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Contents

Camdessus address to IOSCO

Transparency and improved standards are key to stable and efficient financial systems

Following are edited excerpts from an address given by IMF Managing Director Michel Camdessus at the twenty-fourth annual conference of the International Organization of Securities Commissions (IOSCO) in Lisbon, Portugal, on May 25. The full text is available on the IMF's website (www.imf.org).

The last decade of the twentieth century has seen a remarkable step forward in the evolution of financial intermediation. Investment and saving habits are changing worldwide—as we can see from proliferating securities markets, diverse financial instruments, and large flows of foreign direct and portfolio investment. These have been—and have all the potential to be much more—essential instruments of this explosion of international transactions of the last 15 years—a major component of globalization with all its opportunities and risks. During the last two years, we had a vivid illustration of these risks and of the virulence of the crisis, which is the other side of the glittering promise of globalization. The worst of this crisis being over, and being a member of the team of firefighters who had

(Please turn to the following page)

IMF Board meets with ECOSOC ambassadors to strengthen dialogue on economic issues

On June 1–2, in Washington, the IMF for the first time brought together ambassadors from the UN's Economic and Social Council (ECOSOC) and members of its Executive Board for a special dialogue to promote a better mutual understanding of the IMF's policies and UN activities in a wide area of shared concerns. The meeting is part of the IMF's continuing efforts to strengthen its outreach with UN agencies, improve the transparency of IMF policies and operations, and benefit from the perspectives of other international organizations.

F. Paolo Fulci, President of ECOSOC (left), with Alassane D. Ouattara, IMF Deputy Managing Director.

In his opening remarks, Alassane D. Ouattara, Deputy Managing Director of the IMF, focused on the IMF's efforts in economic security, good governance, and social development. While stressing the importance of sound macroeconomic policies and accelerated structural reform, he noted that sustainable growth will depend, among other things, on attention to education, health, public infrastructure, social safety nets, and the quality of governance, including the rule of law and efficient and accountable public sectors. With its Enhanced Structural Adjustment Facility (ESAF) and Heavily Indebted Poor Countries (HIPC) Initiative, the IMF is striving to combine effective policy reform with improved living standards and poverty alleviation, he said.

Ouattara reaffirmed the importance of cooperation between the IMF and the ECOSOC and hoped this enhanced dialogue and coordination could help the international community deal more efficiently and effectively with economic problems. ■


Shailendra J. Anjaria


Margaret R. Kelly


Reinhard Munzberg


Brian C. Stuart

IMF announces senior staff changes, establishes new departments

On May 24, IMF Managing Director Michel Camdessus announced his intention to appoint several senior staff to new positions and to make a number of organizational changes at the IMF to take effect in the coming months. Following is the text of Press Release No. 99/18. The full text is also available on the IMF's website (www.imf.org).

Current department heads who will be assuming new posts at the IMF are Shailendra J. Anjaria, Reinhard Munzberg, and Brian C. Stuart. Margaret R. Kelly is being promoted to head a new department.

Shailendra J. Anjaria, a national of India and the current Director of the External Relations Department, will become Secretary of the IMF, effective August 2, 1999. He succeeds Reinhard Munzberg, a German national, who has been appointed as the IMF's Special Representative to the United Nations. Munzberg will also have oversight of the IMF's Office in Geneva, Switzerland.

Effective July 1, 1999, Margaret R. Kelly, an Australian national who is currently Senior Advisor in the Asia and Pacific Department, has been appointed Director of the newly created Human Resources Department, which incorporates the personnel functions of the former Administration Department. Ulrich Baumgartner, an Austrian national and current Deputy Director of Administration, will become Deputy Director of the Human Resources Department.

Brian C. Stuart, a national of Canada who is Director of the Administration Department, will become Director of the new Technology and General Services Department. The Technology and General Services Department incorporates the operations of the Bureau of Computing Services, the Bureau of Language Services, and the Administrative Services Division and Joint Library functions of the Administration Department. The new services department will also incorporate parts of the Communications and Records Divisions and part of the Documents Section of the Secretary's Department.

Warren N. Minami, a national of the United States who is Director of the IMF's Bureau of Computing Services, has been named Associate Director of the Technology and General Services Department. Patrick Delannoy, a national of France and Director of the IMF's Bureau of Language Services, will be a Deputy Director of the Technology and General Services Department. Inger E. Prebensen, a Norwegian national and currently Deputy Director of the Administration Department, will be a Deputy Director of the Technology and General Services Department.

Camdessus stresses need for improved standards

(Continued from front page) to contain and extinguish it, and at the same time being active in the workshop where the new architecture of the international monetary and financial system is being designed, I believe that I can perform no better service than to bring you up to date with the work governments and financial institutions are undertaking to adapt this system to the globalized world of the twenty-first century.

New economic and financial system

As the world emerges from a period of intense turbulence, what kind of economic and financial system can we expect to develop?

The emerging markets crisis revealed deficiencies in the international financial system both on the debtor side—in the national policies and institutions—and on the creditor side—notably in the capacity of investors to undertake adequate risk assessment and of supervisory authorities to monitor properly their activities. The cost of it was high: the most severe worldwide crisis of the last 50 years. Was that a reason to abandon globalization with all its promise for a more prosperous world, in favor of the old models of protectionism and state intervention? There was, on the contrary, a very broad consensus for embarking on a major and immediate cooperative effort simultaneously to contain the crisis—a task now well advanced—and to reform the "architecture" of the system. This had to entail a profound change in what has been the relationship among governments, banks, and enterprises in promoting economic development during the last 30 or 40 years. The emerging consensus reaffirms a world economy based on free market mechanisms—on open trade and capital movements—buttressed by sound national financial systems and by good public and corporate governance. This would be a system that fosters the private sector—both domestic and foreign on a truly equal footing—as the primary source of investment and growth. It would require establishing an arm's-length relationship between governments and markets, neither too close nor too distant. It is a partnership that demands good governance, transparency and disclosure of information, and a respect for standards and codes of good practice that are consistent across countries.

Investors should be able to assess risks realistically and operate within a clearly defined, but not oppressive, framework of laws and regulations. And a consistently stable macroeconomic framework will be a *sine qua non* of national and global stability. It would also be a world that benefits from the existence of international institutions with well-defined, but constantly evolving, mandates that promote the smooth functioning of markets and economies and, as far as the IMF is concerned, could strengthen and, if needed, broaden further its surveillance to better promote the stability of the global system.

Transparency

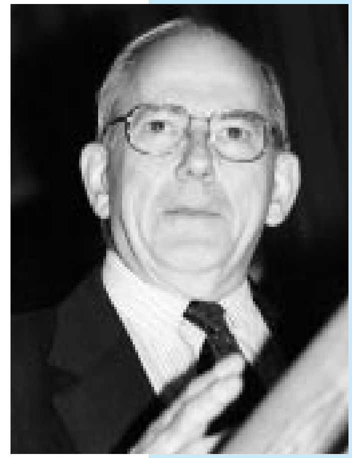
There is a strong consensus for making transparency the "golden rule" of the new international financial system. A lack of transparency has been found at the origin of each recurring crisis in the emerging markets, and it has been a pernicious feature of the "crony capitalism" that has plagued most of the crisis countries and many more besides. Markets cannot work efficiently, and they will remain vulnerable to instability in the absence of adequate, reliable, and timely information from all quarters. Here, IOSCO has been in the forefront, not only developing principles for the securities markets but also working together with other agencies, for instance the International Accounting Standards Committee, to develop proper accounting and disclosure rules. It may seem like a tall order to change the culture and attitudes of many decades, but, in fact, considerable progress is being achieved in defining new standards and establishing new practices.

International standards

A consensus is clearly crystallizing on the need to establish at the international level the discipline that has progressively come to prevail in domestic markets. In the international markets, we are already living in the twenty-first century but with an absence of universally accepted rules and standards reminiscent of the domestic environment that prevailed at the end of the nineteenth century in the industrial countries. No wonder that a number of countries have hesitated to expose themselves to such a risky environment.

