

IMF Publication

IMFSURVEY

International
Monetary Fund
VOLUME 31
NUMBER 20
November 4, 2002

www.imf.org/imfsurvey

IMF cuts growth forecast for euro area, urges compliance with Stability and Growth Pact

The IMF has added its voice to the debate over the euro area's Stability and Growth Pact (SGP), urging the three largest countries—France, Germany, and Italy—to rein in their fiscal deficits. It also trimmed its economic growth forecasts for the 12-nation monetary union and urged the European Central Bank (ECB) to adopt a bias toward lowering interest rates.

In its annual assessment of euro area economies, discussed by the IMF Executive Board on October 18 and published on October 29, the IMF said the region was still on track for recovery, but at a more gradual pace than previously forecast. "It's coming, but in our view, not until next year," said Michael Deppler, Director of the IMF's European 1 Department, which covers the European Union countries. The IMF fore-



cast euro area GDP to grow by 0.75 percent in 2002 and 2.0 percent in 2003. In a conference call with the press, Deppler said that inflation was expected to recede next year to about 1.5 percent. "Hence, given the downside risks to the recovery, in our view, a bias toward interest rate cuts is needed. This is the view of both the staff and the Board," he said. The euro, he added, continued to be undervalued, and so there was scope for further appreciation of the currency. The ECB has kept its main refinancing rate at 3.25 percent since November 2001. Growth in Germany, Europe's largest economy, was surprisingly weak. "Germany basically still needs to adjust to a shock—namely, unification—that has led to big increases in labor costs," Deppler said. The report, written as part of the regular IMF monitoring of members' *(Please turn to the following page)*

Interview with Timothy Geithner

Emerging market economies need stronger cushions for the bad times

Timothy Geithner took up the reins as Director of the IMF's Policy Development and Review Department in the fall of 2001. Before coming to the IMF, he served from 1988–2001 in the U.S. Treasury, most recently as Under Secretary for International Affairs. Laura Wallace spoke with him about what it was like to be in the IMF after working closely with it during the financial crises of the 1990s. She also asked him for his thoughts on crisis prevention and resolution and on the role of the United States and other major industrial countries in international decision making.

IMF SURVEY: The recent crisis in Latin America has shaken hopes that the international financial community finally has a handle—post-Asian crisis—on how to prevent and resolve financial crises. Aren't we making any progress?



Geithner: "It is important not to take refuge in the fact that much of the criticism of the IMF is ill informed and comes from opposite directions."

GEITHNER: We have made considerable progress. If you look around the world, you see countries that have invested in disclosing *(Please turn to page 339)*

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The core of the problem is the fact that the three largest countries basically haven't lived up to the rules.
—Michael Deppler

Credibility of euro area's SGP under strain

(Continued from front page) economies, said that there were nagging concerns about the performance of the euro area. "With the prospects of a slower recovery abroad and an appreciated euro curtailing external demand, sustaining growth requires a strengthening of domestic demand. Historically, however, domestic demand has tended to follow rather than lead recoveries."

Big 3 cause worries

The report said that the divergent underlying fiscal positions in the three largest economies of the euro area could further strain the credibility of the European Union's (EU's) SGP. The SGP, the fiscal framework for the monetary union, commits members to running budgets that are close to balance or in surplus in normal times, with the leeway to run deficits of up to 3.0 percent of GDP during downturns. "The core of the problem is the fact that the three largest countries basically haven't lived up to the rules," said Deppler. These countries' structural deficits remain in the 1.5 to 2.0 percent range and, as a result, the cyclical weakness of economic activity has pushed overall deficits close to, or above, the 3 percent of GDP ceiling.

At their October 18 discussion of the report, the IMF's Executive Directors endorsed a proposal that France, Germany, and Italy should commit to adjusting their underlying fiscal positions by at least 0.5 percent of GDP a year over the next few years until they reach close-to-balance structural positions. Such an approach would give needed fiscal credibility at both the national and areawide levels that could significantly curb the short-term negative demand effects of the adjustment, particularly if fiscal consolidation is anchored in expenditure reforms, according to a release on the Board's discussion.

Deppler said that the SGP's aim of a budget close to balance or in surplus was a good norm for the medium term because all of the countries in the euro area face steep increases in indebtedness arising from aging populations.

Labor reform needed

The IMF report said that the scope for boosting the euro area's potential output through structural reforms remains large. "Following eight quarters of subpotential growth, the agenda has become increasingly urgent to implement," the report said. Reforms are needed particularly in labor markets. "While productivity levels in Europe are fairly high in absolute terms, per capita income is much lower— about two-

thirds the level of the United States," said Deppler. "And this difference, in terms of the productivity performance versus the per capita income performance, is really rooted in different rates of utilization of labor, pointing to the need for Europeans to focus much more on labor market reforms."

With respect to the trade policies of the EU, Directors emphasized that, given its prominent role in world trade, the EU has a special responsibility to pursue liberal trade policies, including in agricultural products; improve access to developing country exports; and advance the agenda of multilateral trade liberalization. They welcomed the leading role played by the EU in the successful launch of the Doha round of trade negotiations and the priority given by EU trade policy to further liberalization and better trade rules in the multilateral context. They were encouraged that further escalation of transatlantic trade disputes, which could have undermined progress under the Doha round, has so far been avoided.

Directors considered that reform of the Common Agricultural Policy (CAP) should be a policy priority for the EU, given the costs it imposes on EU consumers, trading partners, and agricultural markets. The proposals under the mid-term review of the CAP, which involve delinking financial support from production, are a crucial first step in this direction, and determined political leadership is now required to pursue reform comprehensively, including by aiming to eliminate agricultural export subsidies.

Directors welcomed the EU's commitment to increase developing countries' access to its market and urged the EU to go further by being prepared to eliminate or reduce tariff peaks and tariff escalation, including on export products of interest to developing countries. In textiles and clothing trade, quota removals should be accelerated in order to help smooth the adjustment in both EU industries and in those developing country suppliers currently protected by the quota system. ■

Copies of the *Staff Report on the Monetary and Exchange Rate Policies of the Euro Area and the Trade Policies of the European Union* and *Selected Issues* are available for \$15.00 each from IMF Publications Services (see page 341 for ordering information). The *Staff Report, Selected Issues*, Public Information Notice, and a transcript of Michael Deppler's press conference call are also available on the IMF website (www.imf.org).

Geithner on financial crises

(Continued from front page) more, building more resilient financial systems and exchange rate regimes, and buying more insurance so that they have better shock absorbers against adversity. Those investments will have substantial returns in terms of reduced vulnerability. Already, financial markets are differentiating better among countries. But it's not realistic to expect a world without crises. We still see a number of vulnerable countries. The combination of large financing needs, the damage to credibility of past defaults or periods of high inflation, and the uncertainty that comes with political transitions are a formidable challenge, particularly in a less benign global economic and financial environment.

IMF SURVEY: *Is there any hope of coming up with a way to forecast crises, so that policymakers can move more quickly to head them off?*

GEITHNER: Most of the serious people who look at this question don't have a lot of confidence that we are going to find models that can predict crises with accuracy. We need to assume that we're in a world of substantial volatility and uncertainty. In this reality, the most promising reforms are those that encourage countries to put in place policies with stronger cushions—in terms of reserves, fiscal balance, liability-management strategies, and strong financial systems—as well as those that make the IMF better equipped to help countries deal with financial stress when it comes. Progress in these areas will, I believe, be more promising than putting vast resources into ever more sophisticated early warning models.

IMF SURVEY: *What is the IMF doing now that it didn't do before to prevent crises?*

GEITHNER: My sense is that there has been a lot of change over the past several years. For example, there is now a more systematic internal effort in place for continuous monitoring of vulnerabilities across the membership. The quality of the internal work on sources of risk and sustainability assessments is, I believe, better than that done anywhere else. There is also now more systematic use of diagnostic tools, like those in the Financial Sector Assessment Program and reports on standards and codes, to help strengthen institutions and policy frameworks. These changes have had a meaningful impact already, and they hold substantial additional promise.

IMF SURVEY: *What made the Latin American crisis different from the Asian crisis?*

GEITHNER: The past decade of financial crises under-

scored the lesson that, if you are a general, you don't want to think about future threats through the prism of your last war. In the 1990s, the causes of individual crises were remarkably diverse, from excessive exposures in private sector balance sheets to more classic unsustainable fiscal and debt positions. This is one reason why the IMF needs to have a stronger and more flexible set of instruments to deal with the diverse challenges its members face.

IMF SURVEY: *A recent in-house review said that our surveillance should be of higher quality, more focused, more effective. How can our advice have a greater impact on policies?*

GEITHNER: The effectiveness of surveillance depends critically on the quality of our advice. It depends on how much we can bring to the table in terms of practical and compelling solutions, framed with a well-grounded knowledge of the domestic political constraints on policymakers. It depends on our capacity to integrate the lessons from cross-country experience into our advice. And, ultimately, it depends on what our members are prepared to do. These key elements can't be achieved simply through better internal procedures and documentation guidelines in the IMF, though they can help.

IMF SURVEY: *To what extent is crisis prevention really a matter of politicians making the needed policy adjustments? And how can the IMF better adapt its policy advice to that reality?*

GEITHNER: An assessment of the political environment that surrounds economic policymaking is at the center of any decision that the IMF makes. The IMF has in its resident representatives and mission chiefs some of the best resources around to assess the political dimensions of economic strategies. But we can always do more to make sure we draw on outside expertise in making our judgments, including with more systematic dialogue with a broader cross-section of people in politics, finance, and civil society in the context of missions.

IMF SURVEY: *Assessments of countries' observance of international standards and codes are becoming increasingly resource intensive. Is it really contributing to crisis prevention? Without changing the size of the IMF, can we discharge this new mandate?*

GEITHNER: It's still early, but the initial reviews suggest that—particularly in the core standards (on data, fiscal, financial, and monetary policy transparency, and the Basel Core Principles)—mission chiefs, country



There is now a more systematic internal effort in place for continuous monitoring of vulnerabilities across the membership.
—Timothy Geithner

The better we are at explaining what we do and exposing people to the nature of the choices we have to make and the rationale for our decisions, the greater our credibility.
—Timothy Geithner

authorities, and the financial community have a growing appreciation of the value of these standards as diagnostic tools. As we move forward, however, we need to make sure the standards remain relevant, that assessments are as focused and concretely prescriptive as possible, and that we are equipped to do more systematic follow-up.

IMF SURVEY: At the Annual Meetings, financial leaders voted to move ahead on two new paths of crisis resolution—collective action clauses and a sovereign debt restructuring mechanism (SDRM). What are the next steps?

GEITHNER: We have a team of people working very hard to put together an operational design for the SDRM that can serve as a basis for further discussion with the IMF's Executive Board, the financial community, and emerging market issuers. We hope to have a concrete proposal ready for review by the IMF–World Bank Spring Meetings. As for collective action clauses, there is an active effort within the financial and official communities to agree on a set of model clauses that ideally would become market practice in New York and other jurisdictions. The hope is that this would encourage emerging market issuers to adopt these clauses.

IMF SURVEY: Cynics doubt these initiatives will be realized. What's your view?

GEITHNER: This is a very complicated area, with many failed previous attempts at innovation. But, more than at any point during the past 10 years or so, there is now more ambition for change, more political will, and more innovative thinking on how to design a better system and a stronger legal framework for dealing with unavoidable restructurings.

IMF SURVEY: The IMF recently announced new guidelines on the conditions it attaches to its loans. Will this change the way the IMF negotiates programs with borrowers?

GEITHNER: This initiative has already made a material difference in the way programs are designed and negotiated, the scope of conditionality, and the standards used to judge which measures are critical to a program's success. Across a significant part of the membership, there's been a substantial reduction in the number of conditions in IMF programs and an appropriate narrowing of the scope of IMF involvement. The guidelines themselves don't provide a simple guide to what is critical to the macroeconomic objectives of the program and what is not, and they will not by themselves engender ownership where it has been elusive, but they will help.

IMF SURVEY: How about those heavily indebted poor countries (HIPCs) that are receiving relief but now need a lot more money than originally anticipated, given weak commodity prices and the weak global economic picture?

GEITHNER: The HIPC framework was designed with a reasonable amount of flexibility to provide deeper relief at the completion point to make sure that debt relief can be increased to bring debt down to the levels targeted in the initiative. But it was not designed—and could not be designed—to insulate countries completely from the effects of future external shocks. The capacity to deal with those challenges was always going to depend more on policies adopted at the national level and, to some extent, on the size and concessionality of the rest of the aid envelope.

IMF SURVEY: What other changes would you like to see in the way the IMF goes about its business?

GEITHNER: The credibility of the IMF depends mostly on the quality of its people and the quality of the decisions we make in individual circumstances. The better we are at explaining what we do and exposing people to the nature of the choices we have to make and the rationale for our decisions, the greater our credibility. We need to make sure we deliver on the extensive reforms set in motion over the past several years, but we also need to make sure that we continue to focus on the core elements that most affect the effectiveness of our policy advice, the substantive elements of program design, and our financial instruments and capacity to confront crises. It is also important not to take refuge in the fact that much of the criticism of the IMF is ill informed and comes from opposite directions—that we are systematically too tough or too indulgent, too interventionist or too market fundamentalist. We are more aware than most about where we are vulnerable to legitimate concerns, and that recognition can help shape our agenda for change. We can find ways to be responsive to legitimate concerns, without embracing what's fashionable or expedient.

IMF SURVEY: Your department was traditionally responsible for evaluating the IMF's performance on policy advice and program design. How do you feel about the Independent Evaluation Office (IEO) and its first report on prolonged borrowing from the IMF?

GEITHNER: It's an excellent report. Much of what it says and much of what it recommends is sensible and valuable. If the IEO's future work meets this initial high standard then it can have a constructive impact on policy over time. Not everything in the IEO's reports is going to be perfectly calibrated and perfectly fair to the constraints that the IMF faced when

it made the decisions under review. But that would be a high standard for anyone to meet.

IMF SURVEY: You knew the IMF pretty well before you joined. What have you learned about it since coming here that has surprised you?

