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"An Analysis of Value-Added Taxes in Russia and Other Countries
of the Former Soviet Union" by Victoria P. Summers and Emil M. Sunley

Since the end of 1991, Russia and the other transition countries that were part of the Soviet Union have adopted value-added taxes (VATs). The VATs in Russia and in all the other countries except Estonia, Latvia, and Lithuania (referred to in the paper as "the other transition countries") were originally almost identical to the VAT adopted by the Soviet Union in December 1991, upon the eve of its dissolution. Although the laws of the various countries have diverged over the past two and a half years, most of them still share certain features derived from the 1991 Soviet model.

In principle, the VAT is an efficient, neutral revenue source at the national level. And, in fact, these new taxes now generate a very significant portion of total tax revenues in Russia and the other transition countries. But large and growing arrears in the payment of interenterprise obligations correlate closely with declining revenue performance. This correlation arises in part because interenterprise arrears give rise to liquidity problems, which lead directly to tax arrears, and in part because timing asymmetries resulting from the unique structure of the Russian VAT reduce VAT liabilities (but not VAT credits) in the presence of interenterprise arrears.

The large number of exemptions and preferences found in the Russian VAT causes both a loss of revenue and economic distortions. The major structural anomalies found in the Russian VAT and in many of the laws of the other transition countries include (1) accounting for VAT liability on sales on a cash basis while allowing credit on inputs at the time the inputs are put into production; (2) calculating the tax at the manufacturing and production level on the credit/invoice method, and in the wholesale, retail, and service sectors based upon the taxpayers' gross margins; and (3) denying or delaying credits for the acquisition of capital inputs. The paper recommends that all taxpayers ultimately use an accrual basis for both credits and liabilities. The credit/invoice method should be extended through final sales to consumers in all sectors. In Russia, credit is now permitted for capital inputs, taken in installments over a six-month period. The paper recommends that the countries that have not yet allowed any capital input credits should begin to do so. Ultimately, all countries should give immediate, full crediting for capital inputs. Excess credits should be either refunded or, if carried forward, adjusted for inflation.

These transition countries must also decide how they will apply the VAT to trade among themselves. The paper discusses the effects of adopting an origin-method versus destination-method VAT as well as the issues raised by using the VAT at the subnational level. It analyzes how, since the inception of the Russian VAT, the approach to the problem of interstate trade has evolved. The paper concludes that although administrative considerations play a key role in how the VAT is applied, the basic choice between the origin or destination method must depend upon the sort of economic relationship the countries decide to establish among themselves.

JEL Classification Numbers:

C82, E62, H50, H60, H62, H70, H87

Summary of

WP/95/2

"Government Finance Statistics in the Countries of the Former
Soviet Union: Compilation and Methodological Issues" by Marie Montanjees

This paper examines compilation and methodological issues that affect government finance statistics (GFS) in the Baltics, the Russian Federation, and other states of the former Soviet Union.

The paper finds that several major problems affect the use of fiscal reports from the countries of the former Soviet Union as source documents for GFS data. The most serious of these is the inadequate coverage of the data in the fiscal reports, which exclude significant portions of government activity. Another major shortcoming is the structure of the classification codes, which do not adequately distinguish the different economic characteristics or functional nature of transactions. A third significant problem is the level of aggregation in the fiscal reports, particularly the subannual reports, which hinders both accurate measurement of the deficit or surplus and the compilation of detailed GFS data.

The paper also finds that there has been some uncertainty about the appropriate treatment of certain types of transactions in the countries of the former Soviet Union. It suggests treatments designed to be both consistent with the international methodology and compatible with the operational requirements of the Fund.

The paper concludes that, although the IMF provides extensive training and technical assistance in GFS methodology, progress has been slow in the countries of the former Soviet Union other than the Baltic countries. It identifies priority areas for the future development of GFS reporting systems for these countries.

JEL Classification Numbers:
E21, F41, F43, O11, O16, O57

Summary of
WP/95/3

"Saving Behavior in Low- and Middle-Income Developing Countries: A Comparison" by Masao Ogaki, Jonathan D. Ostry, and Carmen M. Reinhart

The responsiveness of saving to changes in real interest rates is a key parameter in the evaluation of the effects of a number of exogenous and policy-induced shocks in developing countries. Financial sector reforms have typically resulted in increases in real interest rates in developing countries, but the response of saving--and the effects on investment and growth--have been much less clear-cut. In addition, the effects on the external current account balance of fiscal policy changes that alter domestic interest rates depend on the responsiveness of private saving to movements in real rates of return. Finally, temporary terms of trade shocks or trade liberalizations that are not credible contribute to movements in consumption rates of interest (which measure the true cost of consuming today relative to consuming tomorrow) in developing countries, the effects of which on the current account depend critically on the elasticity of saving with respect to the real interest rate.

Empirical evidence suggests that the intertemporal elasticity of substitution in consumption (on which the interest rate elasticity of saving depends) varies considerably across developing countries. This paper argues that a main reason for this variation may be a country's level of development. Specifically, because of the role of subsistence consumption in household expenditure, low-income developing countries will typically exhibit a negligible response of saving to movements in real interest rates. As the per capita income level rises, the fraction of the budget left after subsistence needs have been met increases. As only this fraction of the budget is sensitive to movements in real interest rates, the model implies a nonlinear relationship between the intertemporal elasticity of substitution and the level of development. The interest rate elasticity of saving should therefore be much higher in middle-income than in low-income countries (where it will be close to zero), but it will be only slightly higher in high-income than in middle-income countries, where subsistence plays little role in the expenditure patterns of most households.

These notions find support in the data. Using macroeconomic data from a sample of countries with diverse income levels, the paper concludes that a model in which the intertemporal elasticity of substitution is an increasing function of the gap between permanent income and the subsistence consumption level cannot be rejected. The model implies very different responses of private saving to (exogenous and policy-induced) real interest rate shocks, depending on the level of development.

JEL Classification Numbers:
E24, J23

Summary of
WP/95/4

"Skills, Wages, and Employment in Eastern and
Western Germany" by Felix FitzRoy and Michael Funke

Since unification, the economy of eastern Germany has undergone rapid changes in response to the shift in trading patterns away from the Council for Mutual Economic Assistance countries, the liberalization of prices, and privatization. One result has been a fall in overall manufacturing employment of about 65 percent in 1991-93. At the same time, equity concerns have led to a sharp increase in wages in eastern Germany, from about 30 percent to 60 percent of western German levels. Both the shift in industrial composition and the wage increases should, in principle, have contributed to the employment decline.

This paper quantifies the factors affecting labor demand in eastern Germany by estimating a dynamic model of labor demand that treats skilled, semiskilled, and unskilled workers as different factor inputs having potentially different degrees of complementarity with capital. The model is also estimated for western Germany, which has a substantially different production structure and employment history.

The results show that labor demand in eastern Germany is responsive to wage rates, even more so than in the west. This finding contradicts union claims that the policy of raising eastern German wages toward western levels has not been a major contributor to employment declines. Moreover, capital and skill appear to be complements in production, implying that unskilled labor was much more affected by the wage increases than skilled labor.

These results have implications beyond the eastern German labor market. The skill-capital complementarity means that unskilled labor in developed economies is particularly vulnerable to competition from low-wage labor in developing countries. This observation lends support to the hypothesis that unemployment in the United States has been held down by a widening of the wage distribution, particularly at the low end. By contrast, in Europe, the same factors, together with a more compressed wage structure, appear to have resulted in higher unemployment and less labor force participation (that is, an increase in the number of discouraged workers), particularly among the unskilled.

JEL Classification Numbers:
J23, J24, J31, J32, J64

Summary of
WP/95/5

"The Simple Economics of Benefit Transfers" by Dennis J. Snower

This paper examines the implications of allowing unemployed people-- particularly those who have been unemployed for a long time--the option of "transferring" some of their unemployment benefits into employment vouchers, that is, using a portion of their unemployment benefits to subsidize their own employment. In this way, the policy aims to turn the disincentive to work that is created by the unemployment benefit system into an incentive to seek and provide jobs.

The Benefit Transfer Program (BTP) has five salient features that distinguish it from the standard wage subsidy programs attempted heretofore: (1) it is voluntary; (2) the size of each person's employment voucher is linked to the size of his or her existing unemployment benefits; (3) the longer a person is unemployed, the larger is the stream of employment vouchers to which he or she is entitled; (4) once a person has found a job through the BTP, the size of the voucher gradually falls the longer the person remains employed; and (5) larger vouchers are given to employers who can prove that they are devoting these funds to training their new recruits.

The paper indicates that the BTP may make a substantial contribution to reducing unemployment in a number of member countries of the Organization for Economic Cooperation and Development (OECD). The reason is not that labor demand is generally very responsive to changes in labor costs-- standard estimates of aggregate short-run labor demand elasticities are well under half in most OECD countries--but that many countries spend a lot on unemployment benefits, particularly if these benefits are broadly defined to include not only the cash payments to the unemployed, but also all the associated welfare state benefits and forgone tax revenues.

Since the amount that the government spends on the employment vouchers is set so as not to exceed what it would spend anyway on unemployment support, the reduction in unemployment can be achieved at no extra budgetary cost. All that has happened is that the funds that previously encouraged unemployment are now encouraging employment. If the employment vouchers are appropriately directed at the long-term unemployed, the reduction in long-term unemployment could be achieved without stimulating inflation because the long-term unemployed exert a negligible dampening influence on wages. By linking the vouchers to training, the BTP could become the basis for national training programs.

JEL Classification Numbers:
F13, Q18

Summary of
WP/95/6

"Environmental Protectionism,
North-South Trade, and the Uruguay Round" by Piritta Sorsa

The paper seeks to provide an overview of the present state of debate on trade, environment, and the GATT for developing countries. The threat of green protectionism can arise from the use of environmental product regulations for protectionist purposes, from extraterritorial use of trade measures to influence environmental behavior in other countries, and from the use of trade measures to enforce compliance with international environmental agreements. At present, the protectionist threat seems exaggerated as available information suggests that the use of green trade barriers is still small compared with traditional trade barriers against developing country exports.

To prevent the threat from becoming a reality, the paper contends that developing countries have an interest in seeing that some GATT rules are reviewed, while others are maintained. First, in some areas, existing GATT rules may be too flexible and may not cover all potential environment-related product measures. Further discussion is likely to take place on how to shield eco-labeling from protectionist abuse; how to deal with measures that resemble product standards but have no impact on consumption externalities in the importing country such as recycling content requirements; and how border adjustment of taxes may undermine the environmental objectives of the measures. Second, extraterritoriality is unlikely to be accepted in the trade rules in the context of environmental goals, and existing GATT rules protect developing countries against it. This is not only a North-South issue, but one between large and small countries.

Third, the use of trade measures with international environmental agreements is more controversial and will be a topic for debate in the World Trade Organization (WTO), especially between developing and industrial countries. Here, political consideration is likely to call for some action from the international community. Developing countries should oversee that, if trade measures are used to induce participation in or enforcement of environmental agreements, their use remains limited under clear criteria and a last resort, and that an international environmental agreement has the widest possible participation.

The Uruguay Round will have a number of direct and indirect effects on trade and environment. The Round was important, not only in reducing all protectionist pressures, but also in preserving and reinforcing the multilateral framework to deal with new and old trade issues. In addition, the results of the Round in improving growth, in general, and market access for labor-intensive products, in particular, can be beneficial for improved environmental quality in developing countries. Some rules with links to the environment are modified, and new sectors added to the debate. The paper believes more focus is also needed on the environment's broader links with trade, sustainable development, and other economic policies.

However, developing countries will need to pay more attention to environmental issues. Much of the increase in green standards is a market phenomenon reflecting the increased environmental awareness of consumers. In many cases producers in developing countries have no choice but to adjust or lose markets.

JEL Classification Numbers:

E32, E63, J21, J23, J32,
J41, J51, J64, J65, J68

Summary of

WP/95/7

"Evaluating Unemployment Policies: What do the
Underlying Theories Tell Us?" by Dennis J. Snower

This survey is based on a simple idea that has received lamentably little attention in the literature on unemployment policy: different unemployment policies are generally based on different theories of unemployment, and confidence in a policy should depend--at least in part--on the ability of the underlying theory to account for some prominent empirical regularities in unemployment behavior. In particular, the paper evaluates unemployment policies in advanced market economies by examining the predictions of the underlying macroeconomic theories.

The paper considers four types of policies. First, the laissez-faire policy stance implies that the government should do little or nothing to influence unemployment. This stance is supported by the natural rate theory, the intertemporal substitution theory, and the real business cycle theory.

Second, demand-management policies, based on Keynesian and New-Keynesian theories, as well as on recent developments concerning transmission mechanisms between labor and product markets, cover both government employment and macroeconomic policies aimed at changing product demand.

Third, supply-side policies, designed to raise the productivity of workers across the board, comprise a variety of measures, including reductions in payroll taxes, government infrastructure investment, and improvements in information dissemination. The paper shows how the market failures addressed by these policies are analyzed through search theory, implicit contract theory, and efficiency-wage theory.

Fourth, institutional policies aim to change labor market institutions to reduce unemployment. Labor union theories, bargaining theories, and insider and outsider theories can shed light on how these policies operate. The policies include reform of wage-bargaining systems, measures to reduce labor turnover costs, job search support for the long-term unemployed, worksharing, early retirement, actions to reduce barriers to the creation of new firms, profit sharing, reform of unemployment benefit systems, recruitment subsidies, training subsidies, and benefit transfers.

JEL Classification Numbers:
F41, P20, P50

Summary of
WP/95/8

"Inflation and Stabilization in Transition Economies:
A Comparison with Market Economies" by Ratna Sahay and Carlos Végh

This paper examines inflationary pressures and stabilization in transition economies, and compares them with the experience of high-inflation market economies. A basic message of the paper is that to understand the inflationary pressures experienced on the road to a market economy, it is essential to analyze the inherent nominal instabilities of planned economies. To that effect, the paper develops a simple monetary model to provide insights into the sources of inflationary pressures in planned economies. It is argued that the use of two nominal anchors (prices and wages) leads to an "overdetermination" of the system. As a result, a *temporary* increase in nominal wages relative to their planned values generates a *permanent* increase in the money supply and a *permanent* monetary overhang. Analogously, a *permanent* increase in the level of nominal wages causes an *ever-increasing* money supply and, therefore, an *ever-increasing* monetary overhang. The model also suggests that if prices are freed, the price level will overshoot its new equilibrium level.

Bearing in mind the themes suggested by the analytical model, the paper then discusses the evidence on inflation and stabilization in transition economies during 1990-93. The analysis makes clear that, in the transition to a market economy, centralized wage controls that had provided a nominal anchor in the past ceased to perform that function. At the same time, transition economies inherited the state enterprises' soft budget constraints and lacked the indirect monetary instruments necessary to control the money supply effectively. In essence, therefore, one can think of the inflationary problems experienced by transition economies as resulting from their having abandoned the two nominal anchors of the previous regime (prices and wages) without being able to implement a monetary anchor. Under these circumstances, and provided enough international reserves are available, countries that have resorted to an exchange rate anchor have fared better on the inflation front.

The paper concludes that, despite significant differences in economic structures and institutional frameworks, the inflation and stabilization experiences of transition and market economies are similar in many respects. In particular, monetary accommodation and lack of fiscal discipline are critical in sustaining inflation, and exchange-rate-based anchors seem more successful than money anchors in bringing down inflation. However, wage policies appear to be more critical in reigning in inflation in transition economies than in market economies.

JEL Classification Number:
F14

Summary of
WP/95/9

"The Pattern of International Trade Between Japan and the Pacific
Basin Countries: A Comparison Between 1975 and 1985" by Sayuri Shirai

In recent years, so-called new theories of international trade have been rapidly developed to provide better explanations of actual trading patterns. These new trade theories, which are based on the concepts of product differentiation, imperfect competition, and economies of scale, seek to explain why trade takes place even when countries do not differ much in relative factor endowments or labor productivity. The theories seem to explain the pattern of trade between Japan and the five Pacific Basin countries (Indonesia, Korea, Malaysia, Singapore, and Thailand) that initiated industrialization in the postwar period--patterns that led to strong economic growth in the 1980s.

The purpose of this paper is to analyze the patterns of trade between Japan and these five Asian countries in the light of insights provided by the new trade theories. In particular, the paper attempts to examine the pattern of trade in 1975 and to determine how it had shifted by 1985. In doing so, we examine the deepening economic linkages in the Pacific Basin region, using data on intermediate inputs, final products, and sellers and buyers by country and industry from the international input-output tables for the available years, 1975 and 1985.

This paper shows first that Japan has remained a substantial net exporter of manufactured or capital-intensive products and a large net importer of primary, or natural-resource, labor-intensive products. It also shows, however, that Japan's intra-industry trade in manufactured products with the five Asian countries has increased, although inter-industry trade remained dominant with those countries, such as Indonesia and Malaysia, that are rich in natural resources. The increase in intra-industry trade was more actively observed in manufactured intermediate inputs (such as chemicals, machinery, and metals) than in final products. The rapid growth reflected Japan's increasing dependence on these manufactured products and the expanding intra-industry import/export markets in its Asian partners. In particular, Japanese industries imported more manufactured intermediate inputs from parallel industries in its Asian partners than they obtained from counterpart industries in Japan. As manufacturing firms subdivided the production process of intermediate inputs and shifted their production locations to different countries, the division of labor between Japan and the five Asian countries changed substantially. The largest increase in imports was observed for machinery products and can be attributed to an expansion of intra-firm trade as a result of Japan's foreign direct investment (FDI) in these countries.

Although the paper does not cover the large-scale structural change in trade that took place after the yen began to appreciate in 1985, the deepening of economic linkages between Japan and the five Asian countries was observed before 1985. Thus, we believe a detailed analysis of the structural changes before 1985 is important in understanding the growing international division of labor taking place in the Pacific Basin countries.

JEL Classification Numbers:
E43, E62, F41

Summary of
WP/95/10

"Wage Contracts, Capital Mobility, and
Macroeconomic Policy" by Pierre-Richard Agénor

Nominal wage rigidity and imperfect capital mobility are two important macroeconomic features of many developing countries. This paper integrates both features in an analysis of the effects of macroeconomic policy shocks on output, real wages, the real exchange rate, and the current account. The analysis is based on a two-sector, three-good optimizing model with endogenous mark-up pricing in the nontraded goods sector. Both backward- and forward-looking wage contracts are considered. Because of the highly complex dynamic structure of the model (which is shown to depend crucially on the nature of the expectational mechanism embedded in wage contracts), the analysis focuses on the steady-state effects of policy shocks.

The paper shows that the long-run macroeconomic effects of a reduction in spending on nontraded goods is shown to be independent of the mechanism through which contracts are formed. It lowers the marginal value of wealth (and thus stimulates private consumption), reduces the product wage (thereby raising output in the export sector), and leads to a depreciation of the real exchange rate. Real holdings of foreign bonds (measured in domestic currency terms) rise, whereas net foreign assets held by the central bank may rise or fall. A cut in public spending has no effect on either inflation and output of nontraded goods, or on nominal and real interest rates. By contrast, the steady-state effects of a reduction in the devaluation rate on several macroeconomic variables is shown to depend crucially on whether wage contracts are backward or forward looking. In the case of backward-looking contracts, the real exchange rate depreciates while the product wage rises, leading to a reduction in output in the export sector. With forward-looking contracts, the real exchange rate appreciates while the real product wage falls, leading to an expansion in output of exportables. In both cases, however, inflation, the rate of growth of nominal wages, and the nominal interest rate fall in the same proportion as the devaluation rate--with no net effect on the real interest rate.

The thrust of the analysis in the paper is that the extent to which the nature of wage contracts alters the long-run effects of macroeconomic policies--particularly on the real sector of the economy--depends on the type of shocks considered. An understanding of the mechanisms through which wage contracts are formed is thus important for the choice of policy instruments in stabilization programs.

JEL Classification Numbers:
H5, H7

Summary of
WP/95/11

"Wage Expenditure of Central Governments"
by Daniel Hewitt and Caroline van Rijckeghem

The issue of what determines the level of central government wage expenditures is important in the design of effective reform programs. This paper provides estimates of the impact on central government wage expenditures of (1) institutional factors that influence the level of decentralization of government; (2) the availability of resources; (3) Fund-supported programs; and (4) preference-related variables. These estimates provide a basis for comparing central government wage expenditures across countries in the tradition of Heller and Tait (1984) and possibly for identifying government productive inefficiency or an ambitious set of *central government objectives*.

Empirical investigation using cross-country time series is carried out based on a simple model of public choice, which suggests a two-equation recursive system consisting of a "total expenditure" and a "wage share" equation. The estimation procedure takes account of the possible bias resulting from correlation between the errors of the total expenditure and the wage share equations. The data span 1980-90 and cover 99 countries.

The paper has five main findings. First, federations and countries with large populations--which are viewed as proxies for fiscal decentralization--have lower central government wage expenditures as a percent of GDP. In addition, central government wage expenditures appear to **decline** with per capita income, presumably because decentralization and also human capital increase with economic development. Second, **general** government wage expenditures appear to **increase** with per capita income, as indicated by a comparison of industrial countries and developing countries for which general government data are available. Third, the paper finds that private nonguaranteed foreign financing is associated with higher central government expenditures and, indirectly, with higher wage expenditures. Public and publicly guaranteed net financing, provided often for public sector capital projects, are associated with higher total government spending but have only a marginally significant association with wage expenditures. Fourth, medium-term structural adjustment programs, which often include civil service reform measures, have a significant negative association with wage expenditures, while short-term stabilization programs, which do not include such measures, do not. Fifth, there appear to be systematic differences in expenditures on wages across forms of government. Wage expenditures are lower in socialist countries than in democracies, probably because government employees in the former countries receive a large portion of compensation as in-kind benefits. These findings can be used to put countries with diverse characteristics on a comparable basis. They do not necessarily carry policy implications and do not lead to the conclusion that certain forms of government are preferable from the point of view of fiscal consolidation.

JEL Classification Numbers:
E12, F12, F41

Summary of
WP/95/12

"Pricing to Market and the Real Exchange Rate" by Hamid Faruquee

Since the abandonment of fixed exchange rates in 1973, foreign exchange markets have experienced a great deal of turbulence. However, the large swings in exchange rates under the era of floating have not brought about comparable variation in inflation or disinflation rates as one would expect with pass-through. Instead, volatile nominal exchange rates have translated into volatile real exchange rates in the post-Bretton Woods world, while prices locally have remained remarkably stable.

In an attempt to understand these developments, this paper develops a model of goods market segmentation wherein firms may systematically price discriminate to stabilize prices and quantities across market destinations. Motivated by a preponderance of empirical evidence disavowing the law of one price, the model details some of the economic implications of pricing-to-market behavior. Specifically, the framework examines some of the macroeconomic consequences of market segmentation and shows the resulting behavior of international prices to be broadly in line with the stylized facts. The results include both cross-sectional implications regarding nominal prices and time-series implications regarding relative prices.

Across different trade patterns, significant variation exists in the degrees of pass-through and pricing to market depending upon the degree of intraindustry trade and the substitutability between domestic and foreign goods. Across time, dynamic adjustment in prices suggests that nominal and real exchange rates move together over the short run and over the longer run as well to the extent that markets remain segmented. Overall, pricing to market provides a potentially important source of local price stickiness and real exchange rate variability and persistence.

JEL Classification Numbers:

E23, E24, E31, E37, E51,
E52, E62, E63, P27

Summary of

WP/95/13

"Stabilization and Structural Change in Russia, 1992-94"

by Vincent Koen and Michael Marrese

Following decades of central planning and systematic repression of market forces under the Soviet regime, the relatively peaceful dismantling of the old order in Russia has been a major achievement. However, the full complement of economic policies needed to solidify a market system has not yet been implemented. Stabilization in particular has so far proved elusive, as attested by the recent upsurge in inflation. Nonetheless, much progress has been made since late 1991, especially in the structural area.

The paper analyzes output, consumption, inflation, fiscal, and monetary trends. The output collapse was largely inevitable, smaller than indicated by the official statistics, and did not have a commensurate negative impact on household welfare. Following the jump associated with price liberalization, trend inflation in 1992-93 remained very high, oscillating between 10 and 30 percent a month. It slowed to single digit levels in the first half of 1994 but picked up in the fall. Fiscal and monetary policies gradually became tighter, as subsidies to domestic agents and other states of the ruble area shrunk and real interest rates were gradually increased. The sustained erosion of tax revenues forced adjustment on the expenditure side, notably in the form of sequestration. The paper also describes some of the disruptions that tend to mask the underlying trends, including seasonal variations, ebbs and flows of arrears, political turmoil, the mid-1993 monetary reform, and exchange rate crises.

A numbers of observers and policymakers in Russia initially doubted the merits of applying conventional macroeconomic wisdom to the relationships between money, prices, and output. Time series evidence is now sufficient to investigate these links econometrically. It is shown that money growth does indeed cause inflation in Russia. In addition, the data do not support the claim that there is a trade-off between output and disinflation. In any event, the painful lessons from high inflation in Russia and in neighboring countries are being learned, fostering a broader consensus on this set of issues.

Even on the structural side, progress, while genuine, has been very uneven. Slow improvements on the stabilization front have retarded structural change, and vice versa. Price and exchange rate liberalization as well as privatization have moved ahead fast, but enterprise behavior, and the business environment in general, have not improved in tandem. Some firms are adjusting energetically and stand a chance to survive and prosper in the longer run, but others continue to rely too heavily on rent seeking and state subsidies. Institution building is proceeding, but implementation generally lags. The transition process will likely remain chaotic and somewhat unpredictable for some time. But even though muddling through may not sound like an appealing strategy *ex ante*, it is, *ex post*, far from the worst outcome.

JEL Classification Number:
F31

Summary of
WP/95/14

"Long-Run Exchange Rate Modeling: A Survey
of the Recent Evidence" by Ronald MacDonald

Recently there has been a revival of interest in the determinants of long-run exchange rates. This interest has been generated in large part by developments in the time-series literature, particularly those relating to unit root and cointegration testing. The form of the long-run exchange rate that has received most attention is based on the doctrine of purchasing power parity (PPP). This paper presents an overview of the large number of contemporary tests of PPP.

Recent tests of PPP have been conducted in one of two ways. One approach involves examining whether nominal exchange rates are cointegrated with relative prices, while the other (which is complementary) seeks to determine if real exchange rates contain a unit root. This paper demonstrates that each of these approaches may be derived from a particular account of the balance of payments: generally speaking, the former kind of test stems from current account transactions, while the latter emanates from the capital account. Focusing on one or the other account of the balance of payments, however, may result in a misspecified relationship, especially when a researcher is using data from the recent floating experience. It is suggested that when data for this period are being used to test PPP, it would be better to consider the total balance of payments.

The paper identifies a general trend in recent empirical work on long-run exchange rate modeling, which is that PPP does seem to have some long-run validity. In particular, many currencies are found to have a unique cointegrating relationship between an exchange rate and relative prices, and real exchange rates display mean reverting behavior (two pieces of evidence that are complementary and supportive of a traditional form of PPP). Using a new data base and a variety of estimation techniques, this paper confirms these findings. However, the form of the long-run exchange rate relationship unearthed by recent work does not conform exactly to what many would understand as "traditional PPP." Specifically, there appear to be extremely long-lived deviations from PPP, and the restrictions of symmetry and homogeneity of degree one often associated with PPP are usually rejected. The paper offers some explanations for the apparent discrepancy between the empirical and traditional versions of PPP.

JEL Classification Number:
H60

Summary of
WP/95/16

"Setting up a Treasury in Economies in Transition" by
Teresa Ter-Minassian, Pedro P. Parente, and Pedro Martinez-Mendez

In most countries, the primary mandate of the national treasury is to optimize the financial management of government operations. This basic institutional mandate, however, encompasses a varying range of functions in different countries. Reflecting historical and cultural factors, the economic situation of the country, and the balance of powers among government agencies responsible for economic management, the treasury may have a more or less extensive role in some, or all of the following areas:

1. the planning and control of the execution of the central government budget and the monitoring of operations of the extrabudgetary funds and subnational governments;
2. day-to-day cash management, including control of inflows and outflows into the government account(s) with the banking system; and securing the smooth financing of government expenditures;
3. the management of government debt and debt guarantees;
4. the management of government financial assets, including equity holdings in public enterprises; and
5. the accounting of government operations and the development and maintenance of government financial information system(s).

The treasury's role in budget execution can range from passive (when the treasury merely makes resources available to spending agencies, to execute their approved budgets) to fully active (when it is empowered to set limits on commitments and/or payments of expenditures, or even to authorize individual expenditures on the basis of pre-established criteria). Similarly, the treasury can share to different degrees the management of the public debt with the central bank. Finally, the treasury may or may not be responsible for the accounting function within the central administration.

This paper reviews in some detail the gamut of possible treasury functions and the implications of different assignment of responsibilities to the treasury for its organization and structure. It argues that, in countries facing substantial economic and financial adjustment problems and/or rapid institutional change, such as the economies in transition, it is desirable to give the treasury a broader (rather than narrower) range of responsibilities in government financial management.

The paper also highlights the importance of an appropriate government financial information system for the effective financial management of government operations and discusses the main desirable features of such a system. It concludes with a discussion of the relationship of the treasury with other public sector entities, in particular the central bank.

JEL Classification Numbers:
H25, H32, D21, E24, J30

Summary of
WP/95/17

"Excess Wages Tax" by Alan A. Tait and S. Nuri Erbas

Excess wages tax (EWT) is a tax-based incomes policy instrument used by some countries in transition. Under EWT, the government taxes the excess of the wage bill above the norm, calculated typically on the basis of inflation and some multiple of the prevailing minimum wage. The main goal of EWT is to curb inflationary pressures by penalizing through taxation the "excessive" wage awards granted by enterprises in the course of wage and price liberalization. This paper examines the effect of EWT on enterprise behavior, wages, and profits, and its possible impact on inflation.

First, EWT's impact on the profit-maximizing enterprise under monopsony is examined as a benchmark. The paper shows that EWT increases the marginal cost of labor. Consequently, although EWT serves to lower the wage award, this is achieved at the cost of lower output and employment, and smaller profits. Also, EWT penalizes more productive enterprises. The impact of EWT on total tax revenue (standard corporate tax revenue plus EWT revenue) is ambiguous because even though the statutory tax base with EWT is broader, taxable profit is smaller. Furthermore, although EWT can curb enterprises' wage awards in the face of inflation, EWT can be pro-inflationary and even result in stagflation, depending on the government's minimum wage policy.

A more realistic model for enterprise behavior in the economies in transition is provided by the labor-dominated enterprise. In this case, with homogeneous labor, it is shown that EWT results in a decline in wages. With heterogeneous labor (managers and workers), wages will also decline, regardless of whether labor shedding is feasible. However, the paper argues that the impact of EWT on wages is moot and that the main determinant of wage awards is the degree of fiscal discipline imposed by the government or the extent to which the government subsidizes the enterprise. It is further argued that EWT does not necessarily curb asset stripping by the employees to pay for larger wage awards.

The experience with EWT in some countries in transition is reviewed briefly. Notably, the evidence from Poland suggests that while EWT has reduced wage awards, it has penalized more productive enterprises, is likely to be highly distortionary, and is not directly correlated with asset stripping. The evidence concerning the impact of EWT on inflation is inconclusive.

The paper suggests that the only role for EWT might be as a temporary measure implemented on the way to privatization and competition. However, even in this role, the distortions introduced would be likely to slow the pace of transition, discourage rapid adaptation, and penalize efficiency and innovation. It is better to control credit expansion, impose credible budget constraints and performance requirements on state-owned enterprises, permit bankruptcy when necessary, and expose the protected enterprises to competition and privatization.

JEL Classification Numbers:
C43, E31, F31

Summary of
WP/95/18

"A Review of PPP-Adjusted GDP Estimation and its
Potential Use for the Fund's Operational Purposes" by Nancy Wagner

International comparison of economic aggregates requires the conversion of such aggregates, expressed in domