IMF resources. They added that they looked forward to the conclusion of the IMF's study on the role of market participants in the crisis.

• Finance ministers and central bank officials should accelerate their work on collaborative initiatives to promote the development of APEC's financial and capital markets and support freer and stable capital flows in the region.

• As evidence of APEC's undiminished commitment to voluntary trade liberalization, the leaders also agreed that early action should be taken in 15 sectors, with 9 to be advanced in 1998 with a view to implementing these measures in early 1999.

APEC membership comprises Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong Special Administrative Region, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, the Philippines, Singapore, Taiwan Province of China, Thailand, and the United States. ■

continuity of the government's efforts during the last six years to improve its macroeconomic fundamentals and strengthen its financial sector. Earlier in the summer, the IMF Executive Board extended its loan arrangement for the Philippines by six months (see *IMF Survey*, August 5, page 250). Even after the country exits from the program, the Philippines may wish to remain under some form of IMF supervision, Camdessus said in Manila on November 15; but he made it clear that this decision was entirely up to the government.

Korea Requests IMF Assistance

On November 21, the Korean authorities announced in Seoul that they had asked the IMF to support a strong adjustment program to help the country in its efforts to overcome the financial crisis affecting the economy. Following the announcement, IMF Managing Director Michel Camdessus said: "I welcome today's announcement by the Korean authorities that they intend to enter into a financial arrangement with the IMF, and I have already assured the Korean authorities of our full support. The management of the IMF has been in contact with the Korean authorities in recent weeks on ways to overcome the financial crisis, which has arisen despite sound macroeconomic trends. Financial market stabilization measures were announced two days ago. They provide a good basis to begin the needed restructuring of the financial system. This restructuring, together with further structural measures as well as an appropriate strengthening of monetary and fiscal policies, would provide a sound basis for a comprehensive package that could be supported by the IMF and the international community.

"An IMF mission will arrive in Seoul next week to begin discussions with the Korean authorities. We will work closely and intensively with the authorities in their finalization of a strong program which I could forward to the Executive Board for approval under the IMF's emergency financing mechanism.

"I am confident that the authorities are resolved to put in place a strong adjustment program that will restore confidence, recreate the ground for sustainable growth, and contribute significantly to financial stability in the region," Camdessus said.

Asian Financial Deputies Agree on Framework for Regional Cooperation

On November 18–19, finance and central bank deputies representing Australia, Brunei Darussalam, Canada, China, Hong Kong Special Administrative Region, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the United States, as well as representatives from the IMF and the Asian Development Bank, met in Manila to develop a "framework for regional cooperation and to enhance the prospects for financial stability." Following are excerpts from the communiqué issued on November 19, following the meeting.

Recent market turmoil has not altered the consensus that open capital markets bring significant benefits to an economy. It has, however, brought into focus the challenges that accompany globalization of financial markets and the increased volatility of capital flows.

Against this background, deputies agreed on the need and desirability of a framework for regional cooperation to enhance the prospects for financial stability. This framework, which recognizes the central role of the IMF in the international monetary system, includes the following initiatives:

A new mechanism for regional surveillance to complement global surveillance by the IMF. This mechanism would provide a basis for a more intensive and high-level process of surveillance and dialogue among participating finance ministries and central banks, with support from the IMF, the World Bank, and the Asian Development Bank. It would also help identify potential risks to growth and financial stability and advise on appropriate policy responses to reduce those risks.

Enhanced economic and technical cooperation. Deputies stressed the importance of economic and technical cooperation to strengthen banking and financial systems and to deepen capital markets. They welcomed the efforts undertaken so far by international financial institutions and the international supervisory community to assist domestic authorities in this area.

Measures to strengthen the IMF's capacity to respond to financial crises. Deputies recognized their common interest in strengthening the IMF's capacity to carry out its central responsibilities for the international monetary system by ensuring that it can mobilize substantial assistance quickly in support of strong macroeconomic and financial programs and provide, where appropriate, the predominant share of official financing in situations of severe financial crisis.

A cooperative financing arrangement. Deputies also agreed on the need to develop a cooperative financing arrangement for the region that would supplement IMF and other international financial institution resources. Under this arrangement, the participants could provide, in consultation with the IMF and on a case-by-case basis, supplemental financial resources for IMF-sponsored programs. Such support could be extended in exceptional circumstances to augment a country's reserves after making use of the resources available by the IMF, which should as a first recourse take full advantage of the flexibility provided under the exceptional circumstances clause and any new financing mechanisms.

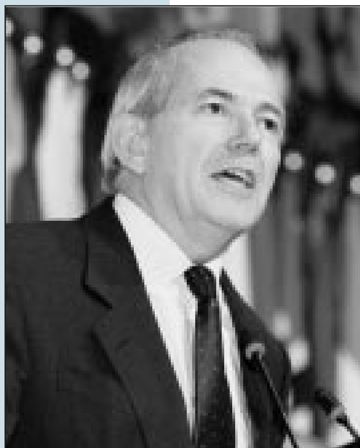
These initiatives underscore the importance of maintaining sound macroeconomic and structural policies, appropriate exchange rate policies, and strong domestic financial institutions and supervisory regimes in fostering and sustaining growth.

Press Briefing in Singapore

What Are the Lessons of the Southeast Asian Crisis?

Following is the edited text of remarks by IMF Managing Director Michel Camdessus on November 13.

How could events in Southeast Asia unfold as they did, after so many years of outstanding performance? We have a fairly clear analysis of what happened in Thailand. The more difficult question is how the crisis spread so quickly to other economies in the region. Let me give you my perspective on the causes of the crisis and where we go from here.



Camdessus: The Thai crisis did not strike out of the clear blue sky.

How Could It Happen?

Certainly, the Thai crisis did not strike out of the clear blue sky. On the contrary, there were numerous signs of a gathering storm. Macroeconomic indicators pointed to considerable imbalances: substantial real exchange rate appreciation; a marked slowdown in export growth; a persistently large current account deficit financed increasingly by portfolio inflows, including a substantial amount of short-term capital; and rising external debt. These problems, in turn, exposed other weaknesses in the Thai economy, including substantial, unhedged foreign currency-denominated borrowing by the private sector, an inflated domestic property market, and a weak and overexposed banking system. Markets issued their own warnings in the form of declining equity prices and mounting exchange rate pressure, as doubts about the sustainability of policies grew. And as you know, the IMF also stressed these problems and pressed for urgent measures in a continuous dialogue with the Thai authorities. It was, of course, difficult for the authorities in Thailand and elsewhere in the region to recognize, after so many years of outstanding macroeconomic performance, that underlying deficiencies could seriously jeopardize their track record. This certainly contributed to the delay in taking the necessary corrective action. And at last, in the absence of convincing policy action, the storm broke.