GEITHNER: I had a lot of admiration for the institution and its people from my previous life. I am now even more impressed by the quality of the people than I was before, and by the difficulty of the decisions we face on an ongoing basis.

IMF SURVEY: There has been some criticism that the U.S. administration got a bit too close to micromanaging the IMF when you were at Treasury. In hindsight, is there any truth in that?

GEITHNER: It's not good for the IMF to be perceived as deferring too much to the views of individual shareholders. On the other hand, it is a reality that the IMF's effectiveness depends on its capacity to engen-

der a broad consensus, not just among—but importantly among—the major shareholders. We need to find a balance. The IMF does not have a monopoly on good ideas, and neither does any of the major shareholders.

IMF SURVEY: Do quotas really matter if most decisions are taken by consensus?

GEITHNER: Since the Board tries to operate by consensus, individual chairs—including developing economies—can have a huge impact on the shape of the consensus. What matters is the quality of the idea, not just the number of votes. The effectiveness of the United States and the Group of Seven depends significantly on the quality of their ideas, the credibility of their proposals, and their capacity to engender support. When I was at the U.S. Treasury, we never had the capacity to move the consensus unless we were able to get a critical mass of countries, often from outside the Group of Seven to support the approach. ■

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—Timothy Geithner

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Other

Annual Report of the Executive Board, Financial Year 2002 (free)

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Köhler in the Maghreb

Stronger regional integration could help accelerate growth

Stressing the stimulus that regional economic integration can provide to the Maghreb's development, IMF Managing Director Horst Köhler called upon the leaders of Mauritania, Algeria, and Tunisia to enhance cooperation. The October 14–19 trip, which he undertook at the invitation of the three countries, marked Köhler's first visit to the area as IMF Managing Director. He hopes to visit Morocco in the foreseeable future. High on the agenda were steps the three countries could take to boost growth, create jobs, and reduce poverty and the role that the IMF could play in helping these countries achieve these goals.

One of Köhler's main messages to his hosts was the crucial role that stronger regional economic integra-

tion can play in expanding opportunities. In Algeria, he called upon all the countries of the Maghreb "to enhance economic integration in order to enlarge your markets, increase the region's attractiveness for invest-

ment, and accelerate growth." This, he said, would also position the region to enhance the collective benefits that the area could draw from its Association Agreements with the European Union.

While acknowledging that the Arab Maghreb Union, formed in 1989 by Algeria, Libya, Mauritania, Morocco, and Tunisia, has to date made slow progress, Köhler indicated to reporters in Tunis that, with the encouragement of the Maghreb's leaders, he and the IMF would pursue the question of regional economic integration. He urged the Union's leadership to "sit together and define a policy for better cooperation and better growth and job creation for their people."

For its part, the IMF has already taken a first step in this direction. In early 2002, it sent a fact-finding mission, at the invitation of the countries of the Maghreb, to identify obstacles to trade within the region and to suggest possible solutions. The mission highlighted the considerable scope for greater inte-

gration, pointing out that only about 1 percent of Algeria's total trade currently takes place with its Maghreb neighbors. Even for Tunisia, the most integrated of the area's economies, that total is still under 6 percent. IMF staff will be working with the Maghreb countries to create forums for greater coordination and for experience-sharing on trade and customs reform among the three countries.

Country priorities

Over the past decade, all of the countries of the Maghreb have made progress in achieving macroeconomic stability and strengthening growth. The IMF has been a partner in these efforts, providing policy advice, technical assistance, and financial support, including through its Poverty Reduction and Growth Facility.

But the region's policymakers face continued challenges if they wish to see their countries keep pace with an increasingly competitive global economy and if they hope to fulfill the aspirations of their youthful populations. Clearly, the pace of sustainable growth must quicken to bring about lasting improvements in social indicators—notably greater reductions in the region's high levels of unemployment—and structural reforms must be stepped up.

Mauritania. One of Africa's largest countries in terms of land area and also one of its most sparsely populated, Mauritania is in the process of opening up its economy and integrating it into the global economy. In Nouakchott, where he met with President Maaouiya Ould Sid Ahmed Taya, Köhler praised the strong progress the country has made under the latest of a series of IMF-supported policy programs over the past decade. He joined with President Taya in calling on advanced economies to move more quickly to open their markets and phase out trade-distorting subsidies.

Mauritania has recorded low inflation and robust economic growth, which has brought with it, most importantly, progress in reducing poverty. President Taya has made fighting poverty Mauritania's top pri-



Mauritanian Central Bank Governor Yahya Ould Attigh (left) with IMF Managing Director Horst Köhler.

ority, and the country's efforts have been strengthened by progress in the implementation of policies set out in its poverty reduction strategy paper, which established medium-term goals and described the steps that will be taken to achieve these. Mauritania has recently received \$1.1 billion in debt relief under the Heavily Indebted Poor Countries Initiative.

Major challenges remain, however, if the country is to boost growth and reduce poverty further. Key among important additional measures are continued efforts to improve public expenditure management (in part, to better target social and poverty-reducing expenditure) and improved operation of the foreign exchange market—an essential step if the business environment is going to play its crucial role in enhancing growth and reducing poverty.

Algeria. In discussions with President Abdelaziz Bouteflika, Köhler highlighted Algeria's success in restoring financial and monetary stability under difficult conditions. The country was moving in the right direction, he said, citing, in particular, the progress made in modernizing the economy with financial support from the IMF.

This progress should not distract attention, however, from the significant work that remains to be done. The sustained economic expansion needed to generate employment, reduce poverty, and raise general standards of living requires further structural reforms. Köhler underscored that Algeria's current strong fiscal and monetary position affords a window of opportunity to both pursue these reforms and expand the country's social safety net.

At the core of the needed reforms is a revitalization of the enterprise sector. Improved productivity and profitability, he said, are essential for faster economic growth. Among a number of critical steps to be taken, Köhler singled out the importance of developing a better regulatory environment, in a climate of greater transparency and accountability, to encourage private sector development. He noted, too, that restructuring and privatizing viable public enterprises, while treating employees fairly, would enable these enterprises to grow again, make profits, and export while relieving the treasury of the cost of supporting these enterprises.

Banking sector reform should complement these ambitious but vital measures. Given the key role that a modern financial system plays in financing productive investment, Algeria cannot afford to neglect the health and well-being of its banks. In this regard, Köhler welcomed Algeria's decision to request a systemwide analysis under the IMF's Financial Sector Assessment Program. This assessment will provide the country with the information it needs to further modernize its banking sector and ensure that Algeria's banks play an effective

role in the economy, including through increased lending to small and medium-size enterprises.

Tunisia. In a meeting with President Zine el-Abidine Ben Ali, Köhler congratulated him on the country's sustained economic growth and remarkable improvement in social conditions. Tunisia, he said, has benefited from its smooth integration into the global economy. It has succeeded in opening its economy and achieving export-led growth while maintaining macroeconomic stability. These outward-oriented policies have also been underpinned by a long-term strategy that has been notable for its successful investment in education and its effectiveness in developing infrastructure and institutions. This track record, Köhler emphasized, reflects the importance of national ownership of policies for ensuring the success of reform efforts.

But faced with stiff competition internationally and a fourth year of drought at home, Tunisia cannot afford complacency, Köhler cautioned. To preserve its achievements and make further progress, Tunisia must embark on a number of additional reforms, notably a further privatization of external trade, liberalization of the telecom sector, and a strengthening of its financial sector. ■

David Hawley
IMF External Relations Department

For additional information on the Managing Director's trip, please see IMF News Briefs Nos. 02/104 (October 9), 02/105 (October 17), 02/106 (October 17), and 02/108 (October 23). The full text of these is available on the IMF's website (www.imf.org).

Köhler congratulates Brazil's President-Elect

On October 28, IMF Managing Director Horst Köhler extended his congratulations and best wishes to Brazil's President-Elect Luiz Inácio Lula da Silva. The election, he said, affirms Brazil's vibrant democracy and presents "an historical opportunity to meet the economic and social aspirations of the people of Brazil."



Citing the organization's close working relationship with Brazil, Köhler also said that the IMF's management and staff look forward in the coming months to working with the new government "to help create the conditions that would lead to sustained growth in Brazil." In a letter to President-Elect da Silva, he

added that he hoped to meet with the President-Elect and his economic team at the first convenient opportunity.

The full text of News Brief 02/109 is available on the IMF's website (www.imf.org).

A new way of looking at exchange rate regimes

When it comes to exchange rate regimes, what countries say they are doing may not be what they are doing. In a detailed examination, Exchange Rate Regimes and Foreign Exchange Markets—Developments and Issues, IMF staff took note of this and employed a new classification system that better reflected actual policies since 1990. The study points to important, but less polarized than expected, shifts in exchange rate regimes; diminished interest in liberalizing the capital account; and a key role being played by the organizational structure of foreign exchange markets.

Any attempt to analyze exchange rate trends in the volatile 1990s has first to come to grips with the frequent disconnect between what exchange rate regimes were called and how country authorities actually managed their exchange rates. In early 1999, IMF staff took a first step toward fashioning an internally consistent “de facto” classification system. This new system sorted exchange rate regimes according to actual exchange rate policies rather than by member country descriptions, which were often based on legal considerations. The de facto classification is now routinely published in the IMF’s *Annual Report on Exchange Arrangements and Exchange Restrictions* and *International Financial Statistics*.

In its analysis of exchange rate regimes, the new IMF study applies the de facto classification to the post-1990 period and finds that there have been important changes in exchange rate regimes (see chart, page 345). Countries have moved away from intermediate exchange rate regimes toward floating and, to a lesser

extent, hard pegs (see box below for definitions). The study also finds that the momentum of liberalization—especially of capital transactions—appears to have diminished, possibly reflecting growing concerns about the risks associated with sudden reversals of capital inflows. These developments, combined with macro-economic fundamentals and foreign exchange market organization and regulations, the study suggests, may have affected exchange rate volatility.

Important, but complex, shifts

Although the de facto classification system indicates a shift away from intermediate regimes, this shift has been less pronounced than implied by the earlier de jure classification system. The polarization of exchange rate regimes appears to have been more pronounced in countries that already had access to international capital markets. Moreover, in the past decade, intermediate regimes tended to be more prone to market pressures than floating or hard peg regimes.

This evolution in exchange rate regimes also reflects the changing role of the exchange rate in monetary policy frameworks and the increasing degree to which many countries have been integrated into international capital markets. In particular, the study found a drop in the use of the exchange rate as a nominal anchor or intermediate target of monetary policy. Meanwhile, an increasing number of countries have adopted an inflation targeting framework, although the exchange rate still plays an important role in monetary policy where prices move closely with the exchange rate. Many countries with intermediate regimes and greater access to international capital markets have either opted to move toward more flexible regimes to gain greater monetary policy autonomy or been forced to do so in the face of severe pressures on their currencies. Only a few countries have adopted hard peg regimes after exiting from intermediate regimes.

The IMF’s de facto classification system has helped clarify both the nature and the role of members’ exchange rate regimes. It has facilitated discussions with country authorities about how exchange rate regimes are implemented and has contributed to more effective surveillance of the international monetary system. But assessing actual exchange rate policies isn’t always an easy task. It has proved particularly difficult in cases where countries informally target the exchange rate through direct or indirect intervention while officially announcing a floating exchange rate regime. Timely information and a transparent presentation of how exchange rate regimes function are crucial ingredients for accurate classification.

Types of exchange regimes

The IMF’s new de facto categorization of exchange rate regimes identifies eight types of regimes, which can be divided into three broad groups:

- **Floating exchange rate regimes** include independently floating regimes (in which the exchange rate is market determined, with intervention only to moderate exchange rate fluctuations) and managed floating regimes with no predetermined path for the exchange rate.
- **Intermediate exchange rate regimes** include soft pegs (conventional pegs to a single currency or a basket of currencies, horizontal bands, and crawling pegs with and without bands) and tightly managed floating regimes (under which authorities attempt to keep the exchange rate stable without any commitment to a predetermined path).
- **Hard peg regimes** include currency boards and exchange rate regimes with no separate legal tender (such as formal dollarization and currency unions like the CFA franc zone and the euro area).

Are exchange controls an option?

The number of countries maintaining exchange controls during 1998–2000 reflects a slowdown in efforts to liberalize current, but more especially capital, account transactions. The study observed that the share of IMF member countries maintaining “exchange restrictions” on payments and transfers for current international transactions (such as limits on foreign exchange allowances, advance import deposits, and arrears to commercial and official creditors) declined to about 20 percent by the end of 2001, from 30 percent at the end of 1997. However, the share of countries with “exchange controls”—a broader concept that includes other measures in addition to exchange restrictions—fell only slightly, to about 70 percent of total IMF members by the end of 2001, from 74 percent at the end of 1997. Moreover, virtually all members continued to maintain some types of controls on capital account transactions, although some measures were used for prudential and other purposes and were not designed explicitly to restrict cross-border capital flows.

The IMF study found little correlation between the use of exchange controls and the degree of flexibility of exchange rate regimes or the occurrence of currency crises. Excluding countries in the euro area, which are classified as maintaining hard peg regimes and impose virtually no controls on current or capital transactions, no clear relationship appeared between the exchange rate regime and the use of controls on current transactions. Nor was a specific pattern evident with respect to capital controls. Countries that experienced crises tended to resort to exchange controls to reduce pressure on the exchange rate, although no systematic patterns were found in the choice of controls these countries imposed.

Foreign exchange market organization

IMF staff assessed the organizational structure of the foreign exchange markets in a broad range of developing and transition countries in 2001. Foreign exchange markets have an important role to play in the global economy, but surprisingly little systematic information is available on how they are organized. This survey—the first study to collect information on a wide range of institutional and regulatory features affecting foreign exchange trading—noted that foreign exchange intermediation is usually conducted by authorized dealers, who buy and sell on their own account for end-users and providers of foreign exchange as well as between each other. Most countries seek to influence foreign exchange market organization through regulation, which can significantly affect exchange rate dynamics and may lead to the emergence of multiple foreign exchange markets. In addition, in the vast majority

of countries, the central bank is an active participant in the foreign exchange market, though the form this participation takes varies widely.