Consequently, tremendous effort is under way to establish standards and codes of good practice at the international level that build on and offer the potential to globalize the standards that exist within the most advanced nations. New standards are being defined and existing ones refined. The IMF has been formulating standards or codes of good practice for governments in its core domain of responsibilities, which are already well advanced or being implemented. Many agencies have been working to develop standards in their areas of expertise: accounting, auditing, corporate governance, payment and settlement systems, insurance, and bankruptcy. IOSCO was among the first agencies to make a concerted response to the crisis, rapidly bringing to completion in Nairobi last September a set of Objectives and Principles of Securities Regulation that provide a pragmatic launching pad for national regulators to establish codes tailored to their own countries. What is more, the objectives on which those principles are based—protecting investors; ensuring that markets are fair, efficient, and transparent; and reducing systemic risk—can serve as a guide for all of us working on standards and codes of good practice.

In the critical area of financial sector strengthening, the IMF and the World Bank are cooperating closely to help promote stronger financial systems, based on the internationally accepted Basle Core Principles. But there is scope for even deeper international cooperation, and the Financial Stability Forum that has just been established to encourage dialogue among the many relevant national and international agencies will make an invaluable contribution.



Michel Camdessus

IMF's role

What are the implications for the IMF? Our activities are being affected in some quite profound ways. At one level, we have been asked to take the initiative to define standards in three areas:

• The IMF began to formulate standards for data dissemination shortly after the onset of the Mexican crisis. These are now fully operational, and the more demanding Special Data Dissemination Standard (SDDS) has now been adopted by about one-fourth of the membership, with the large majority of those countries participating in capital markets.

• In April 1998, the Interim Committee adopted the Code of Good Practices on Fiscal Transparency. Since then, we have made this code operational through the preparation of an implementation manual and development of a questionnaire that a number of countries are now using to assess the transparency of their fiscal systems.

• The IMF—working together with the Bank for International Settlements, a representative group of central banks, the World Bank, and the Organization for Economic Cooperation and Development, among others—has prepared a draft code of good practices on transparency in monetary and financial policies. The unusually broad participatory approach used in this case will continue through consultations with the public and other agencies, with a view to finalizing this code before our Annual Meetings in September.

Looking to the future, new priorities are emerging for the IMF. With many agencies now preparing or updating their standards, principles, and codes of good practice, attention is shifting to the challenge of implementation. There are no special difficulties within the domain traditionally covered by IMF surveillance, but the question arises beyond that, since many agencies do not have the capacity to conduct the country-by-country consultations that will be necessary. Although the IMF does not yet have the expertise to assist in implementing many of the new standards, it is in a unique position to contribute to their dissemination and, with the help of the standard-setting institutions,

We are already living in the twenty-first century but with an absence of universally accepted rules and standards reminiscent of the domestic environment that prevailed at the end of the nineteenth century in the industrial countries.

to contribute to their implementation. The IMF's mandate enables it to have regular contacts with all member countries for policy discussions. This has led to a number of calls for the IMF to use its surveillance to play a significant role in encouraging the implementation and monitoring of observance.

The precise mechanics of this have yet to be worked out, but it will clearly build on the experience that we will gain in implementing the standards that are the direct responsibility of the IMF (data dissemination and transparency in fiscal, monetary, and financial policies). It will also build upon the collaborative approach with the World Bank under the Financial Sector Assessment Program that we have recently formalized. Another proposal is that countries should prepare transparency reports. In a first experiment, three countries—Argentina, Australia, and the United Kingdom—have volunteered transparency reports. We will continue to work with our members on this most promising avenue.

A further reason for the IMF to become involved in encouraging and assessing the implementation of standards arises from the important adaptation in our functions that follows from the newly established Contingency Credit Lines (CCL). One of the criteria for access to the CCL is the country's "progress in adhering to relevant internationally accepted standards," and clearly judgment calls will have to be made by the IMF.

In executing these new tasks, the IMF will have to enhance and supplement its in-house expertise by relying heavily on the skills, resources, and advice of the many agencies engaged in defining standards. But, even more, we would look to the standard-setting agencies to play an active role in developing methodologies for assessing observance of their standards. We shall have to develop with IOSCO and organizations like it a high degree of collaboration. As we proceed, the most pressing needs will be for technical assistance in countries adopting new standards, and the human resource constraint may well be the largest challenge we face. An uncommon degree of cooperation among the many international bodies and national agencies is now essential to meet this challenge. ■

Recent publications

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World Economic Outlook, May 1999 ($36.00; academic price: $25.00)

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177: *Perspectives on Regional Unemployment in Europe*, Paolo Mauro, Eswar Prasad, and Antonio Spilimbergo (see page 181)

IMF Economic Reviews (free)

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99/58: *The Role of Inter- and Intraindustry Trade in Technology Diffusion*, Dalia Hakura and Florence Jaumotte

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Entry into EMU heightens need to address effectiveness of adjustment mechanisms

While persistently high rates of unemployment in continental Europe have long been a concern, sharp disparities in unemployment rates within countries have garnered far less attention. IMF Occasional Paper Perspectives on Regional Unemployment in Europe *examines the scope of the problem, ramifications for national labor markets, and possible remedies. IMF Economists Paolo Mauro, Eswar Prasad, and Antonio Spilimbergo, authors of the study, discuss their findings in an interview with the* IMF Survey.

IMF SURVEY: *Why have you chosen to focus on regional unemployment within countries?*

MAURO: Regional differences have costs of their own and give us hints as to the underlying reasons why overall unemployment rates are so high. Basically, we looked at this issue for three reasons. First, there is the likelihood that large and persistent regional disparities in unemployment may contribute to a higher national nonaccelerating inflation rate of unemployment (NAIRU). Inflationary pressures are more likely to arise in the initial stages of a recovery in a country with large differences in its regional unemployment rates. If you have 5 percent unemployment in some regions and 25 percent unemployment in others, inflationary pressures will start rising early in the 5 percent unemployment areas. Inflation will rise more slowly in a country with a geographically uniform unemployment rate of 15 percent.

Second, there are large social costs associated with regional unemployment disparities. When you have 15 percent unemployment throughout a country, it's a situation in which I may be unemployed but my neighbors, family, and friends are likely to still be working. Imagine, instead, that you have 5 percent unemployment in some regions and 25 percent in others. In regions where the unemployment rate is 25 percent, many more people will be unemployed and families are much less likely to be able to pool their resources.

But third, and the biggest reason why we look at this, is that the persistence of large differences in unemployment rates within a country suggests that something is wrong with the adjustment mechanisms in that economy. If you have large parts of the country with high unemployment rates for a very long time, and people don't migrate out of the high unemployment areas and firms don't move into the high unemployment rate areas either, something is going wrong.

PRASAD: We view regional disparities, especially persistent disparities, as a symptom of inappropriate or inefficient labor market adjustment. Aggregate shocks may hit an entire economy, but region- and sector-specific shocks have different effects on different regions and usually cause an adjustment to take place. A large body of literature indicates that in the United States, adjustment occurs through labor migration from a negative shock area to a positive one. Migration of capital is an alternative channel of adjustment.

IMF SURVEY: *Your study examines regional unemployment rates in 14 European countries and the United States. Where were the disparities most severe and what do the disparities tell you about the possible reasons for high regional unemployment?*

MAURO: Clearly, Italy and Spain stand out as the countries with the largest regional disparities. Italy, in particular, has striking regional differences. In Spain, Andalusia, in the agricultural south, has an unemployment rate of more than 30 percent. In Navarra, unemployment is 10 percent. But Spain has a higher nationwide unemployment rate. What makes Italy so striking is that the lower national unemployment rate coexists with an equally large regional difference—5 percent unemployment in the north and more than 22–23 percent in the south. In the United States, the regional differences are much smaller—ranging from 3 percent to 8 percent.

When we looked at countries with high regional differences—Italy and Spain in particular—we also looked for clues as to what institutions and policies seemed to be associated with these large regional disparities.

PRASAD: We wanted to examine how wide the dispersion was in European countries as compared to the United States and how persistent these differences were in Europe relative to the United States. In the United States, for example, asymmetric shocks produce temporary increases in regional unemployment. The United States has had many episodes of this over the past 20 years, with fairly large increases in regional disparities in unemployment. But in Europe, these differentials have persisted over long periods of time, suggesting that this disequilibrium is probably perpetuated by labor market and other institutions. In the United States, adjustment mechanisms seem to allow these differentials to be mitigated fairly quickly.

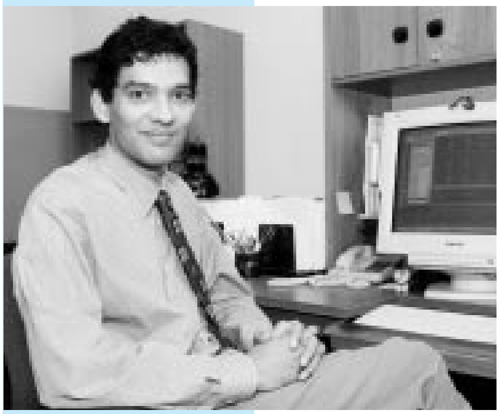
IMF SURVEY: *What is the impact of regional disparities on national economic performance? And which institu-*

Mauro: The persistence of large differences in unemployment rates within a country suggests something is wrong in the adjustment mechanisms.

tional arrangements or policies seem most closely linked to persistent regional unemployment disparities?

PRASAD: Regional unemployment disparities tend to create welfare disparities. If governments attempt to reduce these welfare disparities through social transfers, they will introduce additional distortions into the economy. For instance, if the government chooses to tax residents in the more productive and low-unemployment areas and to distribute these resources to high-unemployment areas to make the welfare comparable, it will have further distortionary effects on labor supply and on other economic decisions, thereby reducing overall economic welfare.

SPILIMBERGO: On your second question, if you have region-specific shocks, you need flexible wages to accommodate local labor market needs. In a centralized bargaining system, the representatives or trade unions look at the overall unemployment rate. Since local wages are not flexible, you don't give the right price incentives for an adjustment to take place.



Prasad: A centralized bargaining system that does not allow wages to adjust across regions could worsen imbalances.

PRASAD: Typically, the region with low unemployment tends to take the lead in wage negotiations. This can exacerbate problems, however, if the initial shock that led to higher unemployment in one region resulted from lower productivity, but wages are then set on the basis of the region with lower unemployment and higher productivity. This will further widen the disparity between productivity and wages in the region hit by the negative shock. A centralized bargaining system that does not allow wages to adjust across the regions increases unemployment in the region that is doing poorly and worsens the imbalances.

IMF SURVEY: *Does centralized bargaining lead to regional disparities or does it exacerbate disparities where they already exist?*

PRASAD: The literature suggests that completely centralized or completely decentralized wage bargaining leads to better outcomes than an intermediate degree of centralization. Given that EMU members will have fewer policy instruments to deal with shocks and given other institutional constraints, going halfway in terms of decentralized wage bargaining could be the worst of all possible worlds. This is currently the case in some countries, particularly Italy.

MAURO: Our approach is probably more forward looking. We see countries with large regional differences and are trying to see what can be done about these differences. When economists wonder why quantities don't adjust—in this case, unemployment rates—we first look at why prices (wages) don't adapt to ensure that those quantities return to the higher-employment equilibrium level. When we see persistent large differences in unemployment rates, we ask what can be done to the wage-setting mechanism to reduce those differences.

IMF SURVEY: *Your study examines Italy and Spain in detail. Describe the workings of these economies and the reasons for the regional disparities there.*

PRASAD: In Italy, there is a clear segmentation of markets between the north and the south. In the north, the unemployment rate is about 5 percent, and, during the recent cyclical recovery, unemployment has been declining. In the south, the unemployment rate has been rising and is well over 20 percent. There is also a clear divide between the north and the south in labor force participation rates and in youth unemployment. People in the south also tend to have much longer spells of unemployment.

Apart from some minor leeway for firms to change wages at the plant level, Italy essentially has a nationalized bargaining system within each sector. A firm in the south has to pay its workers the same as workers in the north, though productivity levels in the south might be lower because of lower human capital or poorer infrastructure. The government has tried to encourage the movement of capital to the south by providing wage subsidy incentives, but this comes at a cost to the public exchequer, with overall distortionary effects on the economy.

Other institutional features that have also led to declines in migration from the south to the north include a rather inflexible housing market and an employment intermediation system dominated by public agencies. With regard to housing, for example, large taxes are imposed at various points in the sale and purchase of a house, and there isn't much of a rental market. Also, public agencies have been very inefficient in providing employment intermediation for those who want to move from the south to the north. A larger role for private sector employment agencies could be very important in enhancing migration.

Recently, the government has tried to provide temporary wage flexibility in the south, but the effectiveness of these measures has been constrained, because investment decisions tend to be driven by longer-term considerations. And these measures haven't been formulated in the context of an overall labor market reform strategy that would have addressed other rigidities, such as hiring and firing costs. The absence of a comprehensive reform agenda has raised concerns about the credibility of the reforms that have been attempted.

SPILIMBERGO: In Spain, the pattern of regional differences is not as clear as it is in Italy. Oversimplifying a bit, Spain has high unemployment in its agricultural south and a "rust belt" area of the north that has relied on traditional industries such as ship-building. But Spain's policies have been similar to those in Italy—its policy responses do not favor the absorption of the local shocks and have included centralized wage bargaining, minimum wages, and unemployment benefits that discourage workers from seeking jobs in other regions. There, too, you have a relatively illiquid market for houses and rentals are infrequent.

MAURO: In Spain, as in Italy, we contrasted high- and low-unemployment areas. We found no differences in real wages or unit labor costs, which suggests there are no incentives for workers to migrate away from high-unemployment areas or for firms to migrate toward high-unemployment regions. In principle, Spain has a nationwide round of bargaining followed by regional, provincial, and in some cases firm-level bargaining. In practice, however, there is usually no downward adjustment at the regional or local level because the nationwide round is viewed as a minimum. We've also seen no differences in wage increases. Trade unions and others in Spain argue that the bargaining system is not as centralized as it seems, but we found no evidence of wages responding to local conditions.

IMF SURVEY: *What institutional steps or policy changes could ameliorate these disparities?*

MAURO: We have already argued that decentralized wage bargaining would allow wages to fall in areas of high unemployment and thus attract firms to move there. In theory, centralized bargaining systems have opt-out clauses, but the conditions currently attached to these clauses make it unlikely they will be used. Less stringent opt-out clauses might be one means of decentralizing wage bargaining.

I don't see minimum wages or unemployment benefits as a major cause of regional disparities. Certainly, though, greater flexibility in the housing market could help. In Spain, for example, rental contracts are rarely for less than five years.

An additional step is to ensure that the level of education is adequate for workers in all parts of the country. Of course, if the labor force in areas of high unemployment is highly skilled, firms are more likely to move there. Therefore, from the perspective of the firm, a high level of education throughout the country is more helpful. In principle, both Italy and Spain aim to provide this; in practice, however, there are still some differences in the education levels.

Antonio and I, in a separate study, looked at workers' migration and their education level. More highly educated workers are more likely to migrate in response to shocks. For less educated workers, the opportunity costs of remaining unemployed in their home region are relatively low. Without a great incentive to move, they prefer to stay and collect unemployment benefits.

PRASAD: In Italy and Spain, a wage structure that is flexible and allows for sufficient differentiation of wages across sectors and regions based on productivity differentials seems to be the key for encouraging the optimal allocation of labor and for reducing these persistent differences in regional unemployment. In the south of Italy, even workers with high levels of human capital have difficulty finding a job. This suggests that employment intermediation mechanisms need to be improved, especially for younger workers making school-to-work transitions.

Spilimbergo: With nominal wages defined in terms of the euro, there will be the temptation to equalize wages across Europe. That would worsen regional disparities.

