Over the past decade, gross cross-border capital flows have surged, not only among industrial countries but also between industrial and developing countries. What impact has this had on developing countries? A recent IMF study finds that once financial integration crosses a certain threshold, the positive effects of international capital flows can outweigh the negative effects. The authors, Eswar Prasad of the Asia and Pacific Department; Ken Rogoff, the IMF’s Economic Counsellor and Director of the Research Department; Shang-Jin Wei of the Research Department; and Ayhan Kose of the Western Hemisphere Department, spoke to the IMF Survey about their study.

Financial globalization’s benefits include cheaper access to capital, transfer of technology, and development of the banking system.

IMF Survey: Why is the IMF looking at financial integration and globalization at this juncture? Is it having second thoughts about their benefits?

Rogoff: Our study could be viewed as building on work that was carried out by the Research Department as far back as 40 years ago. The benefits of financial integration and globalization are an issue whose nuances the IMF is continuously rethinking. People who have followed our work over the past 20 years won’t find anything strikingly new in our paper. You might find many similar results—at least at a theoretical level and, to some extent, at an empirical level—in my 1996 study with Maurice Obstfeld.

Managing financial crises

Drawing lessons for Latin America

The trick to learning from history is divining what lessons it tells us. The IMF had that in mind when it set up internal task forces to draw lessons from recent crises that could aid its effort to help manage the crisis in Argentina and the turmoil in Latin America. The product of that work is now available in a new IMF Occasional Paper. The two coordinators of the project, Charles Collyns of the Western Hemisphere Department and Russell Kincaid of the Policy Development and Review Department, speak with the IMF Survey about the findings.

IMF Survey: How did the IMF mine its previous experience in crisis management to help it deal with deepening problems in Argentina?

Collyns: In early January 2002, the IMF’s management asked that a group of staff with relevant country and policy expertise be assembled to look at issues emerging in Argentina. Management wanted operational recommendations drawn from any direct parallels with earlier crises—notably in the 1990s—and from any differences. When the exercise proved useful, a second task force was put together, in the summer of 2002, to address similar questions for other Latin American countries that were...
Nature, volume may determine benefits of flows

(Continued from front page)

IMF Survey: How do you measure financial integration? Have developing economies been active participants?

Prasad: Measuring financial integration is a rather complicated issue. We take two approaches. One is to look at measures of capital account restrictions or legal controls on capital inflows or outflows. But a more important measure is realized capital flows. These two measures, while closely related, are quite different for some countries. For example, a few countries in Latin America that restricted capital flows in the 1980s actually experienced fairly large capital outflows. They were financially integrated with the global economy in some respects, although they did not entirely intend to be so. In contrast, some countries in Africa that do not have capital account restrictions have, nevertheless, not received significant capital inflows.

During the past decade and a half, developing countries have become much more involved in financial globalization. In fact, capital flows from the industrial countries to developing countries have skyrocketed, but they have gone to a relatively small number of countries. Around 20 of the developing economies we studied—the ones that we refer to as more financially integrated—account for a substantial portion of these flows.

So participation in financial globalization has varied across countries, as has the nature of the capital flows. Some countries have seen great surges in foreign direct investment, while others have received more capital inflows in the form of bank lending or portfolio inflows. These differences have important implications. In particular, foreign direct investment flows tend to be much more stable and thus may be more beneficial for the economies that receive them. By contrast, bank lending and portfolio flows tend to be more volatile and, especially in turbulent times, can be reversed much more quickly. So it’s not just the aggregate amount of capital inflows but also their nature that eventually determine the quality of a country’s experiences with financial globalization.

IMF Survey: What has spurred increased capital flows to developing countries during the past two decades? In view of recent financial crises in many developing countries, are they likely to be left behind as financial globalization advances?

Wei: Broadly speaking, both pull and push factors influence capital flows. Pull factors are policies and developments in developing countries that tend to draw in capital from rich, industrial countries. They include liberalization of domestic stock markets and other financial markets, lifting of controls on capital inflows, and privatization programs. Push factors refer to policies in industrial countries or developments in global financial markets that increase capital outflows. These include macroeconomic policies, business cycle developments, and, in recent years, the rise of institutional investors, such as the increased popularity of mutual funds as savings vehicles.

Whether developing countries will be left behind depends in large part on whether they manage to put in place sound macroeconomic policies, improved governance (including controlling corruption), and strengthened banking supervision. Those that do so will have a fairly good chance of continuing to receive not only a large share of capital inflows but also the more beneficial types of capital flows, such as foreign direct investment.

IMF Survey: Why is financial globalization considered good for developing countries?

Kose: In theory, there are numerous direct and indirect channels through which financial globalization can increase potential growth in developing countries. When we think about the direct channels, it is easy to see how capital flows could increase investment in capital-poor developing countries, reduce the cost of capital, help stimulate domestic financial sector development, and generate technology spillovers from industrial countries. These direct channels have been extensively studied in the theoretical literature.

While acknowledging the importance of direct channels, our study also emphasizes the critical role played by indirect channels, which have been becoming an important research area in recent years. We describe three indirect channels in our study. First, financial globalization provides a set of instruments for risk sharing, which would, in turn, indirectly encourage specialization and raise the growth rate. Second, a country’s willingness to undertake financial integration has a signaling value, as it indicates that the country is going to implement investment-friendly policies. Third, and probably most important, financial integration is a commitment device in the sense that a country makes a promise to discipline its future course of policies. Recent research has shown that this type of...
commitment to “good” policies could shift investment to more productive activities and increase aggregate productivity in a developing economy.

**IMF Survey:** How much of these advertised benefits have actually materialized in the developing world?

**Wei:** From the available data, it is difficult to prove that financial integration leads to faster growth in the developing world or that the positive effect, if any, is quantitatively significant. For example, out of 14 recent studies looking into the question, 3 found positive relationships between these two variables. Most studies have failed to find a positive effect for developing countries.