Exchange rate volatility

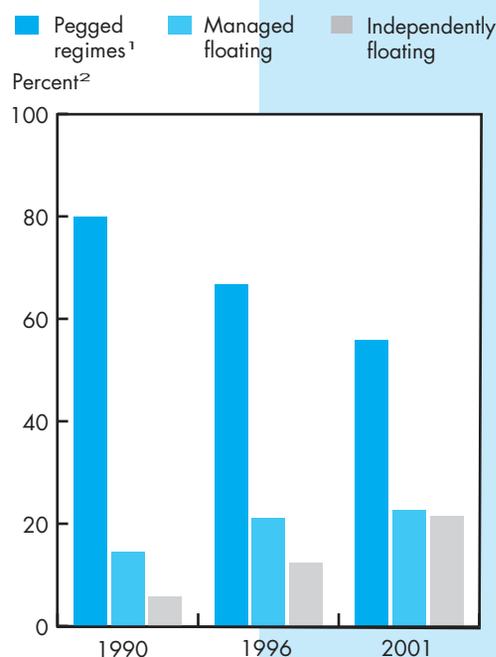
Notwithstanding technological and financial innovations, many countries continue to experience high exchange rate volatility. As financial markets around the world become more integrated, volatile exchange rate movements in one country can spill over to other countries—as recent financial crises have demonstrated. All of this underscores the need to better understand the factors affecting exchange rate volatility. The IMF study recommends that greater attention be given not only to macroeconomic fundamentals but also to other factors, especially the structural features of foreign exchange markets, the type of exchange rate regime, and the presence of exchange regulations.

Some structural features of foreign exchange markets appear to influence exchange rate volatility. Even after taking into account other features—most notably, aspects of macroeconomic performance such as inflation, real GDP growth, and fiscal deficits—countries with decentralized foreign exchange dealer markets tended to have lower volatility in 2001. The type of exchange rate regime also appears to affect volatility; for example, countries with an independently floating regime tend to have greater volatility, while those with a crawling band regime tend to experience less volatility. In addition, the presence of exchange restrictions appears to be associated with greater volatility, while some prudential and foreign exchange market regulations (for example, limits on net foreign exchange open positions and restrictions on monetary use of domestic currency by nonresidents) are associated with less volatility. ■

Shogo Ishii and Karl Habermeier
IMF Monetary and Exchange Affairs Department

The full text of *Exchange Rate Regimes and Foreign Exchange Markets—Developments and Issues* will be available shortly in the IMF’s World Economic and Financial Surveys series.

Countries have moved away from pegged exchange rates



¹Includes arrangements with no separate legal tender, currency boards, conventional fixed pegs, horizontal bands, crawling pegs, and crawling bands.

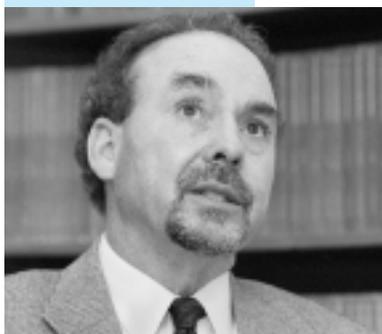
²Of IMF membership.

Data: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions*, various issues

Interview with David Coe

Korea is once again one of the honor students of economic growth

Since the onset of the Asian crisis, many conferences have been held, mainly in the United States, to explore its causes, impact, and resolution. The crisis was largely over when David Coe moved to Seoul in the fall of 1999 to be the IMF's Senior Resident Representative. He and a Korean colleague proposed holding another conference, one that would have a balanced participation of Korean and outside experts. The proceedings of the conference, held in 2001, have recently been published in a volume entitled *Korean Crisis and Recovery*. Coe talked with the IMF Survey about the findings and the lessons for other crisis-affected countries.



Coe: "Korea has probably done more than any other country affected by the Asian crisis to address the problem of nonperforming loans and make banks' balance sheets healthy again."

IMF SURVEY: What was the impetus for this conference, and why did you think the timing was right?

COE: In the winter of 2000, I was having lunch with Se-Jik Kim, who was at the Korean Institute for International Economic Policy (KIEP)—a government-sponsored research institute—and on leave from the IMF's Research Department. A lot of research was being done on the crisis, and we remarked that there had been quite a few conferences about the Asian crisis or the Korean crisis, most of them in the United States. Although Korean economists had participated, the conferences were dominated by well-known U.S. academics. We thought it would be good to organize a conference in Seoul, with equal participation of Korean and outside economists, as well as government officials and staff from the World Bank and the IMF who had actually participated in the design of the IMF program.

We got very good support for the idea from KIEP management and the IMF's Asia and Pacific Department. As for the timing, the IMF program ended in early December 2000 and the conference was held in May 2001, by which time the Korean economy was recovering. In some sense, the crisis was over, at least the macroeconomic crisis, and that provided perspective. Many of the other conferences had been held as the crisis was unfolding, and their assessments were inevitably colored by the 7 percent collapse in output in 1998. Another impetus for the conference was to focus on a single country and its unique experience.

IMF SURVEY: What are the major lessons we have learned from the Korean crisis?

COE: A key lesson is the importance of political leadership. The crisis in Korea broke out during a pre-election period and, not unlike what we saw in Brazil, there was a fair amount of political uncertainty. In Korea, some presidential candidates were saying that, if elected, they would renegotiate any program with the IMF. After Kim Dae-Jung was elected—in a razor-thin victory—he wholeheartedly embraced the idea of working with the IMF, which represented quite a turnaround from his position before the election. He was able to unify the country to overcome the crisis. We call this, in IMF jargon, "ownership."

A second lesson is the importance of private sector involvement. The program was negotiated in early December 1997, but the agreement with the banks was not reached until the end of December 1997. Until the agreement with the banks, there was a great deal of uncertainty about whether the program would succeed. In fact, during most of December, it looked as if it wasn't succeeding.

IMF SURVEY: But wasn't it too early to tell?

COE: In retrospect, it was too early to judge. But one of the ideas of an IMF program is that you go in with a lot of money, reestablish confidence, and turn things around; if that works, you may not even have to use the money. In Korea, it didn't work that way. The situation turned around only after the agreement with the banks to roll over Korea's maturing debt. A chapter by Yangho Byeon, who was actually involved in the negotiations with the banks, and Woochan Kim is a historical record of the negotiation with the banks and how

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
October 21	2.23	2.23	2.85
October 28	2.20	2.20	2.82

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2002).

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

Data: IMF Treasurer's Department

the Korean government approached it. So the lesson here is that private sector involvement can be crucial.

It is also very important to tackle structural issues, especially in the financial sector, early and with determination. Korea has probably done more than any other country affected by the Asian crisis to address the problem of nonperforming loans and make banks' balance sheets healthy again. This is in sharp contrast with a number of Asian countries that have not been able to address this problem in a meaningful way.

In my view, another important lesson is that high interest rates are effective in stabilizing the exchange rate. In Korea, monetary policy—the high interest rate policy—pretty much worked as advertised. Interest rates were raised substantially early in the crisis and had to stay high for a relatively short time until the exchange rate was stabilized. Then, within about six months, they were back to precrisis levels.