IMF SURVEY: *What impact will entry into the European Economic and Monetary Union (EMU) have on regional unemployment disparities?*

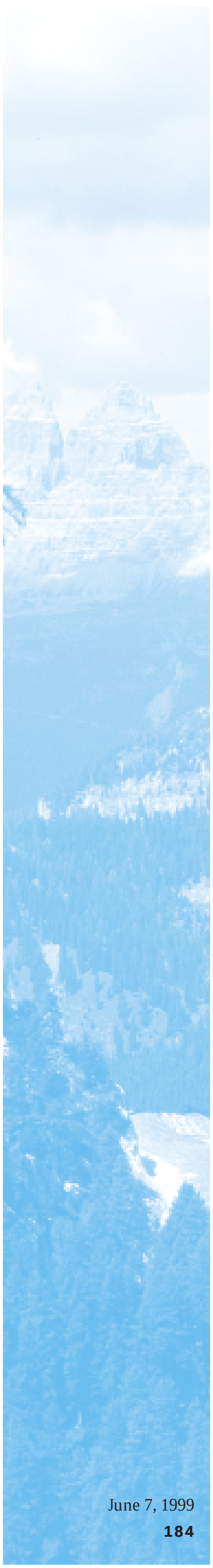
SPILIMBERGO: The EMU has benefits, but it will entail the loss of some policy instruments and could result in problems. One problem is that since nominal wages will be defined in terms of a common currency, there will be the temptation to equalize them across Europe. That would worsen regional disparities.

MAURO: The EMU can draw lessons from the experiences of Italy and Spain. Centralized bargaining in these countries had exacerbated regional differences. You can extrapolate that, if a European-wide centralized wage-bargaining system emerges, low-productivity countries might have much higher unemployment than the high-productivity countries.

SPILIMBERGO: Second, in the past, inflation has increased the flexibility of real wages. Since the euro area will strive to be a low-inflation zone, this mechanism can no longer be used to address regional unemployment differences. And, third, the exchange rate will no longer be available to address country-specific shocks and their asymmetric effects on different regions.

PRASAD: Regional unemployment disparities are essentially a symptom, but a very important symptom, of overall labor market rigidities. Given the constraints on fiscal and monetary policy instruments under the EMU, it is more important than ever that labor market rigidities in European countries be dealt with effectively and quickly.

Copies of IMF Occasional Paper No. 177, *Perspectives on Regional Unemployment in Europe*, by Paolo Mauro, Eswar Prasad, and Antonio Spilimbergo, are available for $18.00 (academic rate: $15.00) each from IMF Publication Services. See page 180 for ordering information.



Swiss monetary policy acts to adapt to internal, external challenges

Since the breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s, monetary aggregates have played a key role in guiding Swiss monetary policy. The intermediate objective of Swiss monetary policy for 24 of the past 25 years has been to stabilize the money supply. However, the Swiss National Bank has recognized the limitations of following a strict monetary targeting framework and has, on occasion, set aside its monetary goals either to accommodate a shift in the demand for money or to counteract deflationary pressures caused by a sharp appreciation of the exchange rate. The resulting framework can be described as a "monetary policy rule with an escape clause." In IMF Staff Country Report No. 99/30, Ketil Hviding of the IMF's European I Department describes Switzerland's monetary policy framework, considers its performance, and outlines a number of challenges the country will face in conducting its monetary policy in the future.

Switzerland, which became a member of the IMF in 1992, is a small economy relatively open to international trade. Perceived as a safe haven for capital, it is subject to large capital flows and is thus vulnerable to exchange rate pressures. A sharp appreciation of the currency, Hviding notes, could have adverse, and potentially long-lasting, effects on the economy. These considerations have at times given rise to pressures to abandon the monetary targeting framework and, instead, to use monetary policy to limit large exchange rate movements.

Monetary targeting framework

When the Bretton Woods system collapsed in the early 1970s, the Swiss authorities decided to float the Swiss franc. To achieve their medium-term goal for inflation of 1 percent a year, they intended to pare down the excess supply of money that had accumulated during the period of fixed exchange rates by slowing monetary growth from 6 percent a year in 1976 to 2 percent a year. In 1974, they announced a goal for the growth rate of narrow monetary aggregates (M1). Within three years of floating the exchange rate, the authorities had succeeded in bringing inflation down. As a result, according to Hviding, the early years of the monetary targeting framework were considered a great success.

In the late 1970s, the Swiss franc appreciated dramatically (in trade-weighted terms, the nominal effective appreciation amounted to about 80 percent), making the exchange rate a primary policy concern. In response, the Swiss National Bank suspended the monetary target strategy in the fall of 1978 and introduced a temporary floor on the value of the Swiss franc against the deutsche mark while imposing temporary capital controls. These measures, Hviding says, led to rapid monetary growth and caused the money supply to exceed the authorities' target for 1978.

The sharp monetary expansion, in turn, created expectations of high inflation, which the Swiss National Bank countered in late 1979 by reintroducing monetary targets in place of the exchange rate floor. It also changed the targeted monetary aggregate to the monetary base (M0), which bank authorities thought would be less influenced by relative interest rate developments than M1 and thus easier to control. The goal—as it had been in the early 1970s, Hviding observes—was to reduce monetary growth gradually, from 4 percent a year in 1980 to 2 percent a year beginning in 1986. In fact, monetary growth fell far short of the target in 1980 and 1981, whereas for the next six years, actual growth came close to the goal in an environment of declining inflation and economic expansion. Because the real exchange rate and the Swiss franc-deutsche mark exchange rate were both stable, exchange rate pressures did not arise. Thus, the monetary targeting framework was not challenged and enjoyed a second "honeymoon."

Difficulties emerge in late 1980s

In general, Swiss monetary policy has been successful in maintaining a low level of inflation and relatively stable growth over the past 25 years. However, its relative performance appeared to deteriorate in the second half of the 1980s, Hviding notes, as structural changes in the financial system made the demand for money increasingly volatile. He lists the introduction of the Swiss Interbank Clearing System—a new electronic interbank system based on real-time gross settlement—and changes in the reserve requirements for bank cash as two developments that sharply reduced banks' demand for base money. A period of rapid inflation ensued, whose origins, Hviding observes, are open to debate. Between 1988 and 1996, the supply of base money fell short of the authorities' medium-term target path and then significantly exceeded it when the authorities shifted to a policy of monetary relaxation.

Although Hviding suggests that the large shifts in demand for base money can be attributed to specific events, he notes that it is difficult to determine the size of the shifts and whether they are short term or whether they are more persistent. Moreover, their frequency has made other indicators of monetary conditions more important in the implementation of Swiss monetary policy since the early 1990s. In December 1997, for example, the Swiss National Bank indicated that it would use a broader definition of money (M3) as a monetary indicator for its 1998 policies. Although research shows that the demand for M3 is more stable than that for base money, broader monetary aggregates are highly sensitive to relative interest rate developments and to financial innovation. Thus, using a broader monetary aggregate is unlikely to prevent a shift toward using a still broader set of indicators, including short- and long-term interest rates, in the operational implementation of monetary policy.

Future challenges

Swiss monetary policy is likely to face many challenges in the future, Hviding observes, including the effects of the move to monetary union by Switzerland's neighbors, the undiminished pace of financial innovation, and the large number and complexity of demand shocks.

The introduction of the euro had little effect on the Swiss franc, but, until euro notes and coins completely replace national currencies in 2002, the demand for the Swiss currency could fluctuate widely. Institutional investors seeking to diversify their portfolios could increase the demand for Swiss francs as several European currencies are replaced by euros. In contrast, as confidence in the euro increases, leading to currency substitution by Swiss firms and households, unexpected outflows of capital and downward pressures on the exchange rate could result. Currency substitution, he cautions, would add to the instability of money demand and further undermine the monetary targeting framework.

Hviding cites one approach for dealing with the effects of portfolio preference shifts, which was the subject of an earlier study conducted by IMF staff. It consists of timely monetary policy action, which would reduce the short-term negative effects on export industries of a currency appreciation, created by either a temporary or a persistent shift in portfolio preference. This active application of monetary policy could not, however, prevent an initial drop in output and could also increase consumer price inflation temporarily. Imposition of a temporary exchange rate ceiling would stabilize output as well as the exchange rate after some initial appreciation.

An alternative and—according to Hviding—radically different approach entails fixing the Swiss franc in terms of the euro, which would eliminate the currency risk involved in trade between Switzerland and the euro area. It would also result, however, in the removal of Swiss monetary policy independence. Monetary policy would effectively be determined in the European Central Bank, without regard to Swiss economic conditions.

