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EXECUTIVE SUMMARY

In the aftermath of the global financial crisis the priority of policymakers around the world is to revive economic growth. With limited scope for expansionary macroeconomic policies in many countries, boosting growth through ambitious structural reforms will be required. In responding to the crisis the Fund has deepened its surveillance of structural policies relating to the financial sector.

Our report addresses two crucial questions for future Fund surveillance: Should the Fund's surveillance work venture further into the domain of structural policies and if so, how should the Fund go about it? Our goal is to identify the macro-critical structural policy areas that are most relevant to the Fund's member countries in the aftermath of the crisis.

We use three criteria to determine which structural policies would be appropriate for an enhanced role for the Fund. First, in the context of the country the policy should be macro-significant, in the sense that it should be important for macro sustainability. Second, the policy should currently be under-emphasized by the country authority and other international agencies. Third, the policy should be reasonably proximate to the Fund's existing capacities.

Using our three criteria, we identify five specific structural policies that would be appropriate for enhanced Fund surveillance: curtailment of rent-seeking; reform of public sector accounting; utility regulation; tax reform; and pension reform.

We suggest a change in the modalities designed to increase the influence of Fund surveillance. These can be summarized as practical examples, menus, partnerships, and broader local engagement. We present some illustrative examples that apply our approach to country surveillance.

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INTRODUCTION

1. For most of its history, the International Monetary Fund has had to restrain inflationary biases in macroeconomic policies against a background of strong global growth. In consequence, its surveillance work reflected this priority. In the run up to the Great Recession, strong growth in the OECD countries appeared at last to have become compatible with low inflation. Manifestly, Fund surveillance was too benign during this period. The crisis revealed that unmanageable imbalances had been accumulated without countervailing responses being put in place. The two immediate priorities were therefore to deal with the consequences of the abrupt unwinding of these imbalances and to correct the regulatory weaknesses that permitted them to arise. For the Fund's surveillance work, advising on and encouraging the working out of imbalances was familiar territory. But strengthening the regulatory framework took the Fund further into the domain of structural policy: specifically, that concerning the financial sector.

2. Unfortunately, each of these policies has been deflationary. In aggregate they have severely curtailed growth in the OECD countries, while eliminating inflation as a short- and medium-run policy concern. This has profound implications for the Fund's surveillance work. The Fund has recognized that in present conditions its traditional stance of urging more rapid fiscal and monetary consolidation would be unwarranted: The priority of governments now is to revive growth. But with the overhang of imbalances leaving little room for expansionary macroeconomic policies, the only remaining policy options are structural. Should the Fund's surveillance work venture further into the domain of structural policies and, if so, how should the Fund go about it? These are the questions addressed by our Report.

3. We will suggest that the Fund should cautiously take on some structural issues. However, going beyond the Fund's well-practiced domain requires caution. The Fund lacks both the resources to acquire the wide range of expertise that would be necessary to be comprehensive, and the mandate that would justify the resources that would be required. Instead, we recommend the selective addition of expertise on structural issues. Our criteria are consistency with the Fund's existing mandate, and likely value-addition to current national and international provision of expertise. We see considerable scope to redeploy resources from current activities whose importance has diminished.

4. Through its surveillance work the Fund is seeking to influence policies. We suggest that if the Fund is to take on new structural issues it will need to change its style of engagement in order to have real influence in these areas. The Fund's comparative advantage is in knowledge of practical country-level experience with policy change. Yet it is not presently organized so as to provide this knowledge efficiently. The influence of advice is increased by preserving a degree of freedom of choice. Hence, we recommend that instead of concentrating on a single 'optimal action', where possible the Fund present options each supported by country experience.

THE FUND'S MACROECONOMIC MANDATE AND STRUCTURAL POLICIES

A. The Mandate and its Implications

5. **At the core of the Fund's surveillance mandate is the maintenance and restoration of macroeconomic sustainability.** That a macroeconomic situation has become unsustainable is eventually made manifest through crisis, which forces radical policy change. The form of the crisis may be either financial or political. In a financial crisis, the government or the commercial banks run out of funding, or the central bank runs out of foreign exchange. In a political crisis, the government loses the authority to sustain its core economic policies, due to opposition either in parliament or on the streets. Financial crises are triggered by shifts in the beliefs of asset holders, political crises by shifts in the beliefs of citizens.

6. **Our mandate is to consider only structural policies, as opposed to macroeconomic policies.** The former are concerned with the efficiency and distributional consequences of the incentives facing economic actors. They are intrinsically long-term. The latter are concerned with matching aggregate demand to aggregate supply and are intrinsically short term. However, it is evident that the two classes of policy are interdependent. Poor structural policies can lead to a macroeconomic situation that becomes unsustainable unless rescued by responsive macroeconomic policies. Conversely, poor macroeconomic policies can sometimes be rescued by responsive structural policies. For example, aggregate demand policies in the Eurozone since 2008 have chosen to deleverage debt exclusively through real adjustments. When the nominal adjustments that are more conventionally adopted as part of macroeconomic crisis management are excluded, the burden of resolution can take many years and be extremely costly. The structural policies which were appropriate under pre-2008 conditions may have become inappropriate under these new macroeconomic conditions. If so, choices in macroeconomic policy will have driven the need for changes in structural policy. However, structural policies affect long-term growth rates and so should not be determined primarily by short-term macro considerations.

7. **Structural policies affect both individual and collective risks.** A country's macroeconomic position could become unsustainable either because a country's own structural policies were imprudent, or because its existing policies became unviable due to the cumulative spillovers from the structural policies of other countries. For example, the reform of a country's corporate taxation policy can reduce its risk of accumulating unsustainable debt. But equally, tax receipts in some countries may decline because other countries adopt corporate tax policies which undermine the collective ability to raise taxes from corporations. In turn, this implies that the Fund has two potential roles in respect of surveillance of structural policies: Alerting particular members to the build-up of vulnerabilities in their own economy, and alerting the collective membership to emerging systemic risks to the global economy. Both types of structural issue fall within our mandate and we consider them in turn.

B. Structural Policies

8. Poor structural policies can lead to macroeconomic outcomes that are financially or politically unsustainable. Those structural policies that increase the risk of a financial crisis work through the persistent accumulation of unmatched liabilities. An example of a structural policy that creates substantial financial imbalance is the specification of the start of entitlement to a state pension in terms of a particular age, rather than relative to average life expectancy. Each decade life expectancy rises by over two years, and in much of Europe all of this has been added to the burden of pensions. A second example is the securitization of mortgages by investment banks in the United States which delinked information about creditworthiness from the ultimate lenders. Fund surveillance should have been more vigorous in warning against these policies.

9. Those structural policies that increase the risk of a political crisis work through generating or permitting the persistent divergence of living standards from accepted norms. Such divergence can be relative to other countries considered as peers, or relative to other groups within the country. People may quite reasonably expect to stay 'within the pack' of countries they consider as peers, such as neighbors. For example, such peer groups may be the Eurozone; China-India; Australasia; Canada-USA; and North Africa. Persistent divergence from peer countries is liable to force radical policy change. While this may lead to the reform of structural policies, it may alternatively risk the resort to populist macro policies. For example, the disaffection in Argentina due to persistent divergence from Chile has induced macroeconomic populism rather than structural reform.

10. Divergence within countries can be due to changes in the distribution of income or wealth. An appropriate political concern is the relationship between median income and GDP. Median income is likely to be the focus of political attention as parties set policies so as to attract the median voter. Divergence in wealth can occur because of the effects of shocks in the context of large differences in net asset positions. Persistent divergence in incomes or wealth risks political polarization, inability to cooperate on essential macro policies, lack of social cohesion and resort to populist policies. For example, Raghuram Rajan has suggested that persistent economic polarization in the United States has reduced common interests, contributing to gridlock and flirtation with debt default. [3]This divergence is thus a risk to macroeconomic sustainability.

11. Although our analysis is primarily focused on surveillance at the level of individual countries, the Fund is one of the few organizations with the mandate and reputation to advise on policies that affect the global economic system. The most salient example of how poor systemic structural policies can create macroeconomic risks is the inadequate regulation of the financial sector. There is a reasonable case for attributing the inadequacies revealed by the Great Recession to the cumulative consequences of competition between financial centers to lighten the regulatory burden, resulting in a regulatory race to the bottom. We do not consider this particular

[3] Raghuram Rajan (2011), "Washington and the Art of the Possible" April 4.

global structural policy further since, although still unresolved, it is already prominent and the Fund has been an active proponent. We do, however, include global issues among the structural policies we recommend for the Fund's attention.

C. Meta-Surveillance at the Country Level

12. The Fund's country-level surveillance role can only be effective to the extent that its guidance has influence at the country level. In some countries this is particularly difficult because a legacy of history is that the Fund is regarded with a degree of suspicion. For example, following the East Asian financial crisis of 1997/1998, fear of the loss of sovereignty implied by a formal Fund program helps to account for the huge accumulation of surpluses in the region (a response which, in the event, proved to be globally destabilizing). Similarly, in parts of Africa, Fund advice is unwelcome.

13. The Fund can neither undo history nor tailor its advice to that which is palatable. However, it needs a strategy for such situations. This is the role of meta-surveillance. By this we mean that the Fund should promote the creation of domestic institutions which themselves fulfill the surveillance role.

14. One example of such a domestic surveillance institution is the recent establishment of independent Fiscal Councils, exemplified by the Office of Budgetary Responsibility in Britain.[4] The members of Fiscal Councils are respected technocrats independent of government who report directly to parliament and the general public. To date, the impetus for such institutions has usually been policy failure. For example, in Britain, a new institution of surveillance was seen as useful to reestablish credibility in macroeconomic policy following a period of unsustainable policies during 2005–10. Reflecting this context of a need to live down past failure, the Fund promotes Fiscal Councils through its programs. New institutions adopted in some countries often get copied by others, but if Fiscal Councils come to be perceived as appropriate only in contexts of acknowledged failure, copying may be limited. Hence, we propose that the Fund encourage their establishment through its surveillance work as well as through programs.

15. A second example of meta-surveillance is utility regulators. In many countries, badly run and heavily subsidized utilities are an important structural source of macroeconomic stress.[5] However, in order to attract credible commercial operators of utilities, governments need regulatory institutions that are effective and independent.

16. A third example is central banks. While traditionally central banks tended to be inward-focused adjuncts of government, in most OECD countries they are now sufficiently independent to take a much higher public profile, reporting directly to the general public and issuing their own

[4] See IMF (2013) "The Functions and Impact of Fiscal Councils" and IMF (2013) "Case Studies of Fiscal Councils - Functions and Impact" for extensive discussion of Fiscal Councils in practice.

[5] See IMF (2013) "Case Studies on Energy Subsidy Reform: Lessons and Implications."

forecasts. But such an approach still tends to be the exception globally, and the Fund could encourage the new norms to spread.

17. In summary, the Fund should try to disseminate the virtues of policy oversight and become less necessary at the country-level by encouraging a wide range of domestic institutions of surveillance.[6] There is less scope in respect of systemic surveillance, although the work by the OECD to counter base erosion in corporate taxation is an example of the potential for partnership.

SPECIFIC STRUCTURAL POLICIES THAT WOULD BE APPROPRIATE AND INAPPROPRIATE FOR FUND SURVEILLANCE

18. We use three criteria to determine which structural policies would be appropriate for an enhanced role for the Fund. All three should hold to justify Fund involvement.

- **Macro-significant**. First, in the context of the country the policy should be macro-significant in the sense that it should be important for macro sustainability. Many structural reforms may be desirable but, if they are not macro-significant, the Fund does not have a mandate to be concerned about them.

- **Underemphasis**. Second, the policy should currently be under-emphasized by the country authorities and other international agencies. Structural policies usually require a reasonable knowledge of local context and this gives the national authorities an advantage. If the national authorities are already on top of an issue, Fund involvement is an unnecessary duplication. Similarly, some topics are better suited for other agencies.

- **Proximity**. Third, the policy should be reasonably proximate to the Fund's existing capacities. Otherwise, the Fund would require substantial resources to become sufficiently expert, and even then might lack credibility.

19. We defer discussion as to how the Fund should best engage on these issues until Section 4. Engagement with a new structural issue would not be appropriate in every country; nor should it necessarily imply a major increase in in-house capacity.

20. Using our three criteria, we indentify five specific structural policies that would be appropriate for Fund surveillance. There are other areas that might also be appropriate. But in the five areas we identify we see potentially significant value added in terms of analytical work and

[6] The Fund's new Fiscal Transparency Assessment (FTA) instrument for evaluating countries' fiscal transparency practices based on a revised draft of the IMF's Fiscal Transparency Code (FTC) is a welcome step in the right direction in this area.

efficiency gains from policy reform in the current economic context. We also give an example of a structural policy that, although important for macroeconomic performance, would not be appropriate for Fund surveillance.

A. Curtailing the Rent-Seeking Sector

21. Rent-seeking occurs where powerful vested interests are able to generate activities in which private returns massively exceed social returns. Such activities reduce growth and increase inequality. In many OECD economies such activities have expanded substantially to the extent that their costs are macro-significant. However, while particular vested interests are periodically tackled, the phenomenon has not yet been recognized for what it is. The problem posed by rent-seeking has been under-emphasized and the Fund has an important opportunity to generate a common countervailing pressure.

22. The concept of rent-seeking was pioneered by Anne Krueger and Jadish Bhagwati and initially applied to lobbying for trade protection.[7] However, the range of applications is much wider. Law firms engaged in complex corporate tax avoidance are purely rent-seeking, with gains to the companies that hire them entirely financed out of the loss of tax receipts to governments. There is no presumption of any gains in efficiency: On the contrary, governments are probably driven to resort to more distorting taxes. Similarly, the development of predatory law suits for patent infringement is not merely rent-seeking, but presumably deters innovation. In the financial sector there has been a huge expansion recently of so-called "high-frequency trading" (HFT). [8]All gains to the practitioners of HFT have counterparts of losses to conventional market participants.[9] Not only is there no net gain in efficiency, country authorities have suggested to us that by lowering the returns to genuine market activity there is a net loss.

23. In recent years these activities have expanded enormously due to the interaction of the internationalization of business and deregulation. In some countries they are now major components of the economy. Rent-seeking diverts resources into socially unproductive activities. It thereby augments measured GDP but reduces real incomes. Conceptually it is similar to deterioration in the terms of trade. By increasing the demand for very highly qualified workers, rent-seeking activities also increase inequality.

24. Such rent-seeking may have a further substantial opportunity cost. Legal and financial rent-seeking activities are usually highly complex and so draw in extremely scarce intellectual

[7] See Anne O. Krueger, "The Political Economy of the Rent-Seeking Society", American Economic Review, Vol. 64, No. 3, Jun., 1974, and Jagdish N. Bhagwati, "Directly Unproductive, Profit-Seeking (DUP) Activities", Journal of Political Economy, Vol. 90, No. 5, Oct., 1982.

[8] For an overview of HFT, see "Economist Debates: High-frequency trading," The Economist.

[9] In a new book focused on HFT, Michael Lewis claims that the market is rigged by HFT traders who front run orders placed by investors. ("Flash Boys: A Wall Street Revolt", Norton & Co., 2014). Lewis also questions the hundreds of millions of dollars spent on a new fibre-optic cable built to shave three milliseconds off the time to transmit orders between markets in Chicago and New York.

talent. The alternative home for such talent is in technological and organizational innovation where, in contrast to rent-seeking, the social return is likely substantially to exceed the private return. The curtailment of rent-seeking is a valuable structural policy because it shifts resources between sectors, from activities in which social returns are far below private returns to activities in which social returns exceed private returns.

25. Countering rent-seeking used to be a core activity of the Fund and one in which it had considerable success. For example, in developing countries the Fund promoted the switch from import quotas to tariff protection. The Fund has yet to promote analogous structural reforms in the OECD countries; however, there is considerable scope to do so. In our interviews with country authorities there was strong appetite for the Fund to take up the issue. An important point made to us was that because rent-seeking is protected by narrow but politically powerful vested interests, it is difficult to achieve reform without external support. Usually country authorities already know the contextual details of how rent-seeking might be curtailed. The Fund's role should not be to duplicate this knowledge, but rather to motivate action by estimating and revealing its costs.

26. In summary, countering rent-seeking will often meet each of our three criteria. In some economies rent-seeking is sufficiently costly that it has macro-significant consequences. It is clearly under-emphasized, with national authorities often finding it politically difficult to tackle vested interests, and no other international agency currently taking the lead. It is closely aligned with the Fund's core expertise: curtailing rent-seeking was indeed the first structural policy with which the Fund was concerned, the initial context being the removal of quotas on trade and foreign exchange in developing countries.