**IMF Survey:** Does this weaken the argument in favor of financial integration?

**Wei:** It certainly is consistent with the view that one needs to be cautious in approaching financial integration.

**IMF Survey:** Does the exchange rate system play a role in financial integration?

**Rogoff:** We did not look at exchange rate regimes in this paper. One lesson from the Asian crisis was that fixed exchange rates, or de facto fixed exchange rates, can be a lightning rod for catastrophe in economies with very integrated capital markets and open financial markets. Further studies need to separate these issues—it was too much for us to tackle here.

**IMF Survey:** What is the impact of financial globalization on macroeconomic volatility in developing countries?

**Prasad:** Economic theory is less clear about the impact of financial integration on output volatility than on growth. However, it does predict that international financial integration should reduce consumption volatility because countries and individuals with access to international capital markets can use financial instruments to diversify the risk that is specific to their own income or output.

One interesting result we report is that, contrary to the predictions of theory, consumption volatility, in fact, rose in the 1980s and 1990s in the more financially integrated economies. Much more research is needed to understand exactly why. One possibility is that many of these countries liberalized their financial sectors and capital accounts at the same time, and that may have fueled consumption booms. In addition, these countries’ access to capital markets has proved to be somewhat procyclical. When they were hit by adverse economic shocks, these countries lost access to capital markets and the ability to reduce fluctuations in consumption.

A particularly egregious manifestation of volatility is a financial crisis. During the 1990s, developing countries—particularly the more financially integrated ones—were especially vulnerable to them. The industrial countries had their fair share in previous decades. It looks like some of the industrial countries have now managed to achieve the benefits of financial integration in terms of lower volatility, while developing countries have not yet done so.

**IMF Survey:** So financial globalization has increased the risk that developing countries will face economic crises?

**Kose:** Yes, it is hard to argue that capital account liberalization has not often been accompanied by increased vulnerability to crises. Financial globalization has heightened some of these risks, since cross-country financial linkages amplify the effects of various shocks and transmit them more quickly across national borders. Having said this, we need to acknowledge that being a part of a financially integrated world economy is quite a new phenomenon for these countries. It is natural that there has been a period of adjustment and learning. While financial globalization has increased these countries’ vulnerability to crises in the short run, one would expect that being a financially integrated economy helps them deal with crises in the long run.

Unfortunately, there is no magic policy prescription for alleviating the risks associated with financial globalization. It is always critical to implement sound fiscal, monetary, and exchange rate policies and to create an environment that could attract more stable capital flows. Recent research shows the importance of implementing sustainable fiscal policies in open economies, as the maturity structure of external debt seems to be a critical factor. More important, the exchange rate regime becomes a crucial policy choice in a financially integrated economy. As Ken mentioned, while fixed, or de facto fixed, exchange rate regimes may have some advantages, they very often unravel abruptly and disruptively, a problem that appears to have played a major role, for example, in the Asian crisis of the late 1990s. Our study has also provided empirical evidence about the importance of good governance practices and the quality of institutions in helping developing countries derive the benefits of financial globalization while minimizing the risks associated with it.
Our perspective is that a country does not need to have perfect institutions before it embarks on financial globalization, but it should have at least basic, adequate policies and institutions in place.
—Eswar Prasad

IMF Survey: Have India and China been wise to move slowly on capital account liberalization? Was Malaysia right to slap on capital controls during the Asian crisis?

Rogoff: It's hard to argue with China's growth performance over the past 20 years, and it's not easy to second-guess the authorities' efforts to manage the difficult economic, social, and political challenges they faced in moving from an extremely poor, rural agrarian economy in the 1970s to essentially a middle-income economy, at least for the 450 million people living in coastal China. That said, at some point, as the Chinese economy becomes more integrated with the global economy, and especially through its recent WTO [World Trade Organization] commitments, it will face many economic pressures to gradually liberalize its capital markets further. Put another way, coastal China has an annual income of about $2,500 a person at purchasing power parity prices. But if it is to move to a level that rich countries enjoy, it will have to work toward something very different. No industrial country today has any significant capital controls.

India is another matter. I don't think one would want to argue that it should have pursued greater capital market liberalization in isolation from other reforms. In fact, trade liberalization should be given greater priority. Whereas China's trade now accounts for 5 percent of world trade, India's still accounts for only 0.5 percent. There is tremendous scope for India to liberalize its markets and trade and, after it has made significant advances in these areas, to think further about capital market liberalization.

Regarding Malaysia, studies argue both for and against its imposition of capital controls. It's hard to argue that Malaysia was wrong, but some countries that have tried to imitate it have not done so well. I would draw special attention to Argentina, where the cost of its 2001 debt crisis was greatly exacerbated by its decision to freeze bank accounts and introduce exchange controls. These measures really locked up the economy and deepened the postcrisis recession.

IMF Survey: Is there a right time to liberalize capital accounts? How should countries assess the risks?

Prasad: Certain preconditions—notably good macroeconomic frameworks, sound institutions, and well-developed domestic financial markets—can help countries reduce the risks associated with financial integration. Well-regulated and -supervised financial markets are very important for ensuring that capital inflows are channeled to productive uses.

Some of the volatility countries face when they liberalize capital accounts is intrinsic to financial globalization, because international capital flows do tend to be volatile. And, for some smaller countries, volatile capital flows can have fairly large macroeconomic effects. By putting in place some supporting conditions before capital account liberalization takes place and, to some extent, controlling the nature of capital inflows, countries can, in fact, reduce the risks.

IMF Survey: Once they liberalize their capital account, countries rarely seem to reverse that decision. Does that suggest that, once done, liberalization's benefits outweigh its costs?

Wei: Countries that have liberalized their capital accounts seldom reverse course, at least not more than temporarily. This suggests that, in these countries' own assessment, the cost of reversing outweighs the benefits. This does not contradict the idea that a set of preconditions needs to be put in place before a country embraces financial globalization. It's like going whitewater rafting—it may be better to go forward once you are in the water. At the same time, if you have not yet gotten into the water, it's always better to make sure that you have the right gear before you plunge in.

IMF Survey: Do your findings support those who have been critical of the policies the IMF has been pursuing over recent decades?