We all have been troubled by developments in the Thai economy, both because they have been so costly for Thailand and its neighbors and because they were so preventable. But at least their origins are by and large clear. What is less evident, and therefore more unsettling to all who are trying to make sense of broader regional developments, is how the crisis spread as it did to economies such as Indonesia, Malaysia, and the Philippines, where current account deficits were generally smaller and foreign direct investment more substantial. Although it may be some time yet before we have the complete answer to this question, some elements of the explanation are becoming clear.

Part of the explanation lies in the extent to which developments in Thailand have affected conditions in neighboring countries. For example, in expectation that the depreciation of the baht would erode the competitiveness of Thailand's trade competitors, their currencies also weakened. And as these currency slides acquired an almost self-perpetuating character, the debt-service costs of the domestic private sector increased. Uncertainty about how far these currencies would slide and how much debt-service costs would increase encouraged a rush to hedge external liabilities that only intensified exchange rate and interest rate pressures.

Another factor is that problems in the Thai economy prompted markets to take a closer look at the risks in other countries. And what they saw—to different degrees in different places—were many of the same problems affecting Thailand: among them, overvalued real estate markets, weak and overextended banking sectors, poor prudential supervision, and substantial private short-term borrowing in foreign currency. Moreover, after Thailand, markets began to look more critically at weaknesses they had previously considered minor, or at least manageable in an orderly way, given time.

I see two other factors that hastened the stampede: one, the lack of transparency and, hence, the increased uncertainty about government and central bank operations, the true state of financial sectors, the links between banks, industry, and government, and the impact these links might have on economic policy; and two, the controls—and threat of controls—on market activity. Given the tendency of financial market participants to run with the herd, this was a sure-fire way to send the herd scrambling for safer pastures and set back efforts to restore confidence.

What Lessons Should We Draw?

The first lesson is the most obvious one: the necessity of taking early action to correct macroeconomic imbalances before they precipitate a crisis. This did not happen in Thailand, despite timely and vigorous warnings. On the contrary, policymakers attacked the symptom of the crisis—the pressure on the baht—accumulating large reserve losses and forward foreign exchange liabilities in the process. This, together with delays in addressing Thailand's severe financial sector problems and lingering political uncertainties, clearly contributed to a deepening of the crisis and its spread to other economies in the region.

The second lesson is that other countries can find that their vulnerability to crises in other markets is greater than economic fundamentals would suggest. Consequently, they need to take pre-emptive actions to strengthen their policies. Where might such actions be needed? Several suggestions come to mind:

• maintaining an appropriate exchange rate and exchange rate regime. Clearly, there is no single "right" choice, but more flexible exchange rates can help provide early and visible signals of the need for policy adjustments and are less likely to invite reckless behavior on the part of borrowers and lenders. But regardless of the exchange rate arrangement chosen, appropriate macroeconomic policies are essential to ensure its success;

• maintaining a proper policy mix, so that high domestic interest rates do not damage the domestic economy, attract excessive amounts of short-term capital, or preclude further monetary tightening if market conditions require; indeed, it is important to keep the option of using the interest rate instrument open, so that the authorities have some room for maneuver in times of international instability;

• strengthening structural policies—especially the policies and institutions, such as better prudential supervision, needed to underpin a sound financial system; and

• carrying out other supporting reforms—what we call "second-generation" reforms—to promote domestic competition, increase transparency and accountability, improve governance, help ensure that the benefits of future growth are widely shared, and otherwise strengthen the foundations for future growth.

Restoring Confidence

As developments have shown, confidence, once lost, is hard to regain. Restoring confidence takes a strong commitment to economic adjustment and reform demonstrated by the implementation of often painful measures. It also requires a free flow of timely, accurate, and comprehensive information so that markets can assess the extent of underlying problems and the seriousness of efforts to correct them and uncertainty can be reduced. And, of course, restoring confidence takes time.

This process is now under way in Southeast Asia. With the support of the IMF, Japan, and a number of other countries in the region, Thailand has launched a courageous and comprehensive program that addresses the problems of large external deficits and troubled financial institutions. As a result, the budget is moving back into surplus and a comprehensive restructuring of the financial sector is getting under way. The Philippines, for its part, has taken necessary measures and extended its program with the IMF under which a substantial amount of economic adjustment and reform has already taken place. Malaysia is also adapting to changing conditions by scaling back investment plans, tightening its fiscal stance, and strengthening prudential banking regulations.

Indonesia has strengthened its policy stance in continuous dialogue with us and has recently reached agreement with the IMF on a major program consisting of strong monetary and fiscal policies to bring about orderly adjustment in the economy and restore confidence to financial markets; a major restructuring of the financial sector, along with measures to ensure its future soundness; and significant deregulation measures and trade reforms that should improve economic efficiency immediately and over the longer term.

Restoring confidence takes a strong commitment to economic adjustment and reform.

Naturally, it will take time for these efforts to bear fruit. But developments in recent months have by no means wiped out the achievements of past decades. On the contrary, the region's longer-term fundamentals—including its high domestic saving rates, strong fiscal positions, dynamic private sectors, and recent gains in competitiveness—remain favorable. Moreover, all of these countries still have a long way to go to catch up with advanced economies. Thus, with sound policies, they should be able to sustain high rates of growth for another two decades or more.

In the less distant future, growth can be expected to rebound strongly after a relatively short, but sharp, weakening of economic activity, especially in Thailand, and a rapid narrowing of external deficits. In fact, we are already seeing improvements in exports, even though recent exchange rate changes have not had much opportunity yet to generate their effects. And as these adjustments take place, each of these countries will have seized the opportunity to strengthen their economies in fundamental ways. This leads me to agree with those in the region who see this crisis *not* as a blight on the future but as a blessing in disguise. Indeed, after this period of adjustment, these economies will emerge stronger than before.

In the meantime, I hope that some perspective about the benefits of global markets will be maintained. First, we must give credit where credit is due: the capital provided by global markets has been a key factor in Southeast Asia's exceptional growth rates and its ability to lift so many out of poverty. Certainly, there are risks in tapping global markets to which no country is immune. At times, markets can be slow to react to changes in economic conditions and then react sharply; and in some instances, herd instinct seems to prevail.

But let us not forget that markets also provide tremendous opportunities to accelerate growth and development, as Southeast Asia itself so vividly shows. Thus, the lesson to be drawn from recent developments is not about the risks of global markets but rather about the importance of approaching markets in a responsible manner—with strong macroeconomic fundamentals and sound structural policies that give markets confidence and therefore encourage long-term investment; with respect for the signals that markets provide; and with transparent and market-friendly policies that allow markets to allocate resources efficiently.

Markets provide tremendous opportunities to accelerate growth and development.

Stronger Regional Cooperation

Spillover and contagion effects can be so rapid, so costly to countries with basically sound policies that every country has an obligation to keep its own house in order. No country should run the risk of becoming the tinder for a wider conflagration. At the same time, there is also much that can be done on a regional and multilateral basis to bolster the efforts of individual countries seeking to manage their economies well.

At the regional level, countries can make a valuable contribution to regional and global stability by joining voluntarily with their neighbors in mutual surveillance. The objective should be to complement IMF surveillance by developing a "club spirit" through which neighboring countries can encourage one another—and, at times, exert some peer pressure on one another—to pursue sound policies. We welcome the efforts being made in this direction in various fora. To be effective, such regional surveillance will, of course, have to be based on sound economic analysis. In this connection, the management and staff of the IMF are ready to contribute to regional surveillance in Asia, as they already do in Europe, the G-7, and other fora. Indeed, one of the tasks of our new regional office in Tokyo could be to help promote more intensive regional surveillance.

IMF Response

At the multilateral level, the international community sees it as indispensable to work and cooperate through a central institution, the IMF, in order to help countries deal with the opportunities and risks of globalization. And given the challenges of the global financial markets, the international community has encouraged the IMF to strengthen its capacity in this respect. The IMF's response centers on four broad areas.

• We have strengthened IMF surveillance, which, as you know, lies at the heart of the IMF's efforts to maintain an orderly international monetary system. In order to detect financial tensions as early as possible, we have sought to make our dialogue with member countries more continuous and probing and put more emphasis on the continuous and timely provision of accurate data. We are also concentrating more on policies decided at a regional level, on the regional implications of national economic policies, on banking and financial sector soundness, and on the policies and institutions that sound financial systems require.

• We are doing what we can to help markets function more smoothly. Considerable progress has been made in liberalizing current account transactions worldwide so that countries can take advantage of the opportunities offered by the expansion of world trade. Now we must turn our attention to fostering an orderly liberalization of capital account transactions, so that countries can also reap the benefits of global capital markets, while minimizing their risks.

At the same time, the IMF is actively encouraging all countries to be transparent about their economic performance by improving the dissemination of economic and financial data to the public. Greater transparency will help strengthen market discipline and avoid market surprises that can lead to disruptive market reactions.

Recognizing the importance for growth of creating an environment that encourages private sector activity, the IMF has also become more active—in close collaboration with the World Bank, regional development banks, and others—in promoting the "second-generation" reforms.

• Third, the IMF has taken action on several fronts to strengthen its resource base and adapt its procedures and financing facilities. As you may know, the membership has just agreed to an increase of 45 percent— equivalent to about $90 billion—in IMF quotas. This will raise the capital base of the institution to some $290 billion. In addition, the IMF has taken steps to augment its financial resources through the agreement on the New Arrangements to Borrow. This is also why the IMF has established an emergency financing mechanism to allow financial assistance to be provided more speedily, when countries facing external crises are willing to take strong corrective action. This mechanism was used effectively to expedite the recent programs for the Philippines, Thailand, and Indonesia.

• Last but not least, recent experience has demonstrated once again that early warnings cannot always prevent crises from blowing up. This makes it indispensable for the international community to strengthen the financial capacity of its central monetary institution to assist countries in a crisis situation.

Corruption Linked to Capital Spending Can Slow Growth

IMFSURVEY

Widespread corruption can often have the paradoxical effect of increasing public investment while, at the same time, reducing a country's growth. This is because while the share of public investment in GDP may have risen, the average productivity of that investment has dropped.

As a new Working Paper by Vito Tanzi and Hamid Davoodi, *Corruption, Public Investment, and Growth,* demonstrates, political or "grand" corruption is often tied to capital projects, especially in countries with weak or underdeveloped controlling or auditing institutions. Corruption distorts the decision-making process connected with public investment projects. It is likely to increase the number of projects undertaken in a country and to change their design by enlarging their size and complexity. The corruption-induced increase in public investment comes at the expense of productivity; and the net result is that public investment ends up having a negative impact on growth. Tanzi and Davoodi's conclusion runs counter to the bias of many economists who favor higher capital spending because they believe it contributes to higher growth.

Corruption and Government Spending

That countries need capital to grow has become an established economic principle since World War II, Tanzi and Davoodi observe. The strong intellectual bias in favor of capital spending has been enshrined in a "golden rule": it is all right to borrow as long as the borrowing is for investment projects. It is not all right, the rule implies, to borrow for current spending. This rule, the authors say, continues to be invoked even in the face of evidence that some current spending—for example, for "operation and maintenance" that keeps existing infrastructure in good condition or spending that contributes to the accumulation of human capital—can promote growth more than capital spending.

Politicians have internalized the bias in favor of capital spending and have exploited it by, for example, staging public ceremonies to celebrate the opening of such major projects as roads, power plants, schools, and hospitals. This pro-investment bias increases the investment budget. But the nature and composition of the investment budget invite corruption. Current spending does not allow much discretion, since it is often linked to explicit or implicit entitlements or previous commitments. Capital spending, in contrast, is highly discretionary, especially when the decisions are made by influential political figures, such as members of parliament, ministers, or even heads of state. These officials make basic decisions about the investment budget, such as its size and general composition; they also select specific projects, their sites, and design. In decisions on specific projects, such high-level figures may have considerable control or influence, especially when the controlling or auditing institutions are not well developed and institutional controls are weak.

Capital Projects and Corruption

The execution of public investment projects is often contracted out to domestic or foreign private enterprises. Because these projects are frequently quite large, contracts can be highly profitable for private enterprises. Managers may therefore be willing to pay a "commission" to the government officials that help them win the contract. Commissions are often a percentage of the total cost of the project; and the public officials who receive payments for helping an enterprise win a contract will have a vested interest in increasing the scope or size of the project so they can get a larger commission.

Corruption-induced increases in public investment come at the expense of productivity.

The approval of an investment project involves several phases, with decisions at each stage. Contracts for complex projects are difficult to write, say the authors; inevitably, there will be areas of uncertainty and disagreement. Further, the project is not completed until

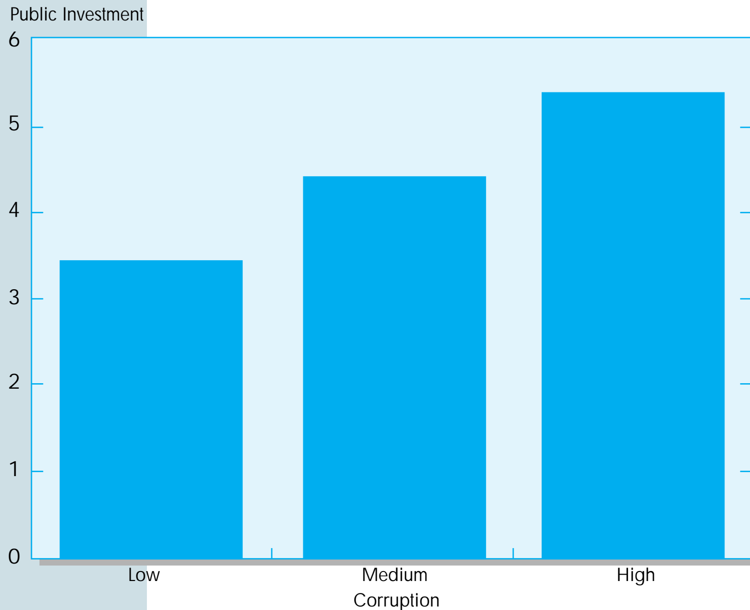
Anti-Corruption Action Reduces Cost of Capital Spending in Milan