A final alternative to the problem of portfolio preference shifts is an inflation targeting framework. It does not differ much from the monetary targeting framework that the Swiss National Bank has followed since 1980, but offers several advantages. It opens the way for a broader set of indicators to be used as the basis for monetary policy and is more forward looking. In such a framework, the authorities would have to produce an explicit medium-term inflation projection on the basis of developments in a range of factors, such as actual inflation, industrial production, business and consumer confidence, measures of capacity utilization, real exchange rate developments, and developments in monetary aggregates. This projection could then serve as an anchor for inflation expectations in the private sector.

Hviding notes that, despite its recent popularity elsewhere, such a framework has several problems. First, if actual inflation were to fall short of, or exceed, the authorities' projection too often, policy credibility would be undermined, even if the central bank were to focus on "underlying inflation," which excludes direct import price effects and other short-term effects, such as mortgage interest rates or consumption taxes. A dramatic change in the fiscal policy stance or other unanticipated events could affect the inflation outcome. Thus, setting a precise inflation goal could be counterproductive. A final complication of this strategy is the exchange rate. Large exchange rate movements could disrupt domestic prices, which could then cause actual inflation to miss the targeted level.

In his study, Hviding discusses monetary policy feedback rules—first proposed in connection with the U.S. Federal Reserve—as a starting point for monetary policy decisions. He considers these rules in the context of Swiss monetary policy, concluding that none of them fully captures the Swiss National Bank's decision-making process. The estimations suggest, however, that the monetary policy formulation of the Swiss National Bank is not too different from that of countries that formally target inflation. The difference lies in how monetary policy is communicated to the markets and the public. ■

Copies of IMF Staff Country Report No. 99/30, *Switzerland: Selected Issues and Statistical Appendix*, are available for $15 a copy from IMF Publication Services. See page 180 for ordering information.

Available on the web (www.imf.org)

Public Information Notices (PINs) are IMF Executive Board assessments of members' economic prospects and policies issued following Article IV consultations—with the consent of the member—with background on the members' economies and following policy discussions in the Executive Board at the decision of the Board. Recently issued PINs include

99/43, Guyana, May 21
99/44, Aruba, May 26

Letters of Intent and Memorandums of Economic and Financial Policies are prepared by a member country and describe the policies that the country intends to implement in the context of its request for financial support from the IMF. Recent releases include

Indonesia, Letter of Intent, May 14

New data

Military spending continues to stabilize; some countries increase social spending

Worldwide military spending has leveled off since 1995, as confirmed by recent data from three different sources (see table, below, and chart, page 187) and as reported in previous reviews in the *IMF Survey* (June 3, 1996, page 181; April 21, 1997, page 119; and May 11, 1998, page 149). In addition, in some countries, reductions in military spending have been accompanied by increased spending on education and health care.

Military expenditures

	1993	1995	1996	1997	1998	1993	1995	1996	1997	1998	Change 1997–98	Number of Countries
	(percent of GDP)[1]					(percent of total expenditure)					(billion U.S. dollars)	
World Economic Outlook												
All countries	2.8	2.4	2.4	2.3	2.3	11.6	10.5	10.6	10.6	10.5	–15.3	131
Advanced economies	2.8	2.4	2.4	2.3	2.3	11.6	10.3	10.4	10.4	10.3	–10.6	25
Industrial countries	2.7	2.3	2.3	2.3	2.3	11.3	10.0	10.2	10.2	10.1	–4.3	22
Newly industrializing Asian economies[2]	3.8	3.5	3.7	3.7	3.7	20.9	19.4	18.9	18.6	16.5	–6.4	3
Developing countries	2.6	2.5	2.3	2.3	2.4	12.3	12.5	11.7	11.8	11.8	–1.3	86
Africa	3.0	2.7	2.5	2.4	2.4	9.8	9.3	8.9	8.6	8.5	–0.3	43
Asia	2.0	1.8	1.7	1.7	1.7	11.9	12.3	11.4	10.9	10.5	–1.9	12
Middle East[3]	6.5	6.4	6.3	6.5	6.6	18.4	21.1	19.5	20.4	21.2	1.0	12
Western Hemisphere	1.2	1.3	1.2	1.3	1.2	7.2	6.8	6.2	6.8	6.7	–0.1	19
Countries in transition	3.1	2.5	2.4	2.4	2.4	10.5	9.8	9.7	10.7	10.4	–3.3	20
Central Europe	2.3	2.2	2.1	1.9	1.9	6.7	6.7	6.8	6.5	6.8	0.6	7
Baltics, Russia, and other former Soviet Union	3.8	2.7	2.6	2.7	2.9	16.1	13.1	12.2	14.3	15.1	–4.0	13
Countries with IMF programs for more than two years	2.1	2.1	2.0	1.9	1.9	9.6	9.3	9.0	9.3	9.2	–3.1	62
Of which ESAF countries	3.8	3.4	3.1	3.0	2.9	14.7	14.2	13.5	13.5	13.1	0.0	37
HIPCs	4.0	2.8	2.4	2.3	2.1	18.5	16.3	15.3	14.7	13.9	0.2	33
Decision point[4]	2.3	1.9	1.8	1.8	1.8	8.9	7.9	8.0	7.8	7.9	0.0	6
Completion point[5]	2.3	1.8	1.8	1.7	1.6	9.6	7.8	7.7	7.6	7.0	0.0	2
ACDA												
All countries	3.2	2.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	102
SIPRI[6]												
All countries	2.8	2.4	2.4	2.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	92
Africa	2.6	2.4	2.2	2.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	23
Asia	1.9	1.8	1.7	1.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	10
Middle East[3]	7.0	6.3	6.7	6.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	12
Western Hemisphere	1.1	1.2	1.3	1.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	15
IISS												
All countries	3.0	2.6	2.6	2.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	89
Africa	3.3	3.0	2.9	2.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	16
Asia	3.3	3.6	3.4	3.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	14
Middle East[3]	7.7	7.6	7.6	7.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	11
Western Hemisphere	1.5	1.5	1.8	1.8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	17

[1]Weighted by country GDP.
[2]Includes Korea, Singapore, and Taiwan Province of China.
[3]Includes Cyprus, Malta, and Turkey.
[4]Benin, Burkina Faso, Côte d'Ivoire, Mali, Mozambique, and Senegal. Guyana was excluded from the sample because of lack of data. At the "decision" point, the Boards of the IMF and the World Bank formally decide on a country's eligibility and assistance under the HIPC Initiative. This point would typically be reached after three years of sound performance under IMF- and World Bank-supported adjustment programs.
[5]Bolivia and Uganda. At the "completion" point, the Boards of the IMF and the World Bank decide that the country has met the conditions for assistance under the Initiative. This point would typically be reached after successful implementation of another three-year adjustment program, but could be reached earlier for countries with a sustained record of strong performance.
[6]For 1997, the sample contains 71 countries.

Data: IMF, *World Economic Outlook*; U.S. Arms Control and Disarmament Agency (ACDA), *World Military Expenditures and Arms Transfers*; Stockholm International Peace Research Institute, *SIPRI Yearbook, Armaments, Disarmament and International Security*; and International Institute for Strategic Studies (IISS), *The Military Balance*

Military spending

Depending on the data source, worldwide military spending now ranges between 2.3 percent and 2.5 percent of GDP, according to the latest data. For 1998, according to *World Economic Outlook* data for 131 countries, such spending was the same—at 2.3 percent of GDP—as in 1997. Although differences in samples make comparisons difficult, the trends in military expenditures in the *World Economic Outlook* database are supported by data provided by the Stockholm International Peace Research Institute (SIPRI) and the International Institute of Strategic Studies (IISS). In a sample of 71 countries, SIPRI reported worldwide military expenditures of 2.4 percent of GDP in 1997, essentially unchanged from 1996. For a sample of 89 countries, IISS reported worldwide military expenditures of 2.5 percent of GDP in 1997 (also essentially unchanged from 1996). The data produced by the U.S. Arms Control and Disarmament Agency (ACDA) are available only up to 1995.

Notwithstanding the general trend, two country groups have registered a small increase in military spending since 1996, according to the *World Economic Outlook* and SIPRI sources. In the Middle East, military outlays increased by 0.3 percentage point by 1998 to 6.6 percent of GDP, and in the Baltics, Russia, and other former Soviet Union countries, to 2.9 percent of GDP. As a result, the share of military outlays in total government spending rose by 1.7 percentage points to 21.2 percent in the Middle East, and by 2.9 percentage points to 15.1 percent in the Baltics, Russia, and other former Soviet Union countries. One data source (IISS) shows an increase of 0.3 percentage point in military spending to 1.8 percent of GDP in Western Hemisphere countries during 1995–97.