Rogoff: All advanced economies have open capital markets. In Asia, developing countries are still moving toward more liberalized capital markets—even countries that experienced great problems during the 1990s—but with refinements having to do with macroeconomic stability, flexible exchange rates, and improved regulation and governance. It's a bit far-fetched to view our study as questioning everything that has been done over the past decades.

Development is a multidimensional process, and no one has the answer to everything. The IMF's core advice is sound, and it is constantly being refined as the world advances. Our job in the Research Department is to ask how we can learn from experience and how things can be improved.

IMF Survey: How can the IMF help developing countries get the most out of globalization while reducing its inherent risks?

Prasad: Compared with a couple of decades ago, when financial markets across the world were not as closely linked as they are now, the IMF is looking at policies in a broader perspective, one that includes structural policies and institution building as well as macroeconomic policies. The IMF is helping developing countries build their capacity in these dimensions through technical assistance and such tools as
Financial Sector Assessment Programs and the Reports on the Observance of Standards and Codes. Nevertheless, a delicate balance needs to be found between building the right institutions and opening up to financial globalization. Financial integration brings with it some benefits in terms of improving those institutions, for instance, via the transfer of technical and managerial knowledge. Our perspective is that a country does not need to have perfect institutions before it embarks on financial globalization, but it should have at least basic, adequate policies and institutions in place.

The full text of “Effects of Financial Globalization on Developing Countries: Some Empirical Evidence,” by Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei, and M. Ayhan Kose, is available on the IMF’s website (www.imf.org). The material will also be published in August 2003 as Occasional Paper No. 220.

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**Other**

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“Large and Complex Financial Institutions: Challenges and Policy Responses—Lessons from Sweden,” R.B. Johnston, Balazs Horvath, Luca Errico, and Jingqing Chai (Policy Discussion Paper No. 03/1, $15.00)

“The Energy Sector Reform and Macroeconomic Adjustment in a Transition Economy: The Case of Romania,” Stephane M. Cosse (Policy Discussion Paper No. 03/2, $15.00)
beginning to face serious strains. The task forces found a number of similarities between the then-current and previous crises. Like Asia, many of the affected countries in Latin America had a variety of soft-peg exchange regimes—or in the case of Argentina, an ostensibly very hard peg—that cracked under the strain. These economies had to find ways to reestablish a credible nominal anchor, and Asia offered relevant experience for how to do this.

A second parallel was that once the exchange rate began to move, and move substantially, the financial and corporate sectors suffered major balance sheet damage. This phenomenon was at the core of the deep economic disruptions in Asia, and we expected similar difficulties in Latin America—perhaps to a greater extent than in Asia.

But there were important differences, too. In Asia, the crises came after 10 years of rapid growth and low inflation. As a result, the markets had a basic belief in the ability of the authorities to pursue responsible macroeconomic policies. In Latin America, where hyperinflation in the 1980s was followed by persistent weaknesses in fiscal policy in the 1990s, it was much more difficult for the authorities to reestablish credibility.

**IMF Survey:** Were there aspects of what happened in Argentina and Latin America that the IMF had simply not seen before?

**Kincaid:** Many. One was the abandonment of the currency board in Argentina. After earlier crises, involving essentially soft-peg exchange rate regimes, the received wisdom was that exchange rates should either float—including being lightly managed—or move to a hard peg, like a currency board or dollarization. Indeed, the resiliency of Argentina’s currency board in the face of the tequila crisis in Mexico and the Russian crisis seemed to validate this so-called bipolar approach.

The crisis in Argentina and its abandonment of its currency board has called this view into question, even though it is still too early for firm conclusions.

Argentina’s experience does not necessarily mean that all currency boards are not viable, but it does underscore how important it is to have consistent policy support for those regimes, notably through appropriately flexible labor market policies, disciplined fiscal policy, and sustainable debt management.

**Collyns:** Latin American countries had unusually high degrees of dollarization, and this complicated crisis management. This made their banking systems much more vulnerable to deposit runs, because their central banks could not function as credible lenders of last resort. The authorities could very quickly get into a situation where they were forced to take rather extreme administrative measures. For example, after Argentina lost a sizable portion of its bank deposits and reserves, it was forced to impose a comprehensive freeze on bank deposits.

**Kincaid:** High degrees of dollarization also meant that these countries faced a much more complicated trade-off than in the Asian countries between intervention policy, using dollars to bolster the domestic currency, and support of their banking systems, which also required dollars. In Asia, governments were able to extend blanket guarantees to depositors to restore confidence in their banking systems. Argentina’s government and central bank lacked the dollars to do so credibly. Moreover, with the default on its sovereign debt, Argentina could not recapitalize its banking system using government bonds as effectively as in Asia.

**IMF Survey:** Are there new lessons to be drawn on the role of the exchange rate in managing crises?

**Collyns:** Countries faced with a loss of confidence and a plummeting exchange rate typically find it difficult to resist the temptation to intervene in the exchange market. But, as the Asian crises made clear, the only way to stabilize the market in a crisis is to let the rate float until it finds a level that can be supported by the market.

A tight monetary policy can usefully signal the authorities’ desire to avoid a surge in inflation, but it cannot substitute for letting the exchange rate decline until expectations begin to turn around. This is the advice we gave to Argentina. Its exchange rate depreciated very rapidly for a time, but eventually the bottom was established after an overall tightening of financial policies, and now it is seeing much more stability—indeed, there has recently been a strong appreciation of the exchange rate. The authorities have begun to relax the controls they had introduced. There is even a concern that the appreciation might be moving too quickly.
Kincaid: There was also concern that there might be a large pass-through to inflation from the sharp currency depreciation. The task force examined experiences in Latin America, Asia, and Russia that demonstrated that the pass-through can, with appropriate policies, be rather small. Indeed, with a limited increase in base money, Argentina has experienced so far a small pass-through to inflation. And with improved confidence in central bank policy—and in economic policies more broadly—inflation has come down to very low levels.

IMF Survey: How large a problem did Latin America’s fiscal situation pose?

Collyns: It was a central issue. In Asia, relatively sound underlying fiscal positions meant that fiscal policy was available as a countercyclical tool to support activity. In virtually all the cases in Latin America, the key to stabilizing the situation was a determined effort to bring fiscal deficits down to levels that could be financed in a stable way without recourse, for example, to inflationary financing from the central bank. Governments successfully restored stable financial environments and eventually laid the basis for a return to growth, but this reflected a restoration of confidence rather than fiscal stimulus.

IMF Survey: Initially, the underlying assumption seemed to be that Argentina’s problems were its own. Were the IMF and Latin American governments slow to recognize the potential for contagion?

Kincaid: I don’t think governments were at all slow, and I would dispute the characterization that IMF staff thought this crisis would be confined to Argentina. In fact, as the crisis unfolded from November 2001 through January 2002, the staff was surprised that Argentina did not have a bigger impact. The crisis seemed to unfold in slow motion.

Consequently, management asked the task force to look at spillover effects. The purpose was to make sure IMF mission chiefs were aware of possible channels of contagion transmission and various early-warning techniques. We did witness direct contagion to Uruguay and Paraguay. In addition, we saw questions being raised in the region about the choice of policy mix and the value of reforms.

Collyns: At the same time, the IMF did its best to contain the contagion by emphasizing the unique features of the Argentine situation and by supporting, in a very deliberate way, neighboring countries with strong policies. In Uruguay, for example, we came in quickly, with far larger financing for their adjustment program than the normal access limits would suggest. We saw Uruguay as a country with basically good policies that was heavily affected by special linkages with Argentina. The situation was mushrooming, and we tried to address it forcefully and eventually succeeded.

Similarly, Brazil had followed and continued to follow basically good policies despite being hit by the uncertainty in the markets related to the political transition in October 2002. Eventually the continuation of those good policies, with timely and very large financial support from the IMF, helped Brazil survive those difficult times. Our judgment that Brazil had a basically sound policy framework was, in the end, vindicated by the outcome.

IMF Survey: What were key lessons that the task forces learned, and how has the IMF absorbed them?

Kincaid: One set of lessons pertained to debt sustainability. A problem encountered in Argentina was that overoptimistic projections about real growth and other variables made the country’s debt seem more sustainable than it was. To remedy this, the IMF’s Executive Board in mid-2002 endorsed a new framework for analyzing debt sustainability that is designed to be more objective. It employs historical values for projections and applies country-specific historical shocks for sensitivity analysis. Based on a retrospective application, one task force report showed that this approach does a better job of testing robustness of debt sustainability, though it’s not perfect. Indeed, debt ratios were underpredicted owing to the higher costs for recapitalizing the banking system and larger-than-expected real exchange rate depreciation.

Sustainable public debt ratios are also much lower than many had previously thought. Indeed, staff work indicates that when debt ratios exceed 40 percent of GDP, the probability of running into debt difficulties increases rather sharply.

Kincaid: “Staff work indicates that when debt ratios exceed 40 percent of GDP, the probability of running into debt difficulties increases rather sharply.”
elements of a credit-driven, debtor-by-debtor process with a government-led, across-the-board process that could be tailored to each country’s circumstances. In the second track, the finding was that the economic costs of default were reduced the sooner the restructuring occurred. Drawing on previous country experience, the task forces developed a step-by-step roadmap to debt restructuring.

**COLLYNS:** Another lesson Asia taught us is that, when you have a crisis, the poor are particularly exposed. We realized early on in Latin America that it was essential to strengthen social safety nets even before IMF-supported adjustment programs were fully in place. In Argentina, we worked very closely with the World Bank and the Inter-American Development Bank. It was very important to cushion the impact of the crisis on the poor. And giving a social dimension to the adjustment program helped build support for the program. People could see that the burden of adjustment was being fairly distributed.

**KINCAID:** Argentina also prompted the IMF to reexamine how it conducts surveillance in program countries. One issue was whether the IMF, in the context of Argentina, gave clear enough advice about exiting the currency board at an appropriate time, say, after the tequila crisis but before the Russian crisis. Did the IMF give sufficient stress to the need for supporting policies for the currency board arrangement?

The IMF’s surveillance of program countries is a topic that our Executive Board has discussed extensively, and more discussions can be expected. Various experiments are under way to increase the fresh surveillance perspective in program countries, including having different staff from the area department or from other departments conduct the surveillance discussions.

Argentina also raised questions about the use of exceptional IMF access in capital account cases. The IMF Board agreed in September 2002 to more clearly define criteria for such exceptional access and to formalize early Board consultations on these requests.

We have not yet learned all the lessons. We therefore look forward to the report by the Internal Evaluation Office on capital account crises and Argentina.

**COLLYNS:** Finally and more broadly, the IMF is fully aware that emerging crises must be dealt with quickly, flexibly, and forcefully, given how rapidly a situation can deteriorate.

The value of a rapid and decisive response has been illustrated recently in Bolivia. In February, the IMF had a mission in the field negotiating a three-year adjustment program financed under the PRGF (Poverty Reduction and Growth Facility). Those negotiations were taking time because PRGFs are very complicated. Unfortunately, there was a sudden outbreak of violence and a tragic loss of life. The mission had to be evacuated, and, amid all this turmoil, Bolivia had a run on its heavily dollarized banking system that could have very quickly led to an unraveling of its macroeconomic situation.

This also happened to be the weekend of the massive East Coast snowstorm. The IMF’s headquarters were closed and the mission team was stuck overseas because Washington’s airports were shut down. But via e-mail, phone, and teleconference, we managed to rethink the situation, discuss it with management, and develop a new approach jointly with the Bolivian authorities. It was decided to step away from the PRGF for the interim and try to negotiate a streamlined Stand-By Arrangement that could stabilize the situation. We negotiated a stabilization program with a Bolivian team in Washington by the following weekend. Other bilateral and multilateral creditors had also stepped in to increase and rephase their financial support. The combined effort of the authorities and the international community helped stabilize the situation in Bolivia. I am pleased to say that things are now much calmer, and we have since returned to La Paz to negotiate the PRGF.

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**Photo credits:** Denio Zara, Michae Spilotro, Pedro Márquez, and Denio Zara for the IMF, Jae-Ku Choi for AFP, page 137.

**Illustration:** Massoud Etemadi, pages 148–49.
Lawlessness and economics

How does economic activity proceed in the absence of formal legal systems? What alternative rules and institutions evolve? Princeton economics professor Avinash Dixit’s April 7 IMF Institute seminar, “Lawlessness and Economics,” addressed the theory of alternative modes of governance using economic models. He drew on the works of prominent thinkers in new institutional economics and the social sciences, using case studies to show different institutional responses to legal failures.

Economists generally agree that law underpins markets, Dixit explained. For markets to perform successfully, there must be a legal framework to protect property and enforce contracts. Even the most ardent libertarian economists, he noted, accept that a legal framework is necessary for markets to work, and they look to governments to provide this function. Some theorists take this view even further, arguing that legal frameworks are sufficient for markets to operate. However, most economists recognize that markets may fail for other reasons.

Since the 1960s, economists have also moved away from the notion of law as the necessary underpinning of a functioning market and have begun to look at the way economic choices and economic equilibrium respond to law and legal liabilities. The new theoretical concepts draw from the realization that, in all countries historically and in many developing and transition countries now, laws have been either too weak, too slow, or too corrupt and biased to allow economic actors to conduct transactions efficiently.

Dixit cited the example of Indian courts, in which 25 million cases are pending. It will take more than 300 years to go through this backlog. In Russia, while adjudication has improved, enforcement is still an issue. Despite such legal failings, some form of governance nonetheless takes place. Indeed, even in systems with functioning legal systems, most transactions are settled through informal means “in the shadow of the law.”

Formal law, therefore, is neither a necessary nor a sufficient condition for markets to work, Dixit argued, because when legal frameworks fail or are weak, alternative frameworks emerge that enable economic activity to continue. He has coined the label “lawlessness and economics” for the field that studies the relation between these alternative forms of governance and economics; it is a subfield of new institutional economics. While the pioneers of new institutional economics, such as Douglas North and Oliver Williamson, look at institutions broadly, this subfield focuses on institutions that protect property rights and enforce contracts.

Institutions and organizations

North distinguishes between institutions and organizations, Dixit said. North defines institutions as the broad frameworks of formal and informal rules and constraints that govern the way organizations, as groups of people, function. Constitutions, for example, are institutions, while legislatures are the organizations that operate under the constitution. The interaction between the two affects the costs of transactions—the primary concern of both North and Williamson. For both, the key is the design of rules, and the operation of policymaking under those rules, in ways that minimize the costs of transactions.

Williamson, Dixit noted, focuses on several kinds of transaction costs, including a combination of asset specificity (the degree to which investments are specialized) and incomplete contracting, which promote opportunism or delay. For example, to undertake a successful venture, one party has to make an irreversible investment. If complete information is available and the complexity of the transaction is fully manageable, the two parties can specify in a binding way how the first party will be compensated for its investment. But these conditions are almost always lacking; hence, contracts unavoidably become incomplete and assurances are not credible. As a result, the second party has an incentive to renege on the agreement. In essence, whether an organization wants to make its own inputs or buy them from another is governed by these types of considerations. Williamson

Selected IMF rates

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<th>Rate of remuneration</th>
<th>Rate of charge</th>
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<td>May 12</td>
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The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members’ remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF’s financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2003).

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

Data: IMF Finance Department

When legal frameworks fail or are weak, alternative frameworks emerge that enable economic activity to continue.

—Avinash Dixit

May 19, 2003

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also focuses, Dixit explained, on the ways in which organizations evolve to cope with such considerations.

Then there is Williamson’s concept of private ordering—when nongovernmental parties come together in voluntary arrangements. Here, Dixit explained, one must distinguish between the observability of an item and its verifiability. Two parties to a transaction may both observe the facts of their situation, but it may not be possible to verify the information to a court or other third parties, in which case a contract may not be feasible. While private ordering can use this information, courts cannot, at least not without great cost; so private ordering, as a system of governance, evolves to save on those costs.

But to work, private arrangements must be self-enforcing—that is, both parties must have a mutual interest in continuing the arrangement. Employment contracts often fall in this category, as do semiprivate means of enforcement, such as arbitration. In the latter case, the arbitrator has no means of enforcement, but courts often uphold the verdict because they trust the “disinterested” third party’s judgment. This, in many ways, is how private ordering operates under the shadow of the law.

**Institutional interaction**

In many developing and transition economies, there is interaction between the formal institutions of imperfectly functioning government and the informal institutions that operate under its shadow.

In many developing and transition economies, there is interaction between the formal institutions of imperfectly functioning government and the informal institutions that operate under its shadow. In these societies, “relational contracts” based on repeated interactions are common and exist even in countries where courts seem to function well. In a relation-based system, Dixit explained, two parties develop ongoing interactions on which they build trust. This system works when opportunities for more formal arrangements are bad, and the cost of switching to other options is high. One might think that relational contracting is more likely to be sustained if government enforcement is weak, but research has shown that effective courts mattered most at the beginning, when they helped establish mutual trust. Once the relationship was established, whether or not the courts functioned did not seem to matter.

**Property rights protection**

In systems of economic governance, property rights protection holds a key place. Property rights consist of control over property, entitlement to income from property, and the right to sell property. All are subject to formal and informal constraints—legal, familial, and communal. And, because of the cost, protection of none of these rights is certain. People might try to encroach on another person's property rights, but what the latter decides to do about it depends on how much it costs to enforce that right (see box for an example of institutional reform).

Costs and benefits can change over time and in response to transaction technology—such as information and enforcement. Thus, property left to the public domain because of the high cost of dispute resolution may, at a later date, be worth pursuing if the cost of enforcement has gone down or the benefits of claiming it have increased.

Drawing on the works of Yoram Brazel, Dixit explained that property rights had multiple dimensions that interacted, sometimes in complementary ways and sometimes as substitutes. The relation between these dimensions can be used to specify contractual arrangements. For example, deciding how long a rental lease should be and who is responsible for the upkeep of the property depends on how the costs and benefits change over time. In some cases, switching to a more formal arrangement may not be feasible because of the high cost of dispute resolution or the benefits of claiming property have increased.

**First rule of institutional reform: Do no harm**

Anthropologist Jean Ensminger's study of the Orma tribe in Kenya analyzes the interaction between state and nonstate governance in light of new institutional economics. The study chronicles the attempts made first by the British and then by the Kenyan government to define a system of formal land titles and to enforce property rights within the tribe.

Historically, the tribal chief allocated land to members of the tribe, but land could not be transferred to anyone else or used without the tribal chief's approval. In an effort to change this system, outsiders created a system under which farmers could borrow against the land to improve it and raise production. Formal titles were introduced and plots consolidated for economies of scale. But the changes proved to be disastrous. Potential lenders knew they could not use the land as collateral because others had claimed to it as well. Moreover, no one had bothered to ask why the tribe relied on small parcels of land. The purpose was to protect farmers from climate change shortages in rainfall that affected one parcel of land often did not affect land a mile away.

Over time, the revised system is being allowed to expire and is being brought back into line with realities. The lesson for the IMF? It must study norms carefully before trying to change them.
two dimensions interact: if the lease is long term, the tenant has an incentive to invest in the upkeep, and the contract will reflect this. But in short-term leases, the tenant has no incentive to invest, and this will be reflected in the rent.

**Systems of social norms**

Dixit next examined property rights in the context of collective action or common-pool resource problems. These are cases where, in the absence of effective social arrangements, individual incentives lead to a degradation of resources. He drew in particular from political scientist Elinor Ostrom's empirical study of communities attempting—some successfully, others not—to regulate the use of common resources. Ostrom's study shows that, in contrast to the prediction of "the tragedy of the commons," problems of common resource pools can sometimes be solved more successfully through voluntary organizations than through state intervention.

But when are these alternative arrangements likely to work? Ostrom finds that small, stable communities with good communications, adequate information, and ongoing interaction built on trust have a higher likelihood of creating workable alternative arrangements. These arrangements also rely on sanctions. Successful sanctions usually employ graduated punishment: first comes a rebuke and an opportunity to make restitution; a more severe sanction is involved only if the first one fails.

**Social and business networks**

Networks can serve several functions, Dixit explained. For example, social networks can make the search for better matching of business opportunities more efficient and, hence, less costly. Moreover, repeated exchange within a network helps sustain cooperation and honesty, although studies have shown that networks work well only in small and well-connected groups.

The reason, Dixit said, lies in the contrast between the cost structure of relation-based and formal rule-based governance systems. As researcher ShuHe Li has observed, a relation-based system has low initial costs, but as business expands, connections weaken, relations become temporary, and risks rise. The marginal cost of the system rises as well.

A rule-based system, in contrast, requires high initial investment, but marginal costs stay low and may even decrease as the number of players increases. Therefore, total governance costs of the rule-based system are lower for large societies, whereas the costs of the relational system are lower for small, stable communities. Although the two systems can and do coexist, rule-based governance becomes more common as economies expand.

**Arbitration: Private intermediaries**

Finally, Dixit discussed the role of arbitration in economic governance systems. Private, profit-motivated systems evolve when one party does not trust the courts of another party. In such situations, the parties go to an arbitration body, which has dealings with, and can be trusted by, both.

Arbitration bodies can be centralized, with formal rules or procedures, or they can rely on informal structures. Often, they are specialized and are thus better able to provide verifiability. And when verifiability is easier, more detailed contracts specifying more contingencies can be written. But arbitration bodies have no enforcement authority. So, when a party avoids fulfilling its obligation under the arbitrator's judgment, enforcement has to rely on courts or other group sanctions. In cases with high potential for enforcement problems, parties must use centralized arbitration systems, while parties with long-standing relationships are better off with informal structures.

In the context of arbitration, Dixit used the work of Diego Gambetta to discuss the role of mafias as an alternative governance response. When neither party trusts the other and both have an incentive to cheat, they need a third party, sometimes a Tony Soprano, to provide information and, if necessary, enforcement. The transaction costs of each differ, depending on the risks. But in this type of alternative governance, the provider of the service often enjoys a monopoly and may trap the participants into a bad outcome from which they can escape only through collective action to depose the Mafioso.

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**Members’ use of IMF credit**

(million SDRs)

<table>
<thead>
<tr>
<th></th>
<th>During April 2003</th>
<th>January–April 2003</th>
<th>January–April 2002</th>
</tr>
</thead>
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<td>General Resources Account</td>
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<td>8,947.75</td>
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<td>EFF</td>
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<td>464.73</td>
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<tr>
<td>CFF</td>
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</tr>
<tr>
<td>EMER</td>
<td>0.00</td>
<td>2.93</td>
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<tr>
<td>PRGF</td>
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<td><strong>5,588.04</strong></td>
<td><strong>9,270.78</strong></td>
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</tbody>
</table>

SRF = Supplemental Reserve Facility  
EFF = Extended Fund Facility  
CFF = Compensatory Financing Facility  
EMER = Emergency assistance programs for countries that have experienced conflicts or natural disasters  
PRGF = Poverty Reduction and Growth Facility

Figures may not add to totals shown owing to rounding.

Data: IMF Finance Department

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Farah Ebrahimi  
IMF Institute  
May 19, 2003  
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For many years, a tale of corruption would be met with a sigh, a shrug, or perhaps a wink. No more. As research and country experience increasingly document the true cost of corruption, the economic benefits of good governance look increasingly attractive. In a recent address at a joint luncheon of the National Economist Club and the Society of Government Economists, Shang-Jin Wei, Advisor in the IMF’s Research Department and a Senior Fellow at the Brookings Institution, made the case against tolerating corruption.

As globalization extends its reach and picks up its pace, the cost of corruption is drawing heightened scrutiny from investors, host countries, international agencies, and academics. Why the growing interest? For one thing, Wei said, the end of the Cold War has reduced the importance of geopolitical considerations in aid allocations. There is now considerably less incentive to tolerate “governance-challenged regimes,” such as those of Ferdinand Marcos’s Philippines or Mobutu Sese Seko’s Zaïre (now the Democratic Republic of the Congo).

There are business reasons, too, for taking a hard look at the costs of corruption. Given increased globalization, investors have options. They can pick and choose where to invest, and the new math of globalization encourages them to factor in such things as the high costs of bribes. Studies indicate, for example, that moving from a relatively clean government environment, like that of Singapore, to one as corrupt as, say, Indonesia under Suharto, could entail costs for foreign direct investment equivalent to a 50 percent increase in the marginal corporate tax rate.

More corrupt economies are also now seen as more prone to financial crises, because they are more likely to depend on short-term foreign loans— the type of capital most likely to flee a country in the event of a shock. Research by Wei and Gaston Gelos, another IMF economist, suggests that portfolio investment is also negatively affected by corruption and that fund managers typically favor less corrupt countries.

Advanced countries have also taken steps to discourage or at least not abet corruption. In 1999, OECD countries (and some non-OECD countries as well) signed a treaty banning bribery by their firms of foreign government officials. Out is the tax incentive for bribery under the old system, and in is the potential for criminal punishment of such behavior under the new law.

**But is it bad for development?**

While there has never been outright support for corruption, Wei said, a number of academics, notably Harvard University’s Samuel Huntington, have argued that corruption has its uses in economies that are otherwise clogged with licensing requirements and other bureaucratic obstacles. In those countries, he observed, corruption helped grease the wheels and actually get things done. In Huntington’s view, the only thing worse than dishonest and rigid bureaucracy is honest and rigid bureaucracy.

But this excusing of corruption, Wei said, confuses the cart with the horse. It is more likely, he said, that bureaucratic red tape is created to provide officials with opportunities to pad their incomes. Rather than condone corruption, why not address the root causes of the problem? In fact, Wei cited various pieces of empirical evidence that overwhelmingly demonstrate that corruption injects sand, not grease, into the economic development process.

**How corrupt?**

How are companies looking to make sound investments, or international organizations seeking to ensure responsible use of their financing, able to measure how corrupt a country is? Reliable quantitative data have long been lacking, but in recent years private organizations, both for profit and not, have developed useful yardsticks. Wei cited several indices that can make the task of measuring corruption easier. He pointed to the Political Risk Services Group, which now offers, for a fee, corruption ratings for a number of countries in its International Country Risk Guide.

Harvard University and the World Economic Forum jointly produce The Global Competitiveness Report. This report contains the results of regular surveys of 5,000–7,000 business executives around the world in which they were asked to estimate and rate the severity of corruption they might encounter in completing several business transactions (such as obtaining import or export licenses, foreign exchanges, or bank loans) in these countries. Transparency International’s (www.transparency.org) Corruption Perceptions Index and the World Bank’s Control of Corruption Index tap a variety of other sources and offer their composite measures on the Internet.
All of these indices, Wei acknowledged, are subjective. But since perceptions often drive business decisions, they provide useful information. In fact, he said, a German study of its exporters—undertaken in the mid-1990s when bribing foreign officials was legal—gathered data on the percentage of export business that involved bribery of foreign officials. Its results were highly correlated with the perceptions-based studies now taking place.

On the international front

Are multilateral institutions like the IMF doing their share to complement domestic and investor interest in better governance? Wei cited a case in which the IMF, in response to severe governance problems, suspended financing to a member country.

Much remains to be done, Wei said, but the international community has begun to “move in the right direction on this important issue.”

## Stand-By, EFF, and PRGF arrangements as of April 30

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<tr>
<th>Member</th>
<th>Date of arrangement</th>
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<th>Amount approved (million SDRs)</th>
<th>Undrawn balance (million SDRs)</th>
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<td>Total</td>
<td></td>
<td></td>
<td>4,450.34</td>
<td>2,473.81</td>
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1Includes amounts under Supplemental Reserve Facility.

EFF = Extended Fund Facility

PRGF = Poverty Reduction and Growth Facility

Figures may not add to totals owing to rounding.

Data: IMF Finance Department
IMF conditionality has attracted much criticism over the years. A recent example is its fiscal policy advice to developing and emerging market countries hit by financial crises over the past 10 years. At an IMF Economic Forum held on April 29, Sanjeev Gupta (Assistant Director, Fiscal Affairs Department) explained the institution’s rationale for its fiscal policy advice. William Cline (Center for Global Development and Institute for International Economics) offered his views on fiscal policy in emerging market economies in crisis, and Carol Graham (Brookings Institution) discussed the social costs of fiscal adjustment. The full transcript of the Economic Forum is available on the IMF’s website (www.imf.org).

A long-standing criticism leveled against the IMF is that it applies a one-size-fits-all approach to countries in crisis. And, its critics say, the IMF’s fiscal policy advice tends to be biased in favor of tightening. Does the IMF really offer the same policy prescriptions to all countries hit by a financial crisis?

In addressing these questions, Sanjeev Gupta referred to work done by the Fiscal Affairs Department over the past several months, in which emerging market countries and low-income countries are considered separately because they face different circumstances and options.

IMF tailors fiscal policy advice
Explaining the rationale for the IMF’s policy advice to emerging market countries, Gupta made five points.

Fiscal imbalances have been a feature of many countries affected by crisis. Most countries that suffered a financial crisis in the second half of the 1990s had large fiscal imbalances and high public debts prior to the crisis, ranging from 30 percent of GDP in Korea in 1998 to 118 percent in Ecuador in 1999.


IMF-Supported Programs have been flexible in setting fiscal targets. In Argentina (1995 and 2000), Korea (1998), and Thailand (1998), IMF-supported programs accommodated larger deficits because of the recessions. And, in 2001 in Brazil, the IMF-supported program targeted a lower primary surplus to accommodate higher investment.