B. Reforming Public Accounting: from Liabilities to Balance Sheets

27. Currently, while commercial enterprises present their accounts as a balance sheet of liabilities and assets, many governments retain reporting conventions that present only the liability side of the balance sheet.[10] There is no economic rationale for this accounting convention but it is now inducing serious biases in public policy. Rather than adding to both sides of the balance sheet in order to increase solvency, many governments are vigorously reducing both sides of the balance sheet, a strategy which is liable to reduce solvency.

28. Reform of public accounting practices to bring them more into line with commercial practices would be macro-significant and timely both in particular national contexts and systemically. Global interest rates are likely to remain low for many years. These exceptional conditions (which are evident whether or not the thesis of 'secular stagnation' is accepted) are ideally suited for an internationally coordinated increase in public investment. International

[10] There are a number of exceptions: New Zealand, for example, publishes regular data about the size and structure of the State's portfolio of assets and liabilities. Assets include the value of real assets such as property, plant and equipment. For a very useful and comprehensive overview of data available on State balance sheets, see "Another Look at Governments' Balance Sheets: The Role of Nonfinancial Assets" IMF Working Paper 13/95, May 2013.

coordination would reduce the dangers of increasing international imbalances. Public investment would directly raise growth in the near term, and may also provide an indirect stimulus to private investment. In addition, public investment would enhance the long-term productive capacity of the economy. As such, the current underinvestment in public capital is clearly an important structural issue. Crucially, at prevailing interest rates there is little danger that public investments would not more than pay for themselves. Hence, with proper accounting, an increase in public investment would enhance government solvency by improving the balance sheet.

29. The proper presentation of public accounts is a core macro function of the Fund. Indeed, until the Fund addresses the bias in current accounting practices, it is difficult to see how reform might occur. Moreover, should such presentation reveal that solvency is impaired, it would allow an appropriate scale of adjustment or resolution of the fiscal issues to foster an orderly process of recovery. The Fund should consider as a matter of urgency encouraging governments to report changes in balance sheets in annual budgets.[11] This may, but need not, be a precursor to full balance sheet presentation of public accounts.

30. In summary, reforming public accounting meets our three criteria. Its effects would be macro-significant systemically and in some national contexts. Despite being important, it is not generally under active analysis by authorities, and no other agency is as well placed as the Fund to tackle it. Indeed, without Fund involvement it is unlikely to happen.

C. Utility Regulation

31. The regulation of utilities has important macroeconomic implications. Directly, these work through the ability to attract private finance for infrastructure and the need for fiscal subsidies to utility users. Indirectly, the reliability and pricing of utilities has significant consequences for the structure and growth of the economy. It is a politically sensitive area with citizens often inclined to populism.

32. Despite its importance, utility regulation is still a relatively recent aspect of economic governance. As a result, no international agency has consistently provided global expertise, although periodically the World Bank has done so from a microeconomic perspective, while the Fund has focused on the fiscal implications of utility mispricing. Yet mispricing is a consequence of mis-regulation and this higher-level issue has not been consistently owned by any institution. This is an area where both governments and citizens would benefit from the comparative perspective that the Fund could provide. While it would not be appropriate for the Fund to develop a major pool of independent expertise, this is a prime example of the need for genuine and effective collaboration with other institutions, such as the World Bank and the OECD. We return to this issue below.

[11] These reforms could be facilitated by an accelerated implementation of the Government Statistics Finance Manual (GSFM) 2014.

33. In summary, utility regulation meets our three criteria. In some national contexts, mis-pricing is so severe as to have macro-significant implications for budgets. Authorities seldom analyze the issue from a unified perspective which considers both macro and allocative implications. While collaboration with other agencies is essential on this topic, a unified analysis by the Fund would bring clear value.

D. Tax Reform

34. Tax policy and capacity is fundamental to macroeconomic sustainability. It is both a macroeconomic policy because it determines revenue and a structural policy because it affects the distribution of income and resource allocation. The Fund already has core expertise in tax policy but it could be enhanced in two respects.

35. First, the Fund might shift the weight of its tax surveillance from macro to structural concerns: that is, from the implications of taxation for aggregate revenue to its implications for growth and distribution.[12] In many OECD countries since the crisis the corporate sector has accumulated surpluses while curtailing investment. In aggregate this behavior has weakened growth and impeded the reduction in fiscal deficits. Increased taxation of profits combined with larger incentives for investment might have discouraged corporate accumulation of liquidity. Similarly, in some OECD countries there has been a persistent increase in household inequality. Revenue-neutral changes in the tax system could have shifted the tax burden to higher income groups by making the income tax schedule more progressive and placing more reliance on property taxes.[13]

36. Second, tax policy is an issue on which the Fund can make an important contribution not only at the country level but systemically. The Fund might usefully shift the weight of its tax policy surveillance from individual country authorities to the international system.[14] In particular, the internationalization of companies has left national corporate tax systems exposed to base erosion. The OECD has taken the lead on this issue but, while Fund technical work is already supportive, there may be considerable scope for a more vigorous partnership.[15] Country authorities have stressed to us that the Fund has a unique power of access and authority. International cooperation

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[12] The Fund is already actively engaged in research in this area. For example, the 2012 IMF Working Paper "Tax Composition and Growth: A Broad Cross-Country Perspective" explores the relationship between the mix of taxation and long-run growth, while the October 2013 Fiscal Monitor includes a review of the literature on tax composition and growth. See also the 2012 Fund Working Paper "'Fiscal Devaluation' and Fiscal Consolidation: The VAT in Troubled Times."

[13] The Fund's stock of work on the relationship between fiscal policy and growth is growing. See, for example, Laurence Ball, Davide Furceri, Daniel Leigh and Prakash Loungani (2013), "The Distributional Effects of Fiscal Consolidation," IMF Working Paper No. 13/151.

[14] Fund surveillance could draw in part on recent Fund research on this topic; for example, "Spillovers on International Corporate Taxation", IMF Policy Paper, May 2014. This paper explores the nature, significance and policy implications of spillovers in international corporate taxation.

[15] See, for example, OECD (2013), "Action Plan on Base Erosion and Profit Shifting," OECD Publishing; and OECD (2013) , "Addressing Base Erosion and Profit Shifting," OECD Publishing.

on corporate taxation is inherently difficult because of the evident incentives for a race to the bottom. Hence, beyond its technical work, the Fund could use its advantages to cooperate politically with the OECD in promoting common action.

37. In summary, systemic tax reform, with integrated revenue and allocative considerations, meets our three criteria. With so many countries struggling to increase revenue, it is manifestly macro-significant. While the OECD is now leading on the systemic issue of base erosion and profits shifting, the topic is of such importance relative to the public resources available to the OECD, that Fiscal Affairs Department should be taking a more prominent role.

E. Pension Reform

38. Pensions are macro significant: They are major liabilities of the state and major assets of households. Pension policies are subject to a systematic bias because, while their political consequences are immediate, they generate costs that only become apparent in the distant future. An example is the reluctance to set the retirement age relative to life expectancy.[16] The Fund therefore has an evident role of countering excess generosity in pensions, somewhat analogous to its earlier role in countering excess money printing (a battle which was won by the meta-policy of giving central banks greater independence).[17]

39. As with taxation, pension policy is both macro and structural. Governments in crisis may resort to pension reforms which reduce macro-liabilities in ways which inefficiently inflate risks for households. For example, whereas pension benefits defined in real terms shift too much aggregate risk from households to the state, individual 'defined contribution' schemes not only shift aggregate risk to households, but create individual risks arising from market volatility.

40. As with rent-seeking, the appropriate role for the Fund may be to do sufficient work to quantify the costs of current policies, while presenting a range of alternatives only lightly sketched, by means of examples drawn from policy reforms in other countries. Much of this could be done in partnership with other institutions such as the ILO and the OECD.

41. In summary, pensions are such substantial government liabilities that policy errors can readily create macro-significant imbalances. Because these liabilities are slow to mature, even if reform is necessarily, it is unlikely to be salient. While Fund surveillance would need to be in partnership with other agencies, the Fund would bring added credibility and urgency to the issue.

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[16] For an excellent summary of recent IMF research on equity issues relating to pension systems and pension reforms, see Benedict Clements, Frank Eich and Sanjeev Gupta (2014) "Equitable and Sustainable Pensions: Challenges and Experience."