Military outlays declined markedly in relation to both GDP and total government spending in a group of 37 countries that had an Enhanced Structural Adjustment Facility (ESAF) Arrangement with the IMF for at least two years during 1995–98; this freed resources for more productive uses. For six heavily indebted poor countries (HIPCs) in Africa that have reached the "decision" point under the HIPC Initiative, military expenditures remain below the regional average.

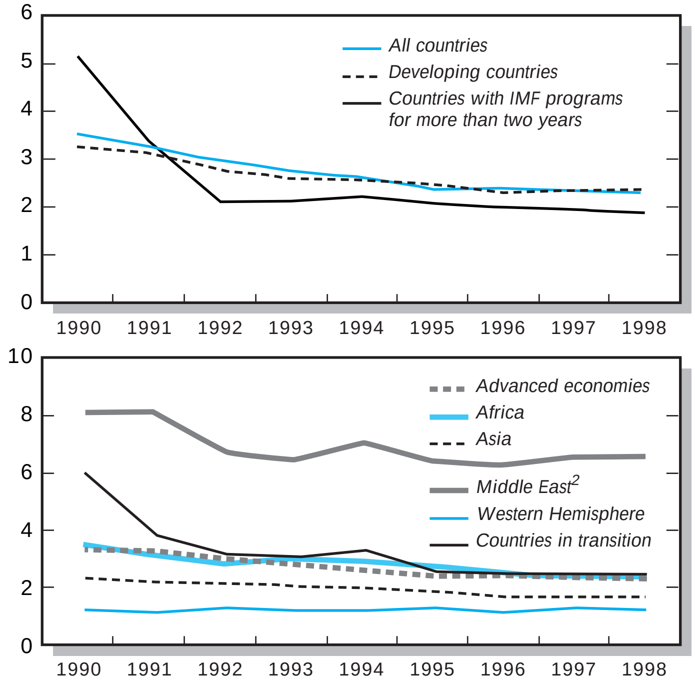
Military, education, and health spending

Consistent with previous findings, military spending appears to have become, on average, a lower priority in government budgets compared to spending on education and health care in 61 countries for which data are available for 1993–97 (see table, below). In these countries, the reduction in military outlays was accompanied by an increase in spending on education and health care as a proportion of GDP and total spending. This increase is larger in countries with ESAF arrangements and in HIPCs.

Two country groups (the Baltics, Russia, and other former Soviet Union countries and the Middle East) display somewhat different trends. Education and health care spending fell in relation to GDP between 1993 and 1997 in both groups. However, in the Baltics, Russia, and the other former Soviet Union countries, such spending increased as a share of total expenditure,

Military expenditures[1]

Percent of GDP



[1]Weighted by country GDP.
[2]Includes, Cyprus, Malta, and Turkey.

Data: IMF, *World Economic Outlook*

Military and education and health care expenditures, 1993–97

	Change in expenditure as a share of GDP[1]			Change in expenditure as a share of total[1]		
	Total	Education and health care	Military	Education and health care	Military	Number of countries
All countries	–2.7	0.2	–0.4	1.9	–1.1	61
Middle East	–5.6	–0.2	–0.2	1.2	2.0	7
Western Hemisphere	0.7	0.2	–0.3	0.9	–2.0	13
Baltics, Russia, and other former Soviet Union	–9.4	–0.4	–0.6	2.9	–0.3	9
Countries with IMF programs for more than one year	–2.3	0.1	–0.3	2.1	–0.6	41
Of which						
ESAF countries	–3.9	0.2	–0.3	3.8	–0.1	21
HIPCs	–2.3	0.6	–0.6	3.0	–2.0	18

[1]Unweighted averages. Excludes industrial countries. Calculations cover the period 1993–96 for 24 countries, and 1993–97 for 37 countries.

Data: National authorities and IMF staff estimates suggesting that these outlays were relatively protected from budget cuts. In the Middle East, however, the ratio of military outlays to total spending increased by more than that of education and health care.

Size of armed forces

A large army relative to population can exert significant pressure on a government's wage bill, thus crowding out spending on more productive programs. According to ACDA data, the size of the armed forces has fallen since 1990 for all regions, except the newly industrialized Asian countries. For these countries, as well as those in the Middle East, the size of the armed forces (relative to population) and of military spending (in relation to GDP and total spending) is above average. Although the transition countries in Central Europe have relatively large armed forces, their military spending is below average in relation to both GDP and total spending. Countries in Africa and the Western Hemisphere have the smallest armed forces as a share of population. (ACDA reports the size of armed forces for every 1,000 people for a sample of countries in 1990 and 1995. For ACDA data, see its website www.acda.gov.) ■

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Press Releases

Following are extracts of recent IMF press releases. Full texts are available on the IMF's website (www.imf.org) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Algeria: CCFF

The IMF has approved a credit for Algeria totaling SDR 223.5 million (about $300 million) under the Compensatory and Contingency Financing Facility (CCFF) to help offset a temporary shortfall in exports of goods and services.

Prospects and policies

Despite a modest recovery in world oil and gas prices, Algeria's external position has continued to be adversely affected. For the year ending June 30, 1999—the shortfall period—receipts from oil and gas sales are expected to be lower by $1.9 billion compared with the previous 12-month period. Against this background, the Algerian authorities remain committed to building on the stabilization achievements of the past three years, and it is expected that the direction of economic policymaking will be maintained by the new government toward ensuring macroeconomic stability and accelerating structural reforms.

The authorities have taken several steps in the past year to curb domestic demand and to improve the external current account and fiscal deficits. The central bank has allowed the dinar to depreciate by around 15 percent (in nominal terms) against the U.S. dollar since September 1998. In addition to the positive budgetary impact of this measure, the government took steps to reduce public expenditures and to pursue a tight wage policy. On the monetary front, the central bank is determined, however, not to allow any further acceleration in inflation and to further tighten monetary policy if needed. On the structural front, the government is committed to further liber-

IMF completes third review under EFF for Argentina

On May 26, the IMF's Executive Board completed the third review under the Extended Fund Facility (EFF) Arrangement for Argentina. Following the review, IMF First Deputy Managing Director Stanley Fischer issued a statement. The text of the statement, issued as News Brief No. 99/24, follows. The text is also available on the IMF's website (www.imf.org).

"Argentina is to be commended for its continued prudent policies. As with a number of other countries in the region, Argentina has had to bear the adverse consequences of external shocks, which have taken a significant toll on economic performance. Nevertheless, the sound macroeconomic management, the strengthening of the banking system, and the other structural reforms carried out in recent years in the context of the currency board arrangement have had beneficial effects on confidence and have allowed the country to deal with these challenges.

"With a view to supporting economic activity, the program's ceiling on the deficit of the federal government has been raised to Arg$5.10 billion (1.5 percent of GDP) from Arg$2.95 billion (0.8 percent of GDP), thereby accommodating most of the impact of the cyclical economic downturn on fiscal revenues.

"Further progress on the authorities' structural reform agenda is necessary to ensure competitiveness and strong economic growth in the medium term. It is particularly important to obtain the early approval and implementation of the structural reforms that are being considered in the fiscal area, such as the fiscal convertibility law and the reforms of social security and revenue sharing with the provinces, as well as the proposed reforms in financial and labor market legislation."

alizing the economy and creating an environment conducive to private sector development.

Press Release No. 99/19, May 26

Ukraine: EFF augmentation

The IMF has approved a request by Ukraine to increase by SDR 274.4 million (about $366 million) the IMF's financial support under the current three-year Extended Fund Facility (EFF) Arrangement, which was approved on September 4, 1998, in an amount of SDR 1.6 billion (about $2.2 billion). (See Press Release No. 98/38, *IMF Survey*, September 28, 1998, page 297.) The augmentation, of which SDR 37.5 million (about $50 million) is available immediately, is a response to the difficult external position arising from the impact of generally weak commodity prices for Ukraine's exports, particularly metals, and depressed demand in the region due to the continuing difficulties in Russia. More recently, the Kosovo crisis has disrupted Ukraine's trade routes along the Danube. The decision was made in conjunction with the completion of the second review of the economic and financial program supported by the EFF, and triggered a total release of SDR 134.7 million (about $180 million).