For years, Italy recorded one of the largest shares of capital spending in GDP among the OECD countries, until a huge corruption scandal in the early 1990s, nicknamed "tangentopoli" (bribe city), toppled the governing party that had ruled the country for several decades. After the scandal broke and several prominent individuals were sent to jail, capital spending fell sharply. This fall, according to Tanzi and Davoodi, was evidently attributable to a sharp reduction in the number of capital projects undertaken—and, perhaps more important—by a sharp fall in the costs of those projects still underway. Citing data released by Transparency International, a nongovernmental organization that traces worldwide corruption, the authors report that within two or three years, the cost of rail links in Milan—the city where the scandal first broke—fell by 52 percent; and the budget for the new airport terminal was reduced by 59 percent, reflecting lower construction costs. Although one cannot wholly discount post hoc rationalization, the connection between the fallout of the scandal and the fall in capital spending, the authors suggest, is too strong to be attributed to coincidence.

someone has verified that the work was done according to the contract. In any one of these phases, a strategically placed high-level official can influence the process so that a particular enterprise is selected. For example, the design specifications can be tailor made for a given enterprise.

A commission of even a few percentage points on a project that costs millions or even hundreds of millions

Corruption and Public Investment
(percent of GDP)



Data: IMF staff estimates

of dollars can be large. If a corrupt official collaborates, however, enterprises can often recover the cost through various channels:

• up-front cost recovery, if the enterprise wins the bidding competition with an offer that includes the cost of the commission;

• an understanding with the "friendly" official that an initial low bid can be adjusted upward later in the process, ostensibly to reflect modifications to the basic design; and

• reduction in costs by skimping on the quality of the work done and the materials used.

With any one or a combination of these alternatives, Tanzi and Davoodi explain, the country will end up with either a project that costs more than it would have in the absence of corruption, a larger or more complex project than necessary, or a project of inferior quality that will not perform up to standards and will require costly upkeep and repairs.

Another form of corruption arises when political personalities steer public investments toward their home districts. Projects may be piloted toward particular areas because of convenience, a bid for political support or popularity, or as a means of increasing the value of assets (such as lands owned by a politician) in those areas.

When corruption plays a large role in the selection of projects and contractors, the decision-making process is also corrupted. The result is a highly distorted capital budget; the by-products are "white elephants" and "cathedrals in the desert." When corrupt high-level officials influence the approval of investment projects, the rate of return as calculated by cost-benefit analysis ceases to be the criterion for project selection. In these situations, the enterprises carrying out the projects care mostly about their profits, and the politicians who authorize the projects and choose the enterprises care mostly about the bribes they will pocket. In the extreme case of a totally corrupt country, the productivity of the projects becomes almost irrelevant.

Widespread corruption in the investment budget not only reduces the rate of return to new public investment but also affects the rate of return that a country receives from its existing infrastructure, for several reasons:

• If corruption is not a new phenomenon, the existing infrastructure has been contaminated because past investments were also misdirected or distorted by corruption.

• Higher spending on capital projects reduces the resources available for other spending, especially spending that is not protected by entitlements or implicit commitments, such as for the operation and maintenance required to keep the existing physical infrastructure in good working condition. In many instances, new projects are undertaken while the existing structure is left to deteriorate.

• In cases of extreme corruption, maintenance may be intentionally reduced so that some infrastructures, such as roads, will deteriorate to the point where they will need to be rebuilt. This affords high-level officials the opportunity to extract another commission from the enterprise undertaking the project.

It is easy, the authors say, to think of situations where the deterioration of the existing infrastructure holds back growth more than new capital projects add to it. In addition, when generalized corruption reduces resources because of the negative impact on tax revenue caused by corrupt tax administrators, operation and maintenance will be reduced far more than public investment. This is because of the intellectual bias that supports borrowing for capital projects but not for current spending.

Empirical Analysis

Using cross-country data and regression analysis, the authors posit several hypotheses about the relationship between corruption, on the one hand, and public investment, government revenue, operation and maintenance expenditures, and quality of infrastructure on the other. Controlling for real per capita GDP and other variables, they find that higher corruption is associated with:

- higher public investment;
- lower government revenues;
- lower operation and maintenance expenditures;
- lower quality of public investment; and
- reduced productivity of public investment.

Corruption short-circuits what has come to be accepted as an almost mechanical relation (the capital-output ratio) between increased capital spending and increased growth. As the authors' analysis shows, however, "grand" corruption can actually reduce growth by increasing public investment while reducing its productivity. In particular, corruption can retard growth by increasing public investment but holding back on recurrent current expenditure—that is, nonwage operation and maintenance spending. The authors' evidence shows that higher corruption is also associated with higher total spending on wages and salaries. This item is a large component of government consumption, and high government consumption is unambiguously associated with lower growth. Finally, corruption can also reduce growth by lowering government revenue needed to finance productive spending.

The main policy implication of their findings, the authors conclude, is that economists should be more restrained in their praise of high public sector investment; the so-called golden rule may not apply in countries where corruption—especially high-level corruption—is a problem. ■

Copies of IMF Working Paper 97/139, *Corruption, Public Investment, and Growth*, by Vito Tanzi and Hamid Davoodi, are available for $7.00 each from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org. The full text is also available on the IMF's web site (http://www.imf.org/external/pubind.htm).

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
November 17	4.33	4.33	4.75
November 24	4.31	4.31	4.72

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 109.6 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

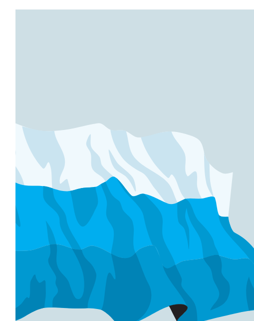
Institutional, Regulatory Reform Is Key to Growth in Russia

In its transition toward a market economy, Russia has made major progress in structural reform, by liberalizing prices and trade regulations, and in privatization. Recently, the country also achieved financial stabilization—a key precondition to growth. Nevertheless, declining investment, sluggish foreign investment, and a growing share of activity accounted for by the gray economy are signs that policies in these areas are still not fully conducive to growth. A complex tax system and high statutory tax burden, onerous regulatory requirements, administrative backlogs, and inadequate legal infrastructure deter the establishment of new businesses and reduce the profitability and expansion of existing ones.

To lay the foundation for sustained medium-term growth, Russian policymakers must introduce institutional and regulatory changes that will foster investment and promote new private sector activity. In a new study, *Legal and Institutional Obstacles to Growth and Business in Russia*, Elaine Buckberg of the IMF's European II Department examines the most crucial changes. Her analysis, which is based on discussions with members of the business and legal community in Russia, covers tax reform, simplification of legal and regulatory requirements, elimination of bureaucratic corruption, strengthening of the judicial system, and improvement of the capital market infrastructure.

Streamlining the Tax System

The Russian tax system is cumbersome and distortionary, Buckberg observes. Tax preferences, varying tax rates, and an uneven application of tax laws cause distortions, and imprecise drafting and ill-defined terminology give tax inspectors a large margin of discretion, facilitating corruption. Tax provisions may be undocumented or not publicly available, particularly at the regional and local government level. Despite the laws' ambiguities, inadvertent errors are penalized at the same rate as willful noncompliance. Furthermore, full compliance with taxation of turnover, wage costs, profits, and capital may leave almost no after-tax profit. Russian firms consider these tax burdens excessive and, as a result, evade taxes in increasingly sophisticated ways. Many smaller enterprises do not pay taxes, and larger firms often falsify their returns. Firms rely heavily on legal means of reducing reported profits, concealing income by overstating expenses, underinvoicing exports and overinvoicing imports, and using transfer pricing to report all profit as accruing to offshore subsidiaries. The transfer of assets offshore, moreover, has



deterred economic activity by reducing the resources available for either financial intermediation or investment in Russia. Also, it is unlikely that the return on assets held offshore is repatriated.

Corruption on the part of tax inspectors further undermines compliance and collection. A firm's total tax obligation is often viewed as a negotiated settlement between a business and its tax inspector; inspectors exploit ambiguities in the code to adjust a firm's assessment and extract bribes. Collusion between tax inspectors and organized crime groups through, for example, sharing bribes paid by taxpayers in exchange for reduced tax assessments, has reportedly undermined tax collection in many regions.

The Duma in Moscow. A proposed comprehensive reform seeks to simplify the tax system.

A proposed comprehensive tax reform now before the Russian parliament (the Duma) seeks to simplify the tax system, thereby facilitating tax administration and compliance. Centered on broad-based taxes at uniform rates, it would also widen the tax net and distribute the tax burden more equitably. Among the key reforms are:

• the introduction of uniform value-added tax (VAT) and corporate income tax rates coupled with the reduction of inappropriate VAT and corporate income tax exemptions;

• a wider definition of deductible expenses for the corporate income tax (notably to include interest, advertising, training, and research and development);

• a shift of the property tax base from balance sheet costs to market value; and

• an improved administrative appeals procedures, including the creation of specialized arbitration court panels dealing exclusively in tax cases.

Reducing Underground Activity

The delay and expense of complying with bureaucratic procedures also hampers growth and contributes to the expansion of the gray economy in Russia. Establishing and operating a business in Russia involves extensive documentation, lags for approval, and high fees. Inadequately funded administrative agencies and low salaries of government officials also lead to rent seeking in the form of high fees for services and demands for bribes. The lack of clear, published regulations facilitates such corruption, because applicants cannot independently verify approval requirements. Ad hoc public expenditure reductions through budget sequestration and wage arrears exacerbate the situation. Changing rules (typically introduced without notification or grandfathering), the need for regular recertification, and onerous record-keeping requirements also increase the cost of complying with bureaucratic procedures, which often price new businesses out of the market. As a result, many businesses prefer to operate underground or to shortcut the administrative approval procedures by paying bribes. A transparent and streamlined approval process would protect the public interest, while minimizing the burden of compliance with bureaucratic requirements; adequate funding for administrative offices could help fight corruption.

Developing Enforcement Mechanisms

Russia's legal system is particularly underdeveloped—major areas of law are incomplete, the judiciary lacks independence and specialization, and courts have no mechanisms to enforce decisions. Although the 1993 Constitution establishes judicial independence, the evolution of precedent has been slow. The author proposes that the creation of specialized courts would enable judges to develop expertise and help judicial interpretation norms to evolve, especially in technical areas such as tax, bankruptcy, patent, and intellectual property rights. Pointing to recent progress in this area, she notes that the number of lawsuits challenging contract violations and bureaucratic corruption is increasing, and judges and attorneys are gaining expertise. Nevertheless, many view judges and prosecutors as corrupt, and incidents of violence against judges undermine the legal system.

The courts in Russia will become effective, Buckberg notes, only if they are able to enforce judgments. As such, the government should, for example, grant courts the power to charge a party with a crime for failure to comply with an adverse judgment; establish an enforcement service to protect judges and to force compliance—by seizing unyielded assets or forcibly selling illiquid assets to satisfy a judgment; and accord courts jurisdiction to seize offshore assets. To help prevent corruption, the government should compensate enforcement personnel adequately.

Improving Governance

To attract foreign investment and improve corporate governance, the Russian government must

strengthen the country's capital market infrastructure. The single most crucial reform in this area, Buckberg considers, would be to replace Russia's cash-based accounting system—which provides no meaningful assessment of firms' profits—with internationally accepted accrual-based accounting standards. The latter would introduce those commonly accepted measures of firms' financial positions that are essential for bank lending and investment. Such a move would not only promote bank lending and portfolio and direct investment but would also facilitate shareholder discipline over corporate managers and the use of bankruptcy proceedings against unprofitable companies.

Another shortcoming of Russia's capital market infrastructure is the lack of facilities to ensure secure, verifiable, and easily transferable shareholdings. In Russia, many companies control their own share registry. This makes transactions costly—because registry changes need to be verified in person—and ownership uncertain—because firms can alter their registers and unilaterally decertify shareholders. To promote financial intermediation, share registries need to be centralized, independent, and regulated.

Reforms Will Determine Growth

Russia's success in implementing these and other key structural reforms will determine whether sustained growth will take hold, in Buckberg's view. The experience of other transition economies indicates that structural reforms make the single largest contribution to growth. As part of Russia's economic program with the IMF, the government has committed to undertake key reforms in tax administration, privatization, capital markets, banking, natural monopoly reform, and land reform (see *IMF Survey*, May 26, page 153). Reform efforts in 1997—including consideration of the draft tax code in the Duma, measures to regulate natural monopolies, and stepped-up efforts to collect or restructure the tax arrears of large enterprises—suggest that the government is now prepared to tackle the structural agenda. ■

Legal and Institutional Obstacles to Growth and Business in Russia, by Elaine Buckberg, is published as IMF Paper on Policy Analysis and Assessment 97/8. Copies are available for $7.00 each from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org. The full text is also available on the IMF's web site (http://www.imf.org/external/pubind.htm).

Sound Policies, Structural Reforms Improve Economic Prospects in MENA Region

After deteriorating or—at best—stagnating for more than a decade, economic performance in the Middle East and North Africa (MENA) region began to pick up in 1996 and improved further in 1997. Growth for the region as a whole has increased, inflation has moderated, and domestic and external financial balances have improved. This turnaround stems primarily from a more determined and widespread pursuit of appropriate domestic policies—particularly in 1997—and, in 1996, positive external developments, including the sharp increase in international oil prices and favorable weather conditions. Progress in overcoming structural impediments has also contributed to economic growth. Nevertheless, while countries that are implementing sustained, far-reaching reforms have generally fared well, others continue to lag, with large immediate and medium-term costs for their population. In a new publication, *The Economy of the Middle East and North Africa in 1997*, Mohamed A. El-Erian and Susan Fennell of the IMF's Middle Eastern Department, document recent economic developments in the region and examine the challenges that lie ahead.

In today's rapidly globalizing world economy, a country's attractiveness for investment is judged not only against its own historical record and prospects, but also against developments in other countries. In this regard, MENA's macroeconomic conditions generally compare favorably with those in other emerging markets. However, structural reform in the MENA region, while accelerating, continues to lag that in

Middle East and North Africa Region

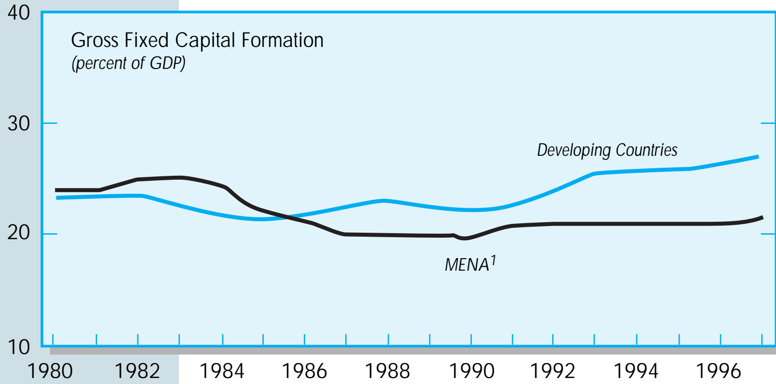
The MENA region encompasses the economies of the Arab League (Algeria, Bahrain, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Somalia, Sudan, the Syrian Arab Republic, Tunisia, the United Arab Emirates, and the Republic of Yemen), as well as the Islamic Republic of Iran and Israel.

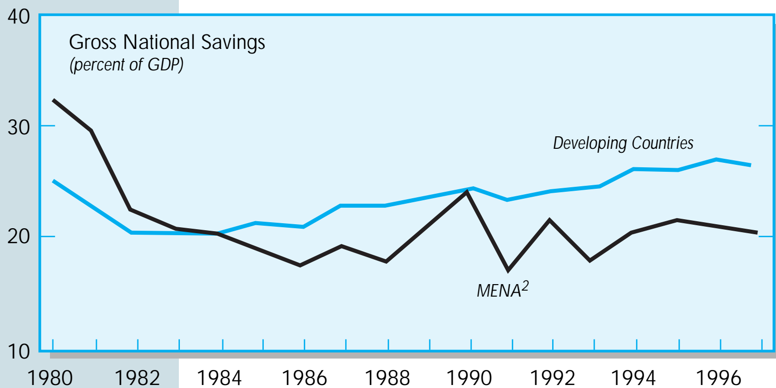
Size. More than 15 million square kilometers, with over 300 million people (about 6 percent of the world's population). In 1996, MENA's nominal GDP amounted to about $720 billion (2.5 percent of world GDP).

Per Capita Income. The region includes some of the poorest countries in the world, with per capita incomes of about $200 (Somalia and Sudan), as well as countries among the high-income group, with per capita incomes ranging between $14,000 and $18,000 (Israel, Kuwait, Qatar, and the United Arab Emirates).

many other countries. As a result, the region's saving and investment rates remain well below those in the average developing country (see chart). The authors stress that to achieve higher growth and deal with what in some cases are disappointing social indicators, the authorities' efforts must focus on increasing investment and saving rates.

Comparative Investment and Saving Rates





[1]Excludes Djibouti, Lebanon, and Sudan.
[2]Excludes Lebanon.

Data: IMF, *World Economic Outlook*, October 1997

Improved Macroeconomic Indicators

For the MENA region as a whole, the economic picture improved considerably in 1996. It remained favorable in 1997, as indicated by developments in the traditional set of macroeconomic indicators, such as economic growth, inflation, and balance of payments, and in intermediate macroeconomic policy targets, including the budgetary position, the external current account, and domestic credit developments. MENA's sustained improvement in the fiscal balances has been particularly impressive. The overall government deficit for the region declined to less than 2 percent of GDP in 1997 from close to 9 percent of GDP in 1986–90. This has facilitated the implementation of prudent monetary policy while alleviating constraints on provision of noninflationary credit to the private sector.

While not all MENA countries registered buoyant economic growth, for the region as a whole, growth picked up to 4.8 percent in 1996 and remains favorable for 1997. In line with this encouraging development, real GDP per capita increased, reversing a declining trend. Authorities have consolidated progress in reducing consumer price inflation, which fell to an estimated 9.6 percent in 1997 from an average of 17.6 percent in 1991–95. This reduction, reflecting greater fiscal restraint and prudent monetary policies, has brought greater financial stability to the region and has contributed to efforts to protect the poorest segments of the population.

On the external front, MENA's outstanding external public debt—while still high in some countries—has been on a declining trend, with foreign exchange reserves continuing to increase. The ratio of external debt-to-GDP has fallen from over 35 percent in the early 1990s to 31 percent in 1996, and an estimated 29 percent in 1997. Likewise, MENA's debt burden, as measured by the ratio of total debt service to total exports, fell to 11 percent in 1996 from over 16 percent just two years previously. The authors project a further decline for 1997. This improvement in external debt indicators reflects both the pursuit of more prudent fiscal policies, with a consequent reduction in the need for external deficit financing and, in some cases, exceptional debt relief from official creditors.

Intensified Structural Reforms

The favorable reversal of past economic trends in the region reflects the strengthening of reforms by a number of countries. Some MENA countries—Egypt, Israel, Jordan, Morocco, and Tunisia—that initiated macroeconomic stabilization programs in the early 1990s, or earlier, have been reaping rewards for some time and are now moving more vigorously to implement structural reforms. Others, which have recently embarked on comprehensive macroeconomic stabilization programs—the Islamic Republic of Iran and the Republic of Yemen—have begun to show favorable results. Still others have yet to embark on full-fledged economic reform programs and have not shared in the economic turnaround experienced by many countries in the region.

In the past, macroeconomic instability and serious structural impediments in most MENA countries constrained the development of the region's economic potential. Now that several countries have improved their macroeconomic positions, they are seeking to eliminate structural impediments that have undermined investment and factor productivity gains. While it is difficult to measure the extent of structural rigidities in MENA, the authors identify three basic features that have hampered economic growth and employment creation:

• An insufficiently strong domestic economic "enabling environment," along with political and other risk factors, has resulted in disappointingly low levels of investment.