[17] The Fund has undertaken a considerable amount of work in this area. Recent examples include: "Pension Reforms in Japan," IMF Working Paper No. 12/285; "Reforming the Public Pension System in the Russian Federation" IMF Working Paper No. 12/201: and "Which Expenditure Saving Should France Consider?" IMF Country Report for France No. 13/252, Selected Issues, August 2013.

F. An Inappropriate Structural Policy: Labor Market Reform

42. Evidently, there are many structural policies on which the Fund could potentially become involved. Many of these are excluded because they do not meet our first criterion of macro-significance; for obvious reasons we do not list such policies. However, one structural policy, namely labor market reform, is undoubtedly macro-significant yet it does not meet our other two criteria of being under-emphasized and being proximate to the Fund's current expertise. In the 'peripheral' Eurozone, where unemployment has recently risen to politically unsustainable levels, the reform of labor markets is undoubtedly salient. The Fund cannot be wholly disconnected from these central policy debates, but we are wary of a substantial role for reasons we now discuss.

43. First, labor market reform is always complex and highly context-specific. Policies need to trade off the objectives of short-term allocative efficiency, long-term investment in firm-specific skills, household security, and income distribution. The Scandinavian approach of 'flexicurity' has enabled allocative efficiency to be reconciled with security. The German approach of worker representation on boards has contributed to the country's impressive record of investment in firm-specific skills. The United States and Britain both have flexible labor markets but their radically contrasting experience during the recession cautions against simple policy prescriptions. U.S. firms raised productivity by aggressive labor-shedding, while British firms preferred to accept reductions in productivity by protecting employment. This important difference is yet to be properly understood, though it may be due to differences in macroeconomic policies, with Britain using currency depreciation and temporary inflation to reduce real wages.

44. Labor market reform is an active area of economic analysis in universities and think tanks, both internationally and in the countries in which unemployment is a problem. The Fund lacks the expertise to engage meaningfully in this well-researched and highly complex area. An important criticism made by country authorities is that the Fund does not cooperate with, or even reference the work of, other agencies.

45. Second, labor market reform is politically extremely sensitive. The Fund is widely perceived as being unsympathetic to organized labor and this perception, whether reasonable or not, can be an impediment to reform. In one peripheral Eurozone country, Fund surveillance recommended a salary pact which included, among other things, a substantial reduction in nominal wages. This external intervention provoked anger and may have made reform more difficult. We discussed a successful labor market reform with the country authority and their assessment was that Fund work had been 'relevant but not a key input'.

46. Third, the extraordinary rise in youth unemployment in the peripheral Eurozone, which clearly threatens the political sustainability of policy, is not due to sudden deterioration in labor market policies. Rather, it is due to the adoption of unconventional macroeconomic policies that the Fund would usually have discouraged. The fiscal response has been pro-cyclical rather than counter-cyclical; nor has it been combined with expenditure switching policies. These have placed all the burden of labor market adjustment on nominal wage reductions. Such reductions are necessarily uncoordinated and therefore extremely slow, in contrast to the coordinated real wage adjustments achieved through exchange rate adjustment. The Fund's core role in addressing the crisis of youth unemployment is not to acquire expertise in labor market policies, but to challenge these unconventional macroeconomic policies. An analogy is the Fund's successful role in orchestrating a depreciation of the CFA Franc after a decade of damaging political resistance.

THE FUND'S MODE OF OPERATION IN SURVEILLANCE OF STRUCTURAL POLICIES

47. Successful Fund surveillance begins with pertinent analysis but it ends in effective influence. If the Fund's surveillance does not result in influence it has failed regardless of whether it correctly foretold macro crisis. For the Fund's surveillance of structural policies to be influential it is important to adjust its mode of operation in four respects.

A. The Power of Practical Examples

48. The knowledge advantage of the Fund is not academic: it is its global practical experience. Country authorities have emphasized to us that what influences them are dispassionate and detailed expositions of successful and unsuccessful policy reforms in broadly comparable countries. The Fund is uniquely well-placed to provide such expositions since in the course of its surveillance work it gets direct knowledge of policy reforms. Academic economists usually do not have the necessary access to policy makers who have implemented reforms, and they lack the incentive to write up descriptive case studies.

49. Since its knowledge of global practical experience is the Fund's key surveillance asset, it is troubling that the primary issue highlighted by the Report on Interviews concerning knowledge and data management is that this specific type of knowledge is not coherently organized by the Fund so as to be retrievable by country teams other than the one which first acquires it. This is evidently a serious limitation on the effectiveness of surveillance. One reason why it has not been adequately addressed is that the deficiency has been incorrectly diagnosed as one of inadequate information technology. Yet the essence of the problem is that within the Fund knowledge of country experience is a public good. As such, individual staff and country teams have insufficient incentive to provide their knowledge for other teams. In other words, the root of the problem is HR not IT. As such, it can only be addressed by changing the incentives facing Fund staff. Related to this, country authorities have expressed to us concerns that Fund staff are over-inclined to proffer econometric studies written up in 'selected issues' papers that, while career-advancing, are not valued by country authorities.

B. Propose a Menu of Options, not an Optimal Policy

50. Influence is increased by the preservation of choice on the part of the recipient of advice. This is a corollary of the well-researched psychological phenomenon of 'reactance,' whereby people try to reestablish autonomy by resisting pressure for any specific course of action.[18] Although in its surveillance work the Fund relies upon influence rather than overt pressure, it needs to be particularly conscious of reactance. Partly, the Fund unavoidably exerts pressure during its surveillance because its growth projections effectively pass public judgment on current policies.

51. Further, its other mode of operation, formal programs, explicitly relies upon the pressure of conditional money. In consequence, recipients of Fund advice are liable to feel pressured unless the Fund goes out of its way to reconcile the adoption of its advice with freedom of action. A clear indication of these concerns comes from the interviews conducted with country authorities as discussed in the Report undertaken as part of the TRS. The interviewers noted that several country authorities did not like the summary assessment of *compliance* with past IMF recommendations in the related box in Article IV consultation reports because they saw it as 'backward looking' *and even somewhat demeaning*.' (our italics). The concept of 'compliance' is fundamentally incompatible with the preservation of choice, and in our view inappropriate for the role of influence intrinsic to surveillance.

52. Further, structural reform seldom has a unique solution. More commonly, a range of possible approaches may be viable, each involving the weighing of distinctive costs and benefits which will determine which among them is optimal. Depending upon the structural policy and the context, much of this detailed work may not be the comparative advantage of the Fund. The Fund may be more influential if it uses its authority to insist that the maintenance of a particular structural policy risks becoming macro-unsustainable (whether due to financial imbalances or political unacceptability), while preserving freedom of policy choice through proposing a menu of possible reforms each of which would potentially be sustainable. Even where the Fund believes that one particular choice would be optimal, its mandate does not give it the authority to pressure for the adoption of that policy. Its mandate is to guard against those structural policies that pose significant risks of becoming macro-unsustainable. Judgments as to which of a range of structural policy choices is optimal are often politically contentious and therefore potentially dangerous territory for the Fund. The Fund should only venture into politically contentious issues where it has good reason to believe that macro-sustainability is at stake.

C. Partnership

53. Structural issues usually fall partly into the domain of other international institutions, such as the World Bank, the OECD, and the ILO. The Fund is seen by country authorities as being reluctant to build effective practical partnerships with these institutions. The structural issues we have selected all have important macroeconomic dimensions which the Fund is best-placed to analyze, but this analysis is best integrated into complementary analysis of the implications for resource allocation and income distribution undertaken by other agencies. We recognize that the capacities of some other agencies currently fall short of those required for timely, substantive, and

[18] Brehm, J.W. (1966), "A theory of psychological reactance," New York: Academic Press.

dispassionate analysis. However, capacity is endogenous to the opportunities to use it. Through its Article IV consultations the Fund has uniquely privileged access to senior levels of government, and by sharing this opportunity with other agencies it can provide them with an incentive to build the required capacities.

54. Specifically, we suggest that the Fund orchestrate the development of cross-agency task forces on specific structural issues. These task forces would provide a standing capacity on which Fund surveillance staff dealing with a particular country authority could draw when they felt that a particular structural issue had become macro-significant.