Ukraine's financial situation remains very fragile. The authorities intend to implement the necessary policy changes to promote financial stability and economic growth. At the same time, however, in view of the country's heavy debt-service obligations, Ukraine's economic recovery will require the continued involvement of private creditors. In that regard, a collaborative solution to Ukraine's debt-service problem must be found in line with Ukraine's capacity to pay. The authorities' recent efforts in this area are consistent with the steps envisaged under the IMF-supported program; progress in this area will be a key factor to be considered in the context of the financing review

Ukraine: selected economic indicators

	1997	1998 Preliminary actual	1999 Preliminary estimate	1999 Annual revised outlook
		(percent change)		
Real GDP[1]	–3.0	–2.0	–5.0	–3.0
Consumer prices (end of period)[2, 3]	10.0	20.0	4.0	21.0
		(percent of GDP)		
General government budget balance (cash basis)	–5.6	–2.7	–1.0	–1.3
Current account balance (excluding Black Sea Fleet transactions)	–2.7	–1.9	–6.0	–2.1
		(weeks of current year imports of GNFS)		
Gross usable reserves (end of period)	...	2.2	2.1	3.3

[1]For 1998 and the first quarter of 1999, the data are staff estimates based on preliminary data.
[2]Changes from the previous period.
[3]Compared to the previous period, quarterly rates are not annualized.

Data: Ukrainian authorities and IMF staff estimates

IMF completes EFF review for Pakistan

In a news brief issued on May 25, IMF Deputy Managing Director Alassane Ouattara announced that in support of the Pakistan government's economic program, the IMF's Executive Board approved the completion of the third review under the Extended Fund Facility (EFF) Arrangement and the release of the next SDR 37.9 million (about $51 million) credit tranche. Including this release, Pakistan to date has drawn SDR 113.75 million (about $153 million) under the EFF (see Press Release No. 97/48, IMF Survey, *November 3, 1997, page 350), with a further SDR 341.2 million (about $459 million) available in the period to October 2000. The text of News Brief No. 99/23, also available on the IMF's website (www.imf.org), follows.*

Ouattara said that policy implementation had largely remained in line with program commitments since the last review was conducted in January 1999. "This has helped strengthen investor confidence, eased pressures in the foreign exchange market, and kept inflation under check. I welcome the recent unification of the exchange rate system. Despite these favorable developments, Pakistan's macroeconomic situation remains difficult. Fiscal consolidation and the restructuring of the budget remain central to the success of the program. Resolute action is needed to broaden the tax base and further strengthen tax enforcement. The authorities also need to accelerate structural reforms to build a solid foundation for high economic growth in the medium term. Important steps have been taken in strengthening the prudential and regulatory framework of the banking system, and some progress has been made with power sector reform. I strongly encourage the authorities to resolve the outstanding issues with Independent Power Producers and complete the restructuring of the power sector without delay. Pakistan has also made important progress in normalizing relations with creditors. I encourage the authorities to move expeditiously in concluding bilateral arrangements with Paris Club creditors and to seek comparable treatment from all other bilateral, commercial, and private creditors. All these measures will help in restoring investor confidence in Pakistan. In that context, it is important for the authorities to focus on issues of good governance and transparency," he said.

for the next drawing that is expected to be considered by the IMF's Executive Board in June 1999.

Ukraine joined the IMF on September 3, 1992; its quota is SDR 1.4 billion (about $1.8 billion). Its outstanding use of IMF credit currently totals SDR 2.0 billion (about $2.6 billion).

Press Release No. 99/20, May 27

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
May 24	3.33	3.33	3.79
May 31	3.34	3.34	3.80

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 (as of January 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 113.7 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 or check the IMF website (www.imf.org/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

Conference on reform

On May 28–29, the IMF's Research Department hosted a conference on key issues in reform of the international monetary and financial system, in Washington. Six papers were presented over the two-day event, as well as keynote addresses by Michel Camdessus, IMF Managing Director; and Jacob Frenkel, Governor of the Bank of Israel. IMF First Deputy Managing Director Stanley Fischer made concluding remarks.

The papers presented were

"The Euro, the Yen, and the Dollar: The Case for No Benign Neglect," Jean Pisani-Ferry and Benoit Coeuré

"Moderating Fluctuations in Capital Flows to Emerging Market Economies," Michael Mussa, Alexander Swoboda, Jeromin Zettelmeyer, and Olivier Jeanne

"When Capital Flows Come to a Sudden Stop: Consequences and Policy Options," Guillermo Calvo and Carmen Reinhart

"Is Greater Private Sector Burden Sharing Impossible?" Barry Eichengreen

"Refocusing the Role of the IMF," David Lipton

"The Role of IMF Advice," Takatoshi Ito

The next issue of the *IMF Survey*, dated June 21, will cover the proceedings of this conference.

Photo Credits: Denio Zara and Padraic Hughes for the IMF, pages 177, 178, and 181–85; Cris Bouroncle for AFP Photo, page 191.

Copper still plays significant role in Chilean economy

Over the past decade, Chile's economic performance has been distinguished by strong growth and increasing diversification. However, copper has long been a chief determinant of the country's fortunes and still plays a significant role in the economy. In the 1990s, the mining sector and the rest of the economy each grew at an average annual rate of 8 percent—the result of two distinct impetuses: massive capital inflows, which fueled a rapid expansion of production in the mining sector, and profound structural reforms and a stable macroeconomic environment, which spurred growth in the remainder of the economy.

In *Copper and the Chilean Economy, 1960–98*, Antonio Spilimbergo examines the dynamic relationships between world copper price cycles and the Chilean business cycle. His study finds that copper prices influenced short-term fluctuations in the country and may also have had an impact on longer-term growth. With copper likely to remain an important element in the Chilean economy, correlations between copper price cycles and Chilean business cycles may have important implications for the country's policymakers.

Copper's role in the economy

Copper has played—and seems likely to continue to play—a significant role in Chile's exports and GDP, and to a lesser extent in its fiscal revenues. In 1997, for example, copper accounted for 42 percent of Chile's exports, with the mining sector, dominated by copper, accounting for at least 8 percent of GDP. (Since copper-related industrial activity is not included in this estimate, the true impact of copper in the economy is likely to be underestimated in this figure.) CODELCO, the state copper company, contributed 3.6 percentage points to GDP in 1997 and accounted for more than 10 percent of the national government's revenues. Earlier analytical studies, which considered the long-term effects of the mining sector on real exchange rates, wages, fiscal revenues, growth, economic cycles, and inflation, all concluded that copper "has played a crucial role in the Chilean economy."

Impact: Short and long term

To determine the degree to which the copper price cycle is correlated with the Chilean business cycle, Spilimbergo examined the behavior of Chile's GDP and compared the evolution of the main components of GDP with copper price cycles.

For all three major copper cycles over the 1987–97 period, GDP growth in Chile peaked three to six months after the peak of copper prices. All the components of GDP proved to be procyclical, but each component exhibited a somewhat different pattern around the cycle.

Investment, Spilimbergo notes, is the most consistent with, and sensitive to, the copper price cycle. In all cases, it peaks one quarter after the copper price peaks. On average, fixed investment grew by more than 30 percent on a four-quarter basis at the peak of the cycle. "In particular," he stresses, "investment in machinery, which is mostly imported, surged at virtually the same rate in both cases for which the data are available." Imports, which are highly correlated to investment and the consumption of durable goods, show a pattern similar to that of investment.

For *exchange rates*, the effects of copper cycles on exchange rates are also strong and correlated with the copper cycle. In each cycle during this period, the nominal exchange rate appreciated (or depreciated less) during the booms and depreciated (or appreciated less) when copper prices declined. On average, the turning point corresponded to the peak in the price of copper and preceded by one or two quarters the peak of the business cycle. Foreign currency inflows increased in the early phase of the copper cycle—a direct result of higher copper revenues and an indirect effect of increased foreign investment. Both factors put upward pressure on the exchange rate, which appreciated until copper prices peaked. When copper prices declined, the appreciation of the real exchange rate slowed until it stabilized about one year after the peak of the cycle.