IMF SURVEY: Did any startling or new insights emerge from the conference?

COE: There's nothing startling in the book, but it certainly contains some new results and some very good papers. The second chapter, by Ajai Chopra and the other members of the Korean team at the time, is an excellent overview of the IMF's view of the crisis, its causes, and the strategy adopted to resolve the crisis; the third chapter presents a more critical assessment by Yoon Je Cho. There's some new research on the impact of interest rates on the exchange rate by Chae-Shick Chung and Se-Jik Kim. And Michael Dooley, Rudi Dornbusch, and Yung Chul Park propose a novel framework for exchange rate policy in Korea. There are also excellent papers by, among others, Anne Krueger, Robert Barro, Jong-Wha Lee, Barry Eichengreen, Changyong Rhee, and Simon Johnson.

IMF SURVEY: After absorbing these lessons, is Korea likely to once again become one of the honor students of economic growth?

COE: The Korean economy bounced back after the tremendous contraction of output in 1998. In the next two years, it averaged almost 10 percent growth annually. It was inevitable that growth would slow after that and indeed it did, at the same time that the global economy slowed. The Korean economy weathered this slowdown better than most, and our current projections for this year and next are for growth to average about 6 percent. At least so far, the evidence is that the economy is again growing strongly. In fact, chapters by Robert Barro and by Yung Chul Park and Jong-Wha Lee specifically address the question of whether potential growth in Korea has been lowered because of the crisis. In both cases, they conclude that it hasn't.

Korea can truly be described as an economic miracle. It is well known that, in the 1950s, Korea was as poor as Ghana and other African countries. Starting in the early 1960s, growth in Korea averaged more than 8 percent a year for about 30 years, which is really remarkable. Per capita incomes are now about \$10,000, Korea is a member of the Organization for Economic Cooperation and Development, and it is classified as an advanced economy by the IMF's *World Economic Outlook*. I don't think anybody expects sustained annual growth of 8 percent in the future simply because Korea is converging to the levels of income we see in the richest countries, and as it gets closer, growth will tend to slow. But I would expect Korea to continue to grow relatively rapidly. If you look at the countries that were hit by the Asian crisis, Korea has probably done the best job on the tough things: cleaning up the banks, restructuring the financial sector, and improving corporate governance. So, yes, Korea is once again, and probably will continue to be, one of the honor students of economic growth.

IMF SURVEY: How about lessons for some of the more recent crises in Latin America?

COE: Some of the lessons I mentioned before—the importance of ownership and of tackling tough problems early and determinedly—are clearly applicable to Latin America and other countries. But we have to be cautious about drawing lessons because Korea is unique. It's only about the size of New York State, with a very homogeneous population—one of the most homogeneous in the world. After the Korean War, the Korean people united behind a common goal of economic development, and they were able to do the same to overcome this crisis.

IMF SURVEY: Who would be interested in this book?

COE: The book will be interesting to various readers, including policymakers, economists, and historians, as well as the general public interested in international economic developments. In addition to the papers mentioned previously, there are chapters on the impact of the crisis on the labor market, the role of the chaebol, corporate restructuring, corporate governance, and the international financial architecture. With half of the chapters written by Korean authors, the Korean perspective is well represented. ■

Copies of *Korean Crisis and Recovery*, edited by David T. Coe and Se-Jik Kim, are available from IMF Publication Services for \$32.00 each. For ordering details, please see page 341.



IMF–State Bank of Vietnam conference

Mekong Delta countries assess prospects for improving FDI flows

Foreign direct investment (FDI) has become an important source of growth for Cambodia, the Lao People's Democratic Republic (PDR), and Vietnam. But what lessons can these countries learn from the investment strategies of other Asian countries? Policymakers and academics gathered in August in Hanoi to discuss how the three Mekong Delta states can compete more effectively for a larger piece of the investment pie.

Although China, especially since its recent accession to the World Trade Organization (WTO), is a magnet for FDI in Asia, many smaller countries have learned to compete for their share of investment. Indeed, for the long term, FDI flows to China and to other parts of Asia could well be complementary rather than competitive, according to two Tokyo-based IMF regional experts, Yu Ching Wong and Charles Adams. They told participants in the conference, jointly sponsored by the IMF and the State Bank of Vietnam, that “more FDI for China need not imply less for other countries.” In their view, the more important issue was getting the domestic policy environment right to attract FDI.

Nearly 150 conference participants considered the key role FDI can play in supporting the transition of Cambodia, Lao PDR, and Vietnam to market-oriented economies by fostering management know-how and nurturing dynamic private enterprises. Review of the global and regional experience with FDI provided the backdrop to a more detailed analysis of how the three Mekong Delta countries could attract and sustain higher levels of FDI.

Several broad conclusions emerged, according to Wanda Tseng, Deputy Director of the IMF's Asia and Pacific Department.

While China will remain a magnet for FDI, it cannot have a comparative advantage in everything. A prosperous China will undoubtedly contribute to opportunities in the region. Some participants, including Nick Freeman of Mekong Capital, said that ultimately China would become a source of FDI for the rest of the region. In this connection, Jiang Xiaojuan of the Chinese Academy of Social Sciences strongly emphasized the benefits of FDI to the Chinese economy.

On the factors driving FDI, there was a convergence of views. It was generally accepted that FDI

cannot flourish without political stability. It was equally clear that the existence of a large and growing domestic market, or an integrated regional market within the framework of a regional association, can be very helpful, but this is not essential because most successful FDI has been in export-oriented sectors, as Jiang pointed out. An open attitude toward global competition and a favorable investment climate are prerequisites, as is a relatively low cost structure, entailing reasonably adequate infrastructure. There is also the need for a transparent and dependable legal framework and a simple investment approval process. In this connection, Chia Siow Yue of Singapore's Institute for Southeast Asian Studies stressed the role of efficient administration. Singapore, she noted, started out by adopting a partnership approach with regional companies that did not try to extract too much from them and did not impose performance requirements.

There were diverse views, however, on how to maximize the benefits of FDI by enhancing technology transfers and spillovers. Most believed that countries should rely more on current comparative advantage, and that FDI that responds to global market forces holds the most promise, particularly FDI in export sectors. However, a few participants suggested that selective interventions based on anticipated trends in comparative advantage can be effective, but this would require careful industry-specific analysis and broad consultation with the private sector. For example, Hooi Eng Phang, Advisor to the IMF Executive Director for the three Mekong Delta countries, cited Malaysia's experience in providing special incentives to encourage a shift from manufacturing to services and, more recently, to high-tech sectors.

Limiting tax incentives

On the possible pitfalls of strategies designed to attract FDI, participants debated the relative merits of tax incentives. One view held that because tax incentives for FDI are typical in the region, no country may be able to avoid them. Yet others believed that over the medium term, the region is moving away from relying on these incentives. Meanwhile, if incentives are unavoidable, they can be streamlined and designed to limit the drain they place on the budget and their potential for corruption.

Policymakers need to recognize that the challenge in the global economy of today is to build knowledge, not just buildings and machines.

—Peter Brimble

While the specific circumstances of each country differ, there are common elements in the strategy for improving the investment climate, not only for foreign investors but also for the domestic private sector. These include maintaining a stable macroeconomic environment aimed at sustained economic growth; strengthening public finances while using public expenditure to build infrastructure and improve labor skills; tackling corruption and strengthening governance; and deepening reforms, especially by pursuing open trade and investment regimes, particularly through the free trade agreement of the Association of South East Asian Nations (ASEAN) and earliest possible accession to the WTO.

Lessons from the region

As FDI can fluctuate with global market conditions, it is important to manage macroeconomic policies prudently and flexibly to deal with external shocks. A key policy in this context is flexible exchange rate management. Peter Brimble of the Bangkok-based consultancy Brooker Group drew applicable lessons from the experience of Thailand and elsewhere in the region. He recommended a shift toward attracting investment in the knowledge economy. "Policymakers need to recognize that the challenge in the global economy of today is to build knowledge, not just buildings and machines," Brimble stated. He noted that both Singapore and Malaysia have been "very proactive with promotional strategies to attract new players to their respective markets." Le Dang Doanh of Vietnam's Ministry of Planning and Investment agreed, saying that, so far, potential investors in Vietnam could not get enough information through the Internet.

What specific steps should the three Mekong Delta countries take? For Vietnam, participants particularly recommended rigorous implementation of its bilateral trade agreement with the United States and active preparations for entry into the WTO as a means to further open market access for investors and to upgrade its legal framework. Equal emphasis was put on improving the business climate by reducing the costs of doing business and leveling the playing field between the private and state sectors. Transparency, predictability, and consistent application of policies are crucial. On a more practical level, they added, simplifying licensing and approval processes would be helpful.

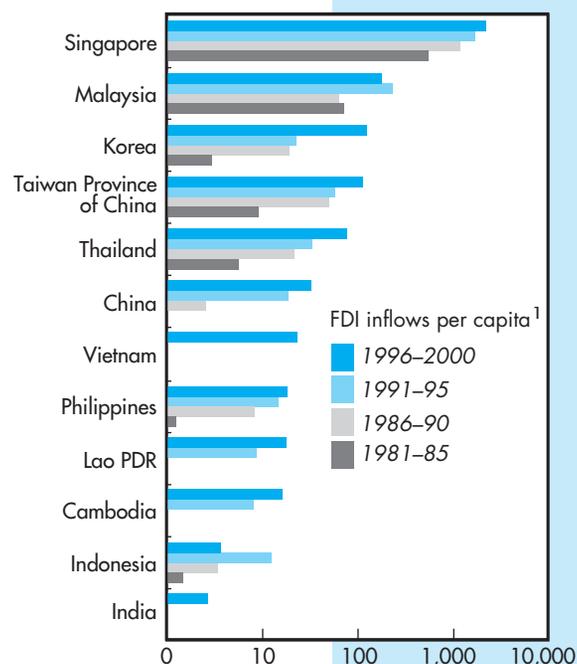
For Cambodia, there is an urgent need to rebuild human capital, basic infrastructure, and the legal framework. Also, to increase budget revenues to help finance economic infrastructure, Cambodia should rationalize its relatively generous investment incen-

tives and broaden its revenue base to avoid higher tax rates—as it has started to do. More generally, continued progress in strengthening the fiscal position and in improving economic management will be essential. Hing Thoraxy of Cambodia's Council for Development said that, because of limited resources, Cambodia would focus on developing industrial corridors and export processing zones where facilities and infrastructure would be competitive.

For Lao PDR, prudent macroeconomic management is needed to ensure overall stability. With its rich endowment of untapped natural resources and a continuation of its liberal investment policy, Lao PDR is well placed to attract FDI. Streamlining approval procedures is important, and promoting special economic zones may be a pragmatic first step to improving infrastructure for investors. Greater policy transparency, especially through increasing information flows, will be critical in boosting investor confidence.

Freeman observed that one of the initial driving forces for French colonial investment in the Mekong Delta was as a backdoor entry to China. Could the region serve as a conduit to the large Chinese market again? Without directly supplying the answer, he said that ultimately China is likely to become a substantial source of FDI for Indochina. Chinese investors have already taken on a more prominent role in Cambodia and Lao PDR, particularly since 1997, but "it will probably take time," he said, "for China's FDI flows into Indochina to gain real momentum." ■

On a per capita basis, smaller Asian countries have been relatively successful at competing for FDI



¹In U.S. dollars.

Data: IMF, *International Financial Statistics*; World Economic Outlook database; IMF country reports; and national sources

Some conference papers are available on the IMF website at www.imf.org/external/pubs/ft/seminar/2002/fdi/eng/index.htm.

For rapidly growing microfinance sector, sustainability and regulation are key issues

Over the past two decades, microfinance institutions have expanded rapidly. A recent seminar at the IMF Institute—“Microfinance Institutions: Facilitating the Sound and Sustained Development of the Sector”—explored the growth of this sector. Participants Daniel Hardy (IMF), Joselito Gallardo and William Steel (World Bank), and Richard Rosenberg (Consultative Group to Assist the Poorest/World Bank) examined how this sector could best be supported and why the IMF is interested in its success.



Daniel Hardy



Joselito Gallardo



William Steel



Richard Rosenberg

Where do poor households and small enterprises turn when the doors of mainstream banking are closed to them? Increasingly, microfinance institutions are meeting the needs of clients who have low and uncertain income, conduct only small-scale transactions, have little usable collateral, and are unfamiliar with formal business procedures. In meeting these needs, the institutions can also play a significant role in poverty reduction and financial sector deepening.

Microfinance comes of age

In many countries, microfinance institutions are numerous; in some, they hold a significant share of total deposits and lending and serve millions of clients. They are especially well developed in Asia and Latin America—notably in Bangladesh, Bolivia, and Indonesia. But even in countries where the microfinance sector is not large, its institutions may be the only ones operating in more remote regions.

When microfinance institutions first began operations in the early 1970s, they principally extended credits. Now they offer a greatly expanded range of services. Increasingly, secure savings facilities is their central function, but many now also offer insurance, business training, and financial planning. But individual transactions and financial stocks remain small. The range of loans may extend from \$50 or less for institutions targeting the very poor to several thousand dollars for institutions targeting successful small businesses. Deposits might be even less (as low as \$5).

Road to success can be rocky

Microfinance services, however, are not cheap. These institutions face relatively high overhead costs vis-à-vis the value of their loans and deposits, and their loans are often considered risky because their borrowers typically have uncertain income and limited usable collateral—for example, because title to land may not be documented.

With these handicaps, microfinance institutions have had to be inventive in generating incentives for repayment. A system of dynamic incentives, for example, can provide small loans at first, with amounts increasing as a repayment history is established. Institutions may also require up-front savings for screening purposes, lend to groups jointly responsible for repayment, or request personal guarantees.

Significant costs and numerous risk factors have forced microfinance institutions to charge high interest rates on loans. Borrowers are presumably willing to pay these high rates because the alternatives are either borrowing elsewhere at even higher rates or not borrowing at all. Similarly, microfinance institutions may offer rather low yields on deposits, but clients may be more concerned about the availability of secure, liquid savings than about a direct monetary return.