D. Engagement with Domestic Actors

55. Since Fund surveillance work must be judged by its influence, it will often be good practice to engage with a wide array of domestic actors. The Fund generally scores well on this front through its broad engagement with relevant policy stakeholders and experts in both surveillance and programs, but there is scope to build on these efforts. Country authorities have suggested to us that sustained engagement with local experts both within and outside the civil service is helpful, and that, often, engagement with a wider group of political actors, notably parliaments, is also valuable. For example, on the issue of rent-seeking, the country-specific nature of these activities means that the insights of locals would be very valuable to the Fund in identifying areas that deserve attention.

E. Benefits of our Suggested Approach

56. Where Fund structural advice is persistently ignored and in consequence the risk of a macro-unsustainable outcome mounts, at some point Fund surveillance has a responsibility to 'blow the whistle' by going public with its concerns. Whistle blowing has most chance of success if it has been preceded by a consistent application of our suggested approach: a menu of alternative options; partnerships with other agencies; and engagement with a wide group of domestic actors.

57. Further, since surveillance is concerned with reducing risks before they have escalated to full-blown crisis, there is invariably a range of policy responses that can return the economy to sustainability. Both arguments lead to the conclusion that, whereas it is essential that the Fund spell out clearly why it regards current policies as posing unacceptable risks so that policy change is necessary, it should suggest a menu of possible responses rather than a single preferred option. The menu approach preserves freedom of choice for the government and so avoids reactance, while enabling it to claim ownership of whatever policy change it adopts, albeit supported by an 'endorsement' from the Fund as to its appropriateness. Indeed, the wider the range of policy choice that the Fund provides, the more convincing is its central message that the current policy configuration poses unacceptable risks of macroeconomic crisis. If it offers only a single policy it can appear that its core desire is not to avert crisis but to get its preferred policy adopted, whereas with a menu approach the Fund can appear neutral over a wide class of alternatives. If each of these policies is capable of averting crisis it further benchmarks the lack of wisdom in the current policy configuration.

APPLYING OUR APPROACH TO COUNTRY SURVEILLANCE: SOME ILLUSTRATIVE EXAMPLES

58. Necessarily, any discussion of how our suggested approach might have been applied in practice is hypothetical. However, by sketching what it might imply in specific contexts some of the strengths and limitations may be revealed. It enables us to contrast our approach with the surveillance that has actually occurred. We focus on a few episodes where there is some reason to suppose that either structural policies were generating risks of being macro-unsustainable or macro policies were liable to become unsustainable unless salvaged by changes in structural policies. In some cases the risk that core policies would become unsustainable arose because they were directly exposing the country to the risk of financial crisis as imbalances accumulated. In other cases they were directly exposing the country to the risk of political crisis from which populist macro policies might ensue. The political stresses were being generated by persistent social divergence, whether from international peers, or between groups within the country.

59. In each illustrative example, we first sketch the reason to fear that the macroeconomic stance would be unsustainable. We then set out how one or other of our proposed structural policy reforms could help. We then show that in the particular context including the issue in Fund surveillance would have met our criteria. Finally, we speculate on whether our suggested modalities would have enhanced the prospects of influence.

A. United States: Median Income Stagnant Since 1970

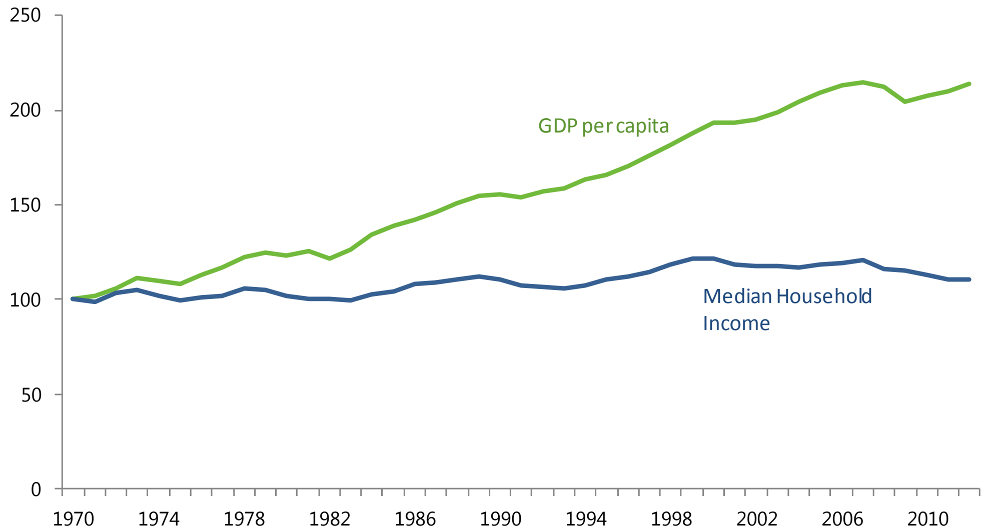
60. Uniquely in the OECD, the United States has persistently failed to provide a policy environment for rising median real incomes. While internationally this is probably sustainable since U.S. citizens are not accustomed to adverse comparisons with other societies, there is mounting internal pressure since the stagnation of median incomes has coincided with substantial growth in GDP. As shown in Figure 1, real GDP per capita has risen substantially since 1970, while real median household income has been largely flat.

61. As noted above, some analysts have suggested that the disastrous expansion of housing loans to those unable to service them, and the political gridlock that resulted in the loss of America's AAA credit rating, both reflect social divergence.

62. The literature points to a number of causes of the divergence between real GDP and median real income that do not concern the structural policies which we have suggested for enhanced Fund surveillance. These causes include skill-biased technical change, globalization, immigration, de-unionization, and minimum wage policy. However, the causes of a problem need have no logical connection to its solution. One of the structural policies that we suggest would be appropriate for Fund surveillance is pertinent for a solution.

Figure 1. U.S. Median Household Income & Real GDP per capita

(Index 100=1970)



Source: U.S. Census Bureau and Bureau of Economic Analysis

63. Part of the divergence between median income and GDP may be because of deterioration in the mapping from GDP to real incomes. An expansion of rent-seeking would have such an effect. In recent decades the U.S. economy has experienced a striking growth in rent-seeking activities. According to data from the Bureau of Economic Analysis, the profits of the financial sector grew to account for nearly a third of corporate profits. It is implausible that its services to the directly productive sectors enhanced their productivity by nearly 50 percent. The legal sector has facilitated the declining taxability of corporate profits and has introduced predatory practices into patent law. Since the expansion of the rent-seeking sector increases the demand for high talent, it also increases inequality. While public policy has permitted the expansion of rent-seeking activities, alternative policies could have curtailed them.

64. In the U.S. context, rent-seeking meets our three criteria. In recent years rent-seeking has expanded to a scale that is likely to be macro-significant. While particular manifestations have attracted spasmodic attention, they have not to date been conceptualized around a unifying framework such as rent-seeking provides. As a neutral international actor, the Fund is well-placed to inject the concept into domestic debates.

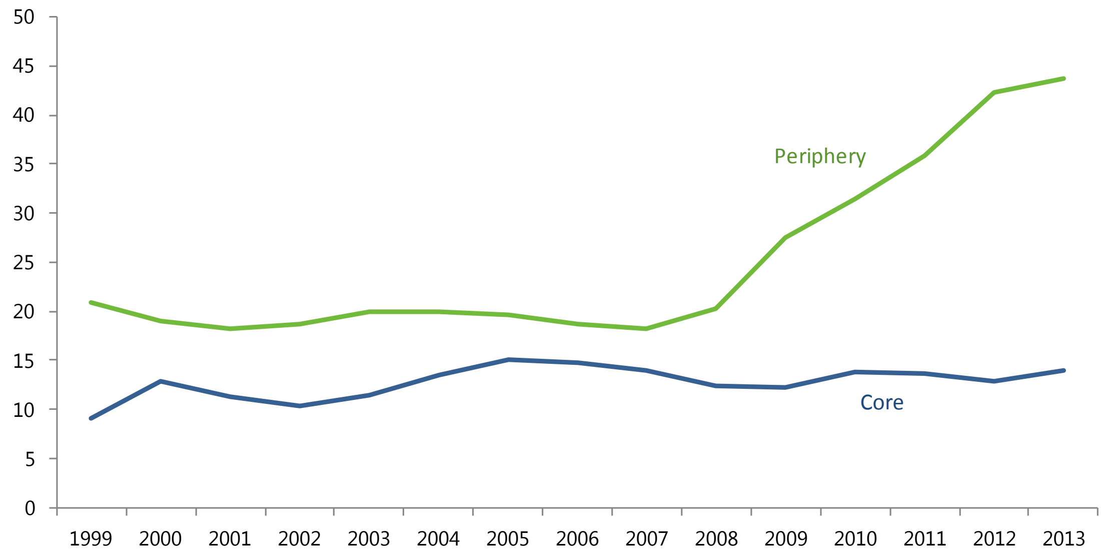
65. The Fund has not yet engaged with the U.S. authorities on rent-seeking. However, from our discussion with the U.S. authorities, Fund work on the issue would be welcomed. Promotion and quantification of the concept of rent-seeking is seen as having the potential to be particularly valuable. Further, some of the rent-seeking opportunities have arisen from state-level policies which are beyond the control of the federal authorities. Fund input that had the potential to influence these policies is seen as particularly valuable.