• The government's unbalanced role in the region's economies has tended to undermine productive private sector activities rather than support them.

• The region's institutional and human development strategies have lagged, weakening a fundamental pillar of a successful development strategy.

Many countries in the region have now turned their attention to structural reform and economic liberalization, in an effort to attract investment while ensuring that policies needed to maintain financial balance remain in place. At the forefront of the structural policy agenda—though to varying degrees across the region—are reforms aimed at:

• enhancing financial intermediation;

• addressing inefficiencies in the labor market and establishing training schemes;

• deregulating domestic markets and production structures;

• liberalizing highly protective external trade regimes;

• strengthening institutions; and

• improving the availability and coverage of data to permit more timely analysis and policy responses, as well as better-functioning markets.

At the same time, the role of the state is being better redefined to support productive private sector activities. The aim is to strengthen market forces and to develop more flexible economies that are able to respond quickly to structural changes in the domestic and external economies. While many challenges remain, the momentum for reform is accelerating. Indeed, after being essentially marginalized from the process of globalization of financial markets, the region is experiencing an increase in the flow of foreign capital, the external reception for the region's debt and equity issues has been favorable, and international credit rating agencies have awarded relatively strong ratings to several countries in the region.

Consolidating Gains

Despite improvements in economic prospects in many MENA countries, much work remains to consolidate progress achieved and extend the benefits of macroeconomic stabilization and reform more deeply and widely. For those countries that have established sound macroeconomic fundamentals, the next steps will involve creating an environment that will encourage higher domestic saving, and more productive investment, which in turn will promote substantial growth over the longer term. In the remaining countries, the immediate challenge is to reduce financial imbalances and to begin eliminating the long-standing structural impediments to high and sustained growth.

The most economically advanced MENA countries will need to embark upon a second generation of reforms aimed at transforming the role of the state in the economy and increasing economic transparency. They face the additional challenge of "managing their growing success" in the increasingly complex global economy. For those countries that have not yet begun to reap the rewards of reform, determined action is needed in the short term to set a sound foundation for growth and avoid being marginalized in the rapidly globalizing world economy.

Looking to the Future

Countries in the region will be unable to rely on a favorable external environment to spur growth and achieve their broader social and economic objectives: oil price developments over the medium term are unlikely to be as favorable as they have been in the past two years; a comprehensive, just, and durable peace settlement remains elusive; and many countries will continue to be adversely affected by the vagaries of weather. The global environment, however, offers promise for the region, particularly globalization and its impact on increasing trade opportunities, enhancing capital flows, and accelerating the transfer of technology and managerial know-how. At the same time, the advantages accompanying greater integration in the global economy bring added risks—for example, sudden reversals of capital flows—and certain limitations on various policy instruments. These are risks that are not only worth taking, the authors note, but can also be minimized through steadfast economic policy management. Only by intensifying economic stabilization and market opening reforms will MENA countries be in a position to reap the potential benefits of globalization. ■

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The Economy of the Middle East and North Africa in 1997, by Mohamed A. El-Erian and Susan Fennell, and a related publication, *Financial Systems and Labor Markets in the Gulf Cooperation Council Countries*, by Abdelali Jbili, Cyrus Sassanpour, and others, may be purchased for $15.00 each from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

General Arrangements to Borrow Renewed

The IMF has renewed the General Arrangements to Borrow (GAB) for a further period of five years from December 26, 1998, to December 25, 2003. The GAB is a long-standing set of bilateral credit arrangements between the IMF and 11 industrial countries, which currently amounts to SDR 17 billion (about $23.3 billion). By strengthening the IMF's ability to support the adjustment efforts of its members and to address their payments difficulties, the GAB are an important element of the IMF's capacity to respond to potential systemic problems.

The GAB have been activated nine times since their establishment in 1962. The most recent activations were in 1977, when the IMF borrowed for lending to the United Kingdom and Italy, under stand-by credits, and in 1978 to finance a reserve tranche purchase by the United States. A proposal for calls on the GAB by the IMF's Managing Director can become effective only if it is accepted by GAB participants and the proposal is then approved by the Board.

Press Release No. 97/53, November 24

The participants in the GAB and the amounts of their credit arrangements are:

Participant	Amount (million SDRs)
United States	4,250.0
Deutsche Bundesbank	2,380.0
Japan	2,125.0
France	1,700.0
United Kingdom	1,700.0
Italy	1,105.0
Swiss National Bank	1,020.0
Canada	892.5
Netherlands	850.0
Belgium	595.0
Sveriges Riksbank	382.5
Total	**17,000.0**

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97/149: *Competitiveness in Transition Economies: What Scope for Real Appreciation?,* Kornélia Krajnyák and Jeromin Zettelmeyer. Estimates equilibrium dollar wages for 15 transition economies.

97/150: *Cooperation, Emergence of the Economic Agency Role of Government, and Governance,* Omotunde E.G. Johnson. Focuses on the emergence of the economic agency role of government and its relationship with cooperation and economic management.

97/151: *Toward a System of Multilateral Unit Labor Cost-Based Competitiveness Indicators for Advanced, Developing, and Transition Countries,* Anthony G. Turner and Stephen S. Golub. Seeks to extend the range of countries covered by the IMF's multilateral real exchange rate indices based on relative unit labor costs in manufacturing.

97/152: *How Macroeconomic Factors Affect Income Distribution—The Cross-Country Evidence,* Michael Sarel. Develops a cross-sectional empirical framework to examine the relationship between the macroeconomic environment and trends in income distribution.

Papers on Policy Analysis and Assessment ($7.00)

97/9: *The Macroeconomic Impact of Privatization,* G.A. Mackenzie. Argues that privatization proceeds should not be treated as revenue but as financing.

Other Publications

The Economy of the Middle East and North Africa in 1997, Mohamed A. El-Erian and Susan Fennell ($15.00)

Financial Systems and Labor Markets in the Gulf Cooperation Council Countries, Abdelali Jbili ($15.00)

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Economic Forum

Can the Potential Crisis in Public Pension Schemes Be Avoided?

Recognition of the potential consequences of aging populations and concerns about needed reforms have prompted widespread discussion, moving the issue to the forefront of public policy debate not only in industrial countries but also in many developing and transition economies. These concerns were recently examined at an IMF Economic Forum on "Aging Populations and Public Pension Schemes: Averting a Crisis," moderated by Peter S. Heller, Acting Director of the IMF's Fiscal Affairs Department. Panelists included Sheetal Chand, Advisor in the IMF's Fiscal Affairs Department; David Lindeman, a Senior Pension Specialist in the Social Protection Team in the World Bank's Human Development Department; and Henry Aaron, a Senior Fellow in the Economic Studies Program at the Brookings Institution and Vice President of the National Academy of Social Insurance.

In the debate about pensions, a frequently heard word is "crisis." In outlining the current terms of the debate over pension reform, Peter Heller said it is necessary to identify the following: Is there really a problem—and for whom? Is it only a fiscal problem? What policy reforms should countries undertake in anticipating future demographic trends? Would the solution involve tinkering at the margin, such as changing benefit or tax rates? Or are more radical, dramatic, and systemic changes needed, such as shifting from a defined benefit pay-as-you-go scheme to a "funded," or defined contribution, pension scheme under which each active generation builds up its own stock of assets, which it then draws down after retirement? A possible alternative may be an increase in national saving rates, Heller noted, but there was little clarity on the potential outcomes of such policy options.

Aging Populations: How Serious?

While the problem of aging populations is an important one, said Sheetal Chand, it has not reached crisis proportions—yet. Although elderly dependency ratios (defined as the ratio of the population over the age of 65 to the population aged 15–64) are already rising for a few countries—such as Germany and Japan—for most countries the problem will begin in earnest after 2010 when the baby boomers start retiring. Given the demographics, the support ratio (the ratio of contributors to the pension system to beneficiaries) will decline, especially after 2010.

Chand noted that ignoring the need for pension reform would result in rising budget deficits and accelerating public debt at current contribution rates, which are already very high. But, he argued, the situation is not completely unmanageable. The magnitude of the net liabilities of public pension systems (the present value of the difference between projected expenditure and revenue at rates projected for 1995) is, however, a concern.

A fiscal position is sustainable if the primary balance (that is, all government outlays, except interest payments, less all government revenue) equals or exceeds the amounts needed to stabilize the ratio of net public debt to GDP. For most countries, fiscal consolidation and pension reforms will be necessary to ensure sustainability. A number of countries—notably, Canada, Italy, and Sweden—have already made sharp reductions in their structural primary balances. But further improvements in the rest of the fiscal accounts will need to be sufficiently large to cancel out the adverse effects of existing pension arrangements.

Based on available estimates, the present system in the industrial countries does not require a radical overhaul of the public pension system, in the sense of moving to a defined contribution scheme. We do not need to "shoot the foot to deal with an infected toe," said Chand, "unless, of course, the toe is allowed to fester."

To eliminate adverse pension-related effects, it might be best to reduce benefits, since any further increases in contribution rates would be more problematic. The most suitable measure, in light of rising longevity, would be to

Pensions: A Primer

In 1889, Chancellor Otto von Bismarck introduced the world's first national contributory pension scheme. Until then, governments had assumed no responsibility to provide for retired elderly citizens. Today, governments in the OECD countries spend an average of 9 percent of GDP on pensions, and this is expected to rise. Public pension schemes—the backbone of the social welfare system for the elderly in most industrial countries—are under increasing pressure as the ratio of the elderly in the population increases everywhere.

Under existing public pension arrangements in most industrial countries—which rely heavily on a defined benefit pay-as-you-go system—workers' contributions are adjusted to match pensioners' benefits each fiscal year. This means that the current benefit levels going to an increasing number of pensioners will have to be financed by a relatively shrinking pool of active workers. With the rising ratio of elderly to workers in most countries, pension liabilities have grown rapidly. As a result, the increasing budgetary costs of social-benefit programs for the elderly are a crucial element underlying several governments' unsustainable fiscal positions.

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extend the retirement age, unifying it for both men and women at, say, 67. Other measures, if needed, could involve changing indexation arrangements or reducing the accrual rates that apply to future pensioners. If such measures were taken sufficiently early, a sustainable contribution rate—a constant rate that does not allow any further buildup in pension liabilities could be introduced. Surpluses would be accumulated in the initial years and then drawn down later as the population ages. The constant rate would spread the burden of support equally across generations, thus reinforcing the solidarity principle on which the defined benefit schemes are based.

Sheetal Chand (left), Peter Heller, Henry Aaron, and David Lindeman at the seminar on public pension schemes.

Which Pension Scheme?

The need to stabilize public pension schemes, David Lindeman said, is not unique to OECD countries. Even countries that have relatively favorable demographics—such as those in Central Europe and the Baltics—often have "system dependency ratios" that resemble those of aging OECD countries. Many transition economies often face system dependency ratios that are as bad as, if not worse than, those of Western Europe. Further, some countries with the worst dependency ratios have some of the youngest populations—for example, those in Central Asia.

So what path should reform efforts take? Lindeman doubted whether increasing contributions to a sustainable rate, as Chand suggested, would be feasible. "This would require Germany to go from today's roughly 20 percent contribution rate to 28 percent right away." The other option of switching from the pay-as-you-go system to a fully funded scheme—as has been tried in Chile—is also not without costs. "In reality, few countries in Latin America, or elsewhere, are considering the pure Chilean model." He advocated a mixed approach that combines a largely pay-as-you-go public pension with a layer of funded defined contribution pensions. The pay-as-you-go system could be downsized while reallocating contributions to a partially funded system. This mixed approach has been implemented in Argentina, and variants of it have begun to take hold in other countries in Latin America and in Central and Eastern Europe, Russia, and Central Asia.

Projections for future payments indicated a huge burden on the public pension system, particularly in Europe, Henry Aaron said. But he was wary of forecasting trends too far into the future, as Chand had done. Events, he noted, had a tendency to falsify predictions. He also noted the importance of including the increasing proportion of women in the labor force into the demographic picture.

A rise in the pension population has two aspects, Aaron said: the increasing shift from economically active to inactive members of the population, and the possible effect on overall economic growth. This distinction, Aaron emphasized, is important in terms of deciding whether and how much to cut benefits and how much to increase reserve accumulation for future pension obligations. National savings (and output) could be increased to compensate for the added cost of pensions—either publicly or privately. But politicians, attracted by the accumulation of reserves, could threaten such accumulation with a move to cut taxes or increase other expenditures—neither of which have any fiscal implications that relate to pension costs. Also, as Aaron pointed out, there are potential offsets to increased private saving. A recent U.S. study showed heavy use of tax-sheltered savings schemes, which resulted in part in an overall decline in private saving.

The issue of pension reform boiled down to three questions, Aaron said: Should pensions be funded? What should be the structure of the system (defined benefit versus contribution plans)? Who manages it?

It is difficult to exaggerate the difference between a simple defined benefit and a defined contribution plan, Aaron said. He cited a study conducted by the Brookings Institution that assumed a defined contribution system in the United States starting from 1870. The results—in terms of benefits to the pensioners—were volatile. Replacement rates that workers would have received behaved like a "roller coaster," rising to 100 percent of earnings at the peak and falling to 30 percent of earnings at the bottom seven years later. What is needed, Aaron concluded, is a system such as the defined benefit plan that diffuses the risks more broadly across workers.

Gita Bhatt
IMF External Relations Department

For further information on aging and pension schemes, see IMF Occasional Paper 147, *Aging Populations and Public Pension Schemes*, by Sheetal K. Chand and Albert Jaeger. Copies are available for $15.00 (academic rate: $12.00) from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.