IMF is mindful of the quality of adjustment.
Because of a country’s political and administrative constraints and the need to act quickly, Gupta said, some IMF-supported programs have contained distortionary measures such as export taxes, across-the-board taxes on financial transactions, expenditure cuts, and one-off measures including tax amnesties. Still, he said, the IMF has paid increasing attention to the social and distributional dimensions of fiscal adjustment despite the difficulty of identifying and targeting the poor. This can be seen, for example, in Brazil in 1998 and Turkey in 2001, where social spending has largely been protected, and in Asia,
where social safety nets were strengthened following the crises in that region.

In low-income countries, Gupta focused on two criticisms: that the fiscal adjustment involved in IMF-supported programs slows progress in reducing poverty and that the IMF limits public expenditures that could be financed by foreign aid. Low-income countries, he said, receive assistance through the IMF’s concessional lending window—the Poverty Reduction and Growth Facility—which allows expenditures and deficits to rise while paying attention to the programs’ macroeconomic consequences.

A comparison of economic performance in low-income countries before and after the establishment of the Poverty Reduction and Growth Facility in 1999 supports these contentions (see chart, page 150). Gupta noted, for example, that the average fiscal deficit targets for three years were quite high in Mozambique (15.4 percent of GDP), Zambia (13.1 percent of GDP), and Uganda (9.4 percent of GDP). He also pointed out that expenditures in these countries were higher by about 1 percent of GDP, on average, in the first year of program implementation, including pro-poor spending in relation to both GDP and the share of total spending. This spending was supported by higher external flows. But he acknowledged that the IMF needed to increase its efforts to shield the poor from the potential adverse effects of fiscal adjustment. Overall, he concluded, the IMF does tailor its fiscal policy advice to country circumstances.

Is fiscal tightening the best solution?
Commenting on the criticism that the IMF appears to ignore Keynes’ prescription for fiscal stimulus in a recession, William Cline said that it missed the point of today’s capital market dynamics and ignored decades of political economic history, particularly in Latin America. Most emerging market economies faced financial crisis, he observed, because capital flows to them dried up. It should therefore come as no surprise, he said, that Keynesian fiscal deficit spending was not necessarily the best remedy for those countries.

Increasing the fiscal deficit when capital market confidence is low could actually cause economic contraction, Cline noted, because a wider fiscal deficit signals to investors a country’s inability to repay its debt, thereby boosting interest rates further in a vicious spiral. This point, he said, combined with, among other things, the presence of crowding out and a lack of available financing, casts doubt on the effectiveness of increasing the fiscal deficit as a response to a recession caused by a collapse in capital market confidence.

Turning to specifics in IMF program countries, Cline noted there might be some validity to the criticisms of IMF fiscal policy advice in East Asia, where the countries did not have fiscal problems, their ratios
of debt to GDP were relatively low, and their fiscal balances were in slight surplus. In Korea, for example, when the markets learned that reserves had declined to $6 billion and short-term external debt was about $100 million, foreign creditors cut lending to Korean banks and corporations, even though government finances were in order. A large IMF loan and the rollover of short-term bank claims eased the liquidity shortage, and positive economic growth resumed. In countries where fiscal adjustments did take place, they were limited to 1-2 percent of GDP, considerably smaller than the Latin American adjustments of the 1980s. As it became clear that the recessions in East Asia were deeper than anticipated, Cline observed, the IMF revised its programs to allow for larger deficits.

But other countries did experience a fiscal crisis, he said, especially Russia in 1998, Ecuador in 1999, Turkey in 2000-2001, and, to a lesser degree, Brazil in 1999 and Mexico in 1995. He referred to Gupta’s evidence of the relationship between the change in the primary surplus and GDP growth: the deterioration of fiscal performance occurs the year before the crisis erupts—that is, before the output collapse. The normal, so-called procyclical fiscal relationships, which derive from the fact that revenue is more sensitive to GDP than spending is, would have predicted the largest deterioration in fiscal balances in the year of the recession. That, Cline said, supports Gupta’s proposition that fiscal adjustment can have a positive effect.

Cline closed with a few thoughts on Argentina, whose recent crisis also featured a fiscal problem. Basically, he said, “there should have been a larger surplus in the years of strong growth to hedge against the subsequent recession.” A “weak political fabric” was also a problem, making a larger noninterest surplus even more crucial for maintaining confidence and, hence, fiscal sustainability.

Quick reform mitigates social costs

Carol Graham, who has extensively studied the social costs of crises and different policies, asserted that social costs were more often than not wrongly attributed to the fiscal adjustments made necessary by bad policies rather than to the bad policies that triggered the crisis. “Blaming the IMF for the social costs of fiscal crises,” she said, “is like blaming the firemen for the fire” countries that have more permanent mechanisms in place tend to suffer lower social costs during crises.

Two points are important to bear in mind, Graham noted. First, for most countries, avoiding difficult but necessary reforms leads to worse crises and higher social costs later on. Moreover, timely reform often gives policymakers a framework that makes it easier to identify and protect the poor. Second, many of the reforms entailing implementation of market policies and changes in the balance of involvement in the economy between the private and public sectors have created an environment conducive to the adoption of new approaches to implementing safety nets.

For example, a demand-based approach incorporates participation by beneficiaries and allocates projects or support to the poor on the basis of proposals from local governments and even civil society. As a result, it is much easier to reach the poor and address their priorities. An additional benefit of this approach, Graham noted, is that it increases the political voice of the poor, giving a traditionally marginalized segment of the population a stake in the reform process. This approach to safety nets, introduced during the 1980s and 1990s, has shifted the balance from compensating the more vocal and organized middle-class or public sector groups to protecting the poorest during crises and periods of fiscal adjustment. But, she said, the change may have gone too far. In the emerging market countries, in particular, the near-poor and middle-income sectors are as vulnerable as the poorest people.

Graham observed that the shift had not obviated the need for broader social contracts or social insurance systems based, in part, on progressive taxation and, to the extent possible, on domestic resources, at least in the middle-income developing countries. Ultimately, she said, it is important to move beyond the debate about the effects of adjustment on the poor and to focus on more permanent forms of social insurance for the near-poor as well as the poor.