B. Southern Europe Since 2008: Exploding Youth Unemployment

66. The problem of youth unemployment in the Eurozone provides a stark example of unsustainable divergence between countries in a peer group. As shown in Figure 2, rates of unemployment among the young in the peripheral Eurozone countries have soared over the course of the Great Recession, while rates in the core countries have remained flat.[19]

Figure 2. Euro Area Core and Periphery, Youth Unemployment Rates

(Percent)



Source: Eurostat

67. Youth unemployment rates of 40–50 percent are undoubtedly radicalizing rates of unemployment, and the crisis is already fuelling a surge in support for anti-EU populist parties.[20] The euro area is not on a sustainable path, with the periphery facing the prospect of a substantial deskilling of a large cohort of the young population. Empirical evidence points to the importance of learning-by-doing effects in the accumulation of human capital. A large number of unemployed

[19] Core country aggregates were computed using Germany, France and the Netherlands, while peripheral country aggregates include Greece, Ireland, Italy, Portugal and Spain.

[20] Some commentators argue that labor market conditions in the periphery are even worse than indicated by the rate of unemployment. For example, Münchau argues that because of discouraged-workers effects, the employment rate (that is, employment as a percent of the working-age population) is a better measure of conditions. He points out that the employment rate in Greece has dropped from 61.4 percent in 2007 to 51.3 percent in 2012. For Spain, the corresponding numbers are 66.6 percent and 56.2 percent. "Confidence is a poor measure of economic health," Wolfgang Munchau, Financial Times, April 27, 2014.

young people in parts of Europe are at risk of "unlearning-by-not-doing," with serious implications for growth and social stability both in the near and medium term.[21]

68. This radical divergence in youth unemployment cannot be accounted for by changes in labor-market policies over the past few years. Rather, as mentioned earlier, this unsustainable divergence reflects inappropriate macroeconomic policies at the euro-area level. Both fiscal and monetary policy in the euro area have failed to provide sufficient support to aggregate demand, against a backdrop of substantial deleveraging in the public, corporate, household and financial sectors.[22]

69. Moreover, because of the very low rate of average inflation in the euro area and the strength of the euro on foreign exchange markets, the necessary adjustments in intra-euro-area exchange rates between countries using the single currency are being delivered not through rapid nominal adjustments but through slow painful real adjustment in the periphery. This adjustment process is driving divergence in labor-market outcomes. To tackle this divergence, either macroeconomic policies need to change direction or policies in other areas need to compensate. Put simply, labor-market policies in Europe are not the cause of the divergence in rates of youth unemployment since 2008, and therefore they are not the solution. That is not to say that the Fund should ignore issues relating to the efficiency of labor markets in Europe. On the contrary, the Fund should continue to recognize problems in the functioning of labor market and bring them to the attention of policymakers. But the Fund should not have a substantial role in trying to solve these problems. However, our view is that there are macro-focused structural policies that could improve the situation.

70. First, with long-term interest rates at historically low levels both in the core and in most of the peripheral euro area countries, there would appear to be a strong case for a targeted euro-area-wide program of public investment.[23] Over the course of the Great Recession, public investment in the euro area has declined from about 2.5 percent of GDP in the mid-2000s to 2 percent in recent years. The fall has been driven by sharp declines in public investment in the periphery, while investment in the core countries has held up.[24] Interestingly, the authorities from one peripheral euro area country expressed the view that public investment in that country had been cut too much, notwithstanding the large budget deficit. To the extent that a bias in public

[21] See Mai Dao and Prakash Loungani (2010) "The human cost of recessions: Assessing it, Reducing it," November, for a summary of the literature.

[22] For a discussion of deleveraging across different sectors in Europe, see various chapters in IMF (2014) "Jobs and Growth: Supporting the European Recovery."

[23] Ahearne and Wolff (2012) argue that a natural area for common public expenditure is where clear European spillovers and externalities exist. For example, the ongoing energy transition is such an area where an ambitious European strategy would be beneficial. See Ahearne, Alan and Guntram Wolff (2012) "The Debt Challenge in Europe" in Transatlantic Economic Challenges, edited by Jacob Funk Kirkegaard, Nicolas Véron and Guntram Wolff.

[24] Real public investment in Germany in 2012 was about unchanged relative to 2008, compared with drops of more than 60 percent in Greece, Ireland and Spain, roughly 50 percent in Portugal, and 25 percent in Italy.

account practices against public investment rules out such a spending program even being considered, then reform of public sector accounting in Europe to include assets could be very important.

71. In addressing the issue of divergences in youth unemployment in the euro area, reforming public sector accounting meets our three criteria. European policymakers appear to have underestimated the amount of fiscal space available at the euro area level and as a result fiscal policy has been unnecessarily contractionary, with macro-significant consequences. Unfortunately, the country authorities in Europe continue to emphasize gross liabilities in making decisions about budgetary policy, without reference to the asset side of the balance sheet. The Fund could therefore make a very valuable contribution by steering euro area governments and the EU Commission towards the proper presentation of public accounts.

72. Second, rent-seeking activities depress productivity and international competitiveness. It follows that rent-seeking in the euro area periphery is hindering the macro-significant intra-euro-area adjustment process. If rent-seeking can be reduced, some of the pressure on downward nominal wage adjustment as a way to improve competitiveness within the euro area can be eased.

73. The country authorities from Europe with whom we met were generally enthusiastic about the prospect of the Fund including both these structural issues in its surveillance work. They agreed that to maximize influence in these areas, the Fund should apply our suggested approach as outlined in the previous section. In particular, European countries currently do not present estimates of general government non-financial assets as part of their budgetary reporting. Indeed, in most cases, such estimates do not even exist at present. The Fund could work in partnership with the European Commission to include the national balance sheet (or, at least, annual changes in the balance sheet) as part of the mandatory reporting under the European semester cycle. The Fund has already gained valuable experience of working with EU institutions through its membership of the EU/ECB/IMF Troika for program countries.

74. Several European authorities made the point to us in our discussions that the Fund, by providing evidence and advice on rent-seeking, could support reform-minded politicians and civil servants in their efforts to tackle harmful vested interests. The idiosyncratic and often opaque nature of rent-seeking across European countries means that engagement on this issue with domestic actors who have local knowledge about such activities will be crucial. Our interlocutors from Europe agreed that, having identified and measured the costs of rent seeking, our suggested menu approach based on practical examples of what has worked and not worked in other countries could be very persuasive.

C. Ghana Since 2007: Unsustainable Structural Policies

75. Ghana's growth story provides two episodes that illustrate the potential of unsustainable structural policies to create divergence and unacceptable economic outcomes. The first began with a huge program of spending on infrastructure development, including on education and public institutions and enterprises. The program was designed to underpin the governance of a newly independent state with the ambition to catch up ("stay in the pack") with a peer group of developing countries (Korea, Malaysia and Singapore). The consequence was unsustainable populist macro policies, a prolonged period of economic decline, a cycle of military interventions and unmet aspirations. Ghana fell, and is still far behind, those peers, in per capita income and living standards, although it was to later embrace the tenets of sound policies. This underscores the critical importance of macro-significant structural policies for long-term sustainable economic progress.

76. The second episode is clearly manifested in the most severe bout of macro instability to hit the economy since 2007. The economy has suffered from mounting fiscal pressures, rising inflation and renewed currency instability over the last two years. We see this as a case where specific structural policy measures in the public sector could have better supported macro sustainability over time rather than foster a macro crisis.