The exchange rate pattern also helped shape the inflation rate behavior. When the real exchange rate appreciated during the first phase of the cycle, inflation declined rapidly. When copper prices fell and the rate of appreciation slowed, inflation stopped declining in two cases and rose sharply in one case in 1989. Inflation always declined when copper prices increased, but inflation did not rise when copper prices dropped. This asymmetric behavior, Spilimbergo suggests, may reflect an asymmetric response of monetary policy to the copper cycle.

Real wages exhibited a quickening of the rate of growth as copper prices increased, which may reflect, Spilimbergo theorizes, both an increase in nominal wages and a slowing down in inflation, given the use of a backward-looking indexation mechanism. Real wages typically slowed after copper prices peaked. The rise in real wages during the first phase of the cycle may also explain the increase in private consumption that is observable one or two quarters after the copper cycle peak.

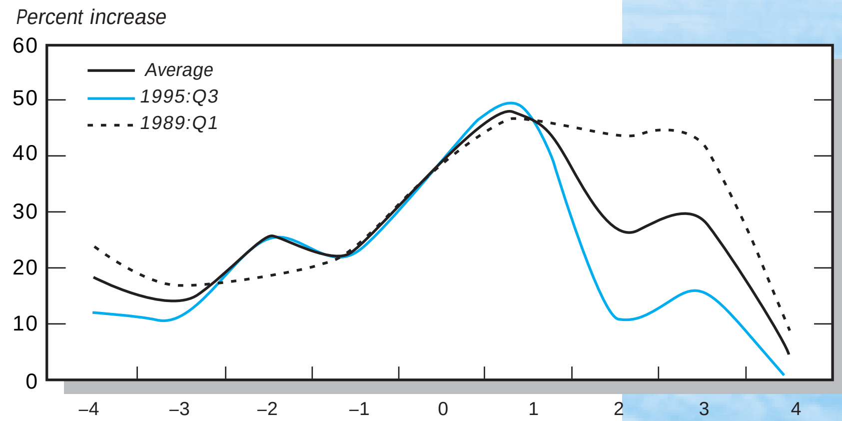
In terms of the longer-term implications of the copper price cycle for Chilean growth, Spilimbergo's data suggest that exports may affect long-run growth, particularly through investment (which in turn affects imports). While private consumption is little changed by copper price trends over the long run, Chile's fiscal position has historically improved sharply when copper revenues swelled. In the 1990s, however, Chile's extensive structural reforms have tended to diminish the dependency of the country's fiscal accounts on copper.

How copper influences the business cycle

After finding strong evidence of a correlation between copper cycles and Chile's business cycle, Spilimbergo

Fixed investment in machinery, fourth-quarter growth

Distance from copper price peak



Data: IMF, *Copper and the Chilean Economy, 1960–98.*

Copper mining in Chile

In 1971, Chile nationalized its large copper mines, which at the time were owned chiefly by U.S. multinationals. By the end of the 1970s, Chilean government-owned mines accounted for 85 percent of national copper production.

In 1974, however, Chile created a legal framework for foreign investment in the mining sector and in 1980 readmitted foreign investment in large new mines. It also adopted a fiscal regime that provided incentives for foreign investment in the mining sector (foreign investors are subject to no royalty payments and are eligible for reduction in their tax burden through accelerated depreciation).

Between 1974 and 1989, foreign investment in the mining sector grew by an annual average of $90 million. By 1990, the annual growth in foreign investment in the mining sector was $803 million. With more than half of all the foreign investment in Chile between 1989 and 1995 going into the mining sector, the share of large private mines in total output rose to 54 percent in 1996 from 6 percent in 1980. By contrast, the share of CODELCO, the state copper company, in total output shrank to 39 percent from 84 percent over the same period.

tested the means by which this effect could be transmitted. He found that

• There is no evidence of long-term changes in consumption growth due to changes in copper export growth, thus ruling out a wealth effect. By contrast, real wages did increase when copper prices rose—a product either of the correlation between a rise in the price of copper and a decline in inflation or of the availability of greater public sector resources during copper booms and higher nominal wage increases.

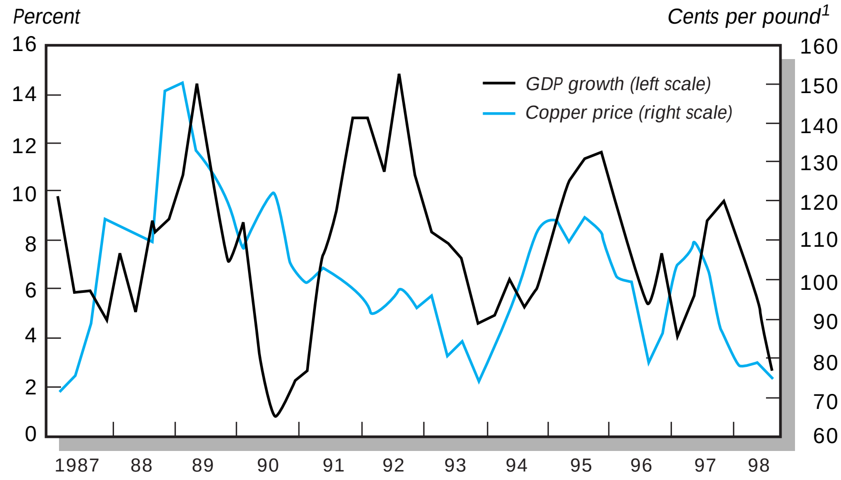
• New investment is attracted when higher copper prices are, or are perceived to be, permanent. Foreign direct investment in Chile surged during copper cycle peaks and was concentrated in the mining sector.

• Chile, aided by prudent macroeconomic policies throughout the 1990s, wisely administered copper export revenues and avoided the rent-seeking behavior that was a widely experienced consequence of high commodity prices and surging capital inflows in other countries.

• The monetary effects of the copper price cycle tended to bolster Chile's efforts in the 1990s to limit the size of the current account deficit. Monetary policy was more expansive in the first phase of the copper cycle, when the current account improved, the exchange rate appreciated, and inflation declined. By contrast, monetary policy grew more restrictive in the later phase when copper prices declined, the current account position worsened, the exchange rate depreciated, and inflation did not go down.

• Copper cycles have also been very relevant for the fiscal balance, even though their importance has been decreasing thanks to the development of alternative sources of revenue and the introduction of the Copper Stability Fund.

Fourth-quarter GDP growth and real copper price



[1]In constant terms.

Data: IMF, *Copper and the Chilean Economy, 1960–98*.

Copper still matters

Ultimately, Spilimbergo concludes, copper prices have important implications for short-term fluctuations in the Chilean economy and also are likely to exert an influence on long-term growth. Among the many mechanisms through which copper prices affect the economy, investment appears to play the most significant role. The exchange rate appreciation that high copper prices have triggered has also favored the central bank's policy of progressive disinflation. According to the study, the fastest gains in the disinflation policy have been obtained when the copper price was increasing. The central bank tended to use periods of decreasing copper prices to consolidate gains in disinflation. Also on the positive side, there is little evidence of a correlation between the copper price cycles and booms in either consumption or share prices.

Copper has played, and is likely to continue to play, a key role in the Chilean economy. But Spilimbergo emphasizes that the reasons for Chile's success in the 1990s are many and go well beyond the development of the copper sector. Increased macroeconomic stability and diversification have served Chile well and have been the product of sound policies and sustained and far-reaching structural reforms. ■

Copper production

Almost half of the world's known reserves of copper are concentrated in two countries: Chile (28 percent) and the United States (17 percent), according to the 1998 U.S. Geological Survey. Copper production is even more highly concentrated, with Chile accounting for 34 percent of production, and the United States accounting for 17 percent. The long-term prospects for copper production are expected to be good, although copper faces increased competition from optic fibers in the telecommunication industry and from aluminum in the construction and automotive industries.

Copies of IMF Working Paper No. 99/57, C*opper and the Chilean Economy, 1960–98*, by Antonio Spilimbergo, are available for $7.00 each from IMF Publication Services. See page 180 for ordering information. The text of this and other IMF Working Papers can also be found on the IMF's website, www.imf.org.

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