Nonetheless, profitability and sustainability remain concerns. Most microfinance institutions continue to be subsidized directly through grants and indirectly through soft terms on donor loans. Many lose money, and the “financially self-sufficient” ones are not those celebrated for serving the very poorest clients. There is also a distinct learning curve: these institutions typically need to survive and grow for an extended period before they can be reasonably cost-efficient and profitable.

Making the most of financial support

Microfinance institutions have attracted considerable support from national governments, bilateral and multilateral donors, and numerous nongovernmental organizations. The support is chiefly motivated by a desire to help the poor. These institutions seem to offer a very direct means to deliver assistance to the poor, yet in a way that empowers them to gain financial autonomy. The financial support can be cost-effective, if these institutions can return the funds and leverage the support by mobilizing savings and additional borrowing. These institutions may also have an informational advantage in that they may be able to distinguish more precisely who can benefit most from the assistance, because they screen their clients carefully, and savers decide for themselves when to build up and withdraw their deposits.

But support for microfinance institutions must compete with other claims. Support could be channeled to direct income support or the provision of human capital, which the poor may prefer. And sup-

port can be counterproductive if it weakens incentives to become self-sustaining, operate efficiently, and instill financial discipline in clients.

Experience suggests that support is best used to encourage financial independence and sustainability. This goal might be achieved through one-time start-up grants or long-term loans, allocation of subsidies by periodic auction, and promotion of a central support organization (called an apex organization) or ancillary institutions (such as a credit record agency). It should also be recognized that not all microfinance experiments will succeed, and a certain amount of failure will inevitably accompany the development of a flourishing microfinance sector.

How useful is microfinance regulation?

An appropriate legal and institutional framework is one form of support that can boost the prospects for a viable microfinance sector. Especially once microfinance institutions begin to mature, effective regulation can help to promote the sector, because well-regulated and sound institutions are likely to be able to attract more financing.

Regulation is principally intended, though, to protect clients, especially those who place their savings in these institutions. Typical depositors are relatively poor and would be gravely affected if an institution failed. With few alternative investment or borrowing opportunities, and scant information and skills to evaluate the soundness of the local microfinance insti-

tution, the clients are also not in a position to exert market discipline on these institutions. There may also be a need to protect the financial system as a whole, notably when the failure of a major microfinance institution could provoke doubts about the soundness of the whole financial system and discourage mass participation in the financial sector.

Notwithstanding the obvious benefits of regulation, there can be significant costs, given the small size of these institutions. These costs include staffing costs for the supervisor, especially in countries with scarce capacity, and expenses for the microfinance institutions in complying with regulations and satisfying on- and off-site supervision. These costs are ultimately passed on to clients. Regulation may also constrain innovation—for example, by forbidding new forms of loans.

The cost-effectiveness of regulations is linked to the breadth of activities undertaken by microfinance institutions. Those that do no more than lend donor funds may not merit any special form of regulation. Indeed, in many countries, deregulation is needed to permit this generally innocuous activity. Large microfinance institutions that attract unrestricted deposits present a greater danger to “innocent bystanders.” A reasonable approach would recognize the heterogeneity of the microfinance sector and accommodate the flexibility and scope for development it needs.

In finding this balance, it is useful to distinguish between prudential and nonprudential regulations.

Sound and sustainable microfinance institutions require honest and transparent management.



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- 02/106: IMF Managing Director Horst Köhler's Remarks in Algeria, October 17
- 02/107: IMF Completes Fourth Review of Performance Under Chad's PRGF Arrangement and Approves Requests for Extension of Commitment Period and Waiver of a Performance Criterion, October 21
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- Opening Remarks, Press Conference on the *World Economic Outlook*, Kenneth Rogoff, IMF Economic Counsellor and Director of Research, Singapore, October 15
- “Sovereign Debt Restructuring: Where Stands the Debate?” Jack Boorman, Special Advisor to the IMF Managing Director, at a conference sponsored by the Cato Institute and *The Economist*, New York, October 17
- Keynote Speech at the East AFRITAC Inauguration Ceremony, Eduardo Aninat, IMF Deputy Managing Director, Dar es Salaam, Tanzania, October 24
- Welcoming Remarks for the East AFRITAC Inauguration Ceremony, Abdoulaye Bio-Tchané, Director, IMF African Department, Dar es Salaam, Tanzania, October 24

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Prudential regulations (for example, capital adequacy norms) are concerned with the financial soundness of the regulated institutions. These are generally relatively complex, are costly to comply with, and often must be implemented by a specialized financial authority. Nonprudential regulation (for example, full disclosure of charges or establishing the integrity of individuals controlling a company) serves other purposes, such as consumer protection and, after obvious modification, applies equally to financial and nonfinancial businesses.

For many microfinance institutions, especially those in the early stages of development, nonprudential regulation may be much more appropriate. Sound and sustainable microfinance institutions require honest and transparent management. Thus the integrity of their founders and senior managers, and their ability to track their own performance (for example, on loan loss recognition and operating costs), may be more important than meeting a battery of prudential ratios.

World Bank, CGAP lend crucial support

The World Bank has actively promoted microfinance institutions and their integration into the financial systems of numerous countries. The Bank's main strategies include fostering an appropriate environment for the institutions, promoting sound practices, building institutional capacity, and seeking innovative techniques, methods, and products. Its support has evolved from lines of credit to assistance with policy formulation and saving mobilization, often tied to technical assistance. The World Bank Group's aggregate portfolio for microfinance currently amounts to about \$210 million. The International Finance Corporation has approved investments in microfinance amounting to almost \$90 million.

The Consultative Group to Assist the Poorest (CGAP) is a consortium of 29 bilateral and multilateral donor agencies that actively assists microfinance institutions, donors, and others, such as regulators. It provides technical assistance and strategic advice, develops and disseminates technical guides and services, provides training, and conducts field research on innovations. CGAP also operates a small grant facility that funds these activities and strategic investments in microfinance institutions.



A banker (left) for Kesuma Tiara, a grassroots microsavings and loan cooperative, collects payments in a Jakarta slum area.

Why the IMF is interested

The growth of the microfinance sector in recent years has begun to receive increased attention from the IMF. This attention is motivated in part by the IMF's interest in promoting stable economic development and financial sector development, notably through adjustment and reform programs supported by its Poverty Reduction and Growth Facility (PRGF). Microfinance institutions normally fall under the World Bank's purview, but the IMF must have an understanding of all aspects of PRGF-supported programs.

The IMF's increased attention to microfinance institutions also reflects the organization's involvement in encouraging sound financial systems. The microfinance sector must be robust enough to provide more benefits than problems, and the design of measures directed at other parts of the financial system must take account of the effects on microfinance institutions. The needs of the microfinance sector must then be factored into a wide range of IMF work, including the policy programs it supports, its oversight (surveillance) of country financial sectors (notably through its Financial Sector Assessment Programs), and its technical assistance, especially that related to banking supervision. ■

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For more information, see *Microfinance Institutions and Public Policy*, by Daniel Hardy, Paul Holden, and Vassili Prokopenko, IMF Working Paper WP/02/159. Copies of the paper are available on the IMF's website (www.imf.org) or may be ordered, for \$10.00 each, from IMF Publication Services. See page 341 for ordering details.