77. During the first episode, quite remarkably, Ghana implemented a series of programs under Fund surveillance and financial support which were widely acclaimed as successful. The result was macro stability, rapid growth, better social indicators and an improved business climate. Sound policies helped pull the economy out of a public-debt trap and Ghana gained access to the international capital markets in 2007. The programs of reform placed a strong focus on budgetary and exchange rate policies, dismantling widespread price and exchange controls fraught with rent-seeking, and on getting prices right. But it also meant implementing other wide-ranging structural measures (for example, exchange and trade liberalization, privatization, and repair of the financial sector) that set the foundations for steady and stable growth.

78. However, the antecedent to the second episode was that macro-critical structural problems in the public sector were not addressed in a fundamental manner as part of the reforms. The Fund's approach, and obviously one acceptable to the authorities, focused on short-term fiscal measures: setting budgetary targets to restrain the public sector wage bill relative to GDP, and adjusting prices and utility tariffs and subsidies primarily to promote fiscal consolidation. The underlying growth of government liabilities, public wage policy, and structural balance sheet problems of key public enterprises in the energy and utilities sectors remain, and they have proven to be potent macro-significant sources of fragility and the main triggers of renewed macro instability.

79. The recent oil find and production, in principle, also brightened Ghana's resources and growth prospects. However, following the onset of oil revenues, the authorities have recently introduced major adjustments in the salary structure that seeks more to establish equity and fairness than to align compensation with productivity and efficiency in the delivery of services. The consequence is that the wage bill has ballooned to the point where it is absorbing over two-thirds of government revenue and is a threat to sound fiscal policy, with government resorting to external borrowing to finance the deficit. Quasi-fiscal deficits of the public enterprises also amplify the risks, due to mis-pricing of utilities and subsidies and inadequate regulation. It is pertinent to note that we see this as an example of a case where a full risk assessment would benefit from a public accounting of liabilities and assets in a framework of the sort we recommended earlier in this paper.

80. As regards our approach, we would ask three questions. First, whether the Fund could have given greater attention to the reform of the public sector as a central policy issue, and as well to regulations governing private participation in the utilities sector to open it up to competition and efficiency? Second, could the Fund have offered a menu of options for discussion with the wider public, albeit against a clear set of objectives that the Fund could support from the perspective of long-term fiscal sustainability? Third, would the transparent use of the power of example from global experience and the power of persuasion have turned any perceived stakeholder resistance and public opinion into support for reform in such a very macro-significant policy area? Arguably, it would be difficult for the general public and therefore policymakers not to accept the promise of a public sector that would be modernized, efficient, and fiscally sustainable because that would have delivered institutions most able to serve as vehicles for 'staying within the pack' and avoiding divergence. One more general point is that this exemplifies the types of reforms which, while difficult, build economic resilience and bolster long-run macro sustainability and where the Fund could legitimately use of all its tools to exercise influence.

D. Ethiopia: a Public Investment Push

81. The Ethiopian government has raised the share of public investment in GDP to East Asian rates, while the country still has African savings rates. This evidently creates a significant risk of macro imbalance. However, Fund surveillance in Ethiopia illustrates the limitations of its current mode of operation.

82. The Fund's surveillance dialogue with the Government of Ethiopia is based on its debt sustainability analysis. Currently, in the Ethiopian context this imposes a ceiling on the present value of public sector debt payments. Based on this exclusive focus on the liability side of the balance sheet, the Fund has adopted a single, 'optimal' policy recommendation: namely to scale back public investment. Its core supporting analysis has been based on the theory of 'crowding out' of private investment, including the use of domestic bank credit for public investment, rather than on practical examples from other pertinent countries. It does not appear to have worked closely either with other international actors or a wide range of domestic actors. For whatever reason, Fund surveillance in Ethiopia appears to have triggered severe reactance. The Fund is very far from being an influential actor.

83. Our alternative approach would be to eschew a recommended policy and instead develop a menu of alternative ways by which the government's core objective of sustaining high public investment in infrastructure could be made macro-consistent. Domestic taxation could potentially be raised substantially from its current level of only 12 percent of GDP. Domestic savings could potentially be raised and switched from dysfunctional forms such as the accumulation of livestock, through the introduction of e-savings arrangements. Private investment could quite possibly be squeezed temporarily without impairing long-run growth, if the resources released are deployed for essential complementary infrastructure for subsequent investment, notably power generation. The Fund indeed has a macro-model which suggests that this can be sensible. Public investment projects could be designed so as to be eligible for project finance. Finally, sovereign borrowing may be sensible if ring-fenced for investment, and there is potential for IBRD finance linked to project finance. Such a menu would enable the government to assess the costs of its marginal projects without feeling that its fundamental objectives were being threatened. In each case, the Fund would illustrate the option with practical experience: for example, e-savings have already become important in Kenya, bringing in partner agencies wherever feasible.

84. In combination, the Ethiopian and Ghanaian examples illustrate the advantage of adopting a balance sheet approach instead of a focus only on increments to gross liabilities. The policies of both governments involved large increases in gross liabilities. However, whereas the Ethiopian strategy was to match these liabilities with productive assets, notably electricity generation, the Ghanaian strategy was to borrow to finance increases in recurrent public spending such as the hike in public sector wages. Using the common language of deficits to critique these different policies exaggerated the dangers of the one, while understating those of the other.

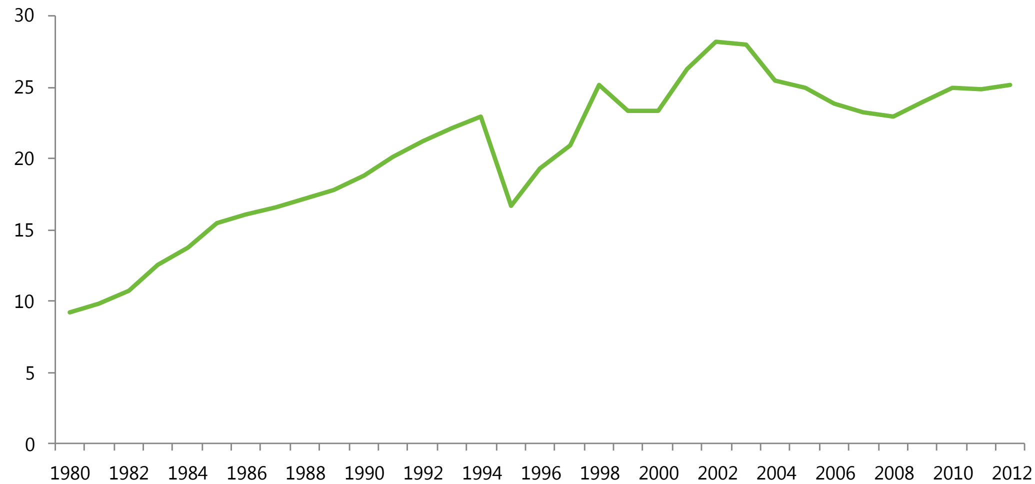
E. South Africa: Why Labor Market Reform is an Inappropriate Issue for the Fund

85. South Africa has a stable and relatively sophisticated emerging market economy with a successful record of macroeconomic stability and managing short-term vulnerabilities. However, it has a labor market in which past policies that sought to protect the apartheid governance system proved unsustainable. GDP growth accentuated divergence and political intolerance.

86. An array of structural policies has been targeted over the last two decades under the new democratic dispensation to address the legacy of labor market segmentation and dualism in formal and informal employment and create jobs. Still unemployment is around 25 percent (Figure 3) and income inequality (Gini of 0.68) is one of the highest in the world today.[25] The persistence of such high structural unemployment and income inequality is macro-significant and a well-recognized source of continued divergence and risks to the political sustainability of policies.

[25] Youth unemployment is around 40 percent.

Figure 3. South Africa Unemployment Rate
(Percent)



Source: International Monetary Fund, October 2013 WEO

87. Fund surveillance has had a mixed record from a policy perspective. On the one hand, South Africa has made considerable economic and social progress. The policy framework and institutions have delivered a globally integrated and diversified economy, with growth rates that have increased GDP per capita by 40 percent. In addition, social assistance has helped reduce the poverty rate by 10 percentage points to 31 percent in 2013. The Fund and the authorities have developed a convergence of views on what are 'optimal' macroeconomic policies; this has bolstered market confidence and underscores the power of influence.

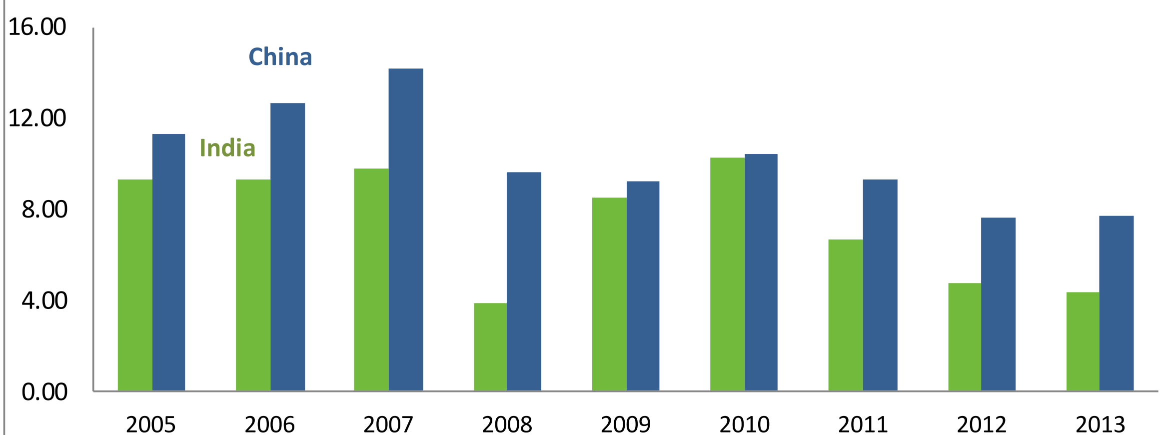
88. On the other hand, Fund advice on a wide range of structural issues and specifically on labor and product market reforms including wage bargaining, labor taxation, and trade unions, has had but limited influence as assessed in the latest round of the Surveillance exercise. We take this to mean that influence has not gone much beyond analysis and recommendations and into significant policy actions

89. This case, in our view, illustrates an involvement in a structural policy area—labor market reform— where the Fund is not strategically well-positioned to be effective. The issues involved are complex and deeply embedded in the social and economic fabric, which insider stakeholders have a strong interest to preserve. The Fund could exercise influence on reform in this area, if at all, not so much by the traditional consultation process, but by facilitating the engagement of interested parties in a dialogue to build domestic consensus for change. Using our menu approach we would offer two options. First, the Fund could agree to exclude formal discussion and advice on labor and employment issues but report the authorities' views candidly in the Surveillance exercise. We believe that approach would focus attention consciously on the authorities' own policies on the issues. Second, the Fund could provide concerted support, in cooperation with expert groups, to seek a negotiated domestic solution to what is fundamentally a political problem and to catalyze financing for it, if needed, in a way analogous to financing macro-policy adjustments. Choosing the first option would remove any perception that Fund endorsement of domestic macro policies, when views are seen to converge, might also suggest that the Fund considers the stark divergences within the country are of a much lesser macro-significant risk. Choosing the second would strongly signal the importance that the Fund attaches to mitigating the huge risk that persistent divergence on the scale still prevailing in the country poses for the sustainability of policies.

F. India Post 2010: Sharp Growth Slowdown to Below Acceptable Rate of Growth

90. India's unexpected slide from near double-digit growth rates during much of the past decade to below 5 percent over the past couple of years shows remarkable macroeconomic fragility and the risk of divergence from peer economies in Asia, particularly China, and from reasonable expectations (Figure 4). These relatively low rates of growth are not sustainable. Neither the political system nor financial markets, who until recently praised India as part of the fast-growing BRIC group of countries, will tolerate persistently low growth.

Figure 4. China and India: Real GDP Growth
(Percent)



Source: International Monetary Fund, April 2014 WEO

91. This slowdown is attributed to a combination of external and homegrown causes. On the domestic front, the Indian authorities prevaricated on structural reform despite advance warning in the context of Fund surveillance and pressures from the financial markets. Second, investor confidence was damaged by uncertainty over future policies resulting from maneuvering of political parties looking for electoral advantage. Third, commentators point to an ongoing measure of dysfunction in governance. All these factors are thought to have acted as a brake on building a consensus to push through critical reforms to raise the growth of potential output (for example, by reducing barriers to inflows of FDI and the execution of infrastructure projects in key sectors, including energy).

92. It is generally accepted that, despite some success, the authorities in India have a considerable way to go in facing down rent-seekers.[26] Rent-seeking activities in India are undoubtedly weighing on growth of potential GDP and exacerbating income inequality. This is a policy area that has not attracted the attention it deserves from the Fund or other international agencies, in part because the Indian authorities have often preferred to try to deal with such structural issues themselves.

93. The regulation of utilities is another macro-significant structural issue for the Indian economy. Analysts have blamed structural problems in the power sector and in the allocation of natural resources for the slow progress in addressing infrastructure and supply-side constraints. In addition, energy subsidies continue to drag on the public finances.

94. The experience shows the importance of structural policies and consistency of policies for confidence and avoiding divergence. But we also see in this episode the lesson that knowing what the right policies are is not enough. Policymakers may have different priorities. Thus, Fund surveillance might detect emerging problems and not be effective in influencing policymakers to take timely action, if at all, when there is no imminent crisis in the short-term horizon.

95. The question arises as to how the Fund can most effectively influence policymakers in India. We note that in our meeting with the Indian authorities, we met considerable resistance to our proposals for the Fund to take on some structural issues. This reaction reinforced our view that adopting our menu approach, which would likely meet with less resistance than a single policy action, is the best way for the Fund to have influence. Moreover, examining these issues in India will likely attract less controversy if they are part of the standard Fund surveillance in many countries.

CONCLUSIONS AND RESOURCES IMPLICATIONS

96. The Great Recession induced a sharp drop in global private investment. With fiscal positions severely constrained, there is little scope for macroeconomic stimulus. As a result, global growth is expected to be weak for several more years. It is therefore natural to look to structural policies as a means of restoring growth and employment. Most structural reforms would take time to have an effect but, since low growth is liable to persist, this lag is not a reason for not doing reforms. We believe that there is considerable scope for structural reforms to raise incomes.

[26] For example, John Kay argues that "[i]n modern India, rent-seeking takes the form of endemic corruption and the crony capitalism that describes too-close relationships between big business and the state." Financial Times, November 20, 2012. See also the discussion in Lal, Deepak, 2011, "India's Post-Liberalisation Blues" World Economics, Vol. 12, no. 4, October–December 2011.

97. The role of the Fund in encouraging and assisting in structural reforms is limited by its mandate. The Fund does not have the remit to offer general purpose economic policy advice. However, on a reasonable interpretation of the Fund's core function of guarding macroeconomic sustainability, some structural policies are pertinent. Poor structural policies can have effects which cumulate to political and financial crises, and good structural policies can avoid or remedy the crises that poor macroeconomic policies create.

98. While pertinence is a necessary condition for Fund involvement in a structural policy, it is not sufficient. Some structural policies, such as the quality of education, are too far removed from the Fund's core expertise to be appropriate. At the other end of the spectrum, some structural policies, such as fiscal and financial reform, are so central to macroeconomic sustainability that the Fund has long been expert in them. Here it has a vital role both at the country level and that of the international system.

99. We have suggested a few structural policies that are sufficiently close to current expertise that they would be feasible and useful extensions: pension reform; utility regulation; tax reform; the curtailment of rent-seeking; and the reform of public sector accounts to add assets to liabilities and so move from deficits to balance sheets. This last would not only be useful in particular countries, but could be helpful systemically in raising global growth.

100. We have also suggested a change in the modalities designed to increase the influence of Fund surveillance. These can be summarized as practical examples, menus, partnerships, and broader local engagement.

101. We do not envisage either the extension into selected structural policies, or the change of modalities, to require substantial additional resources. The additions should not usually be particularly resource-intensive, and there is considerable scope for resource redeployment. Building a stock of well-supported country experiences of policy change readily accessible to all staff should be a core function of the Fund. It requires redeployment from activities that are currently perceived by staff as career-advancing, but are not perceived by country authorities as being useful. As we noted, this is a matter of HR not IT. Effective ongoing partnerships with other agencies to put together standing task forces on the selected structural issues would radically reduce the need for extra Fund resources, while also increasing the influence of Fund-led surveillance. Finally, we should note that the issue of structural policies arises because traditional Fund work on countering inflationary biases in the world economy has become less important and looks likely to remain so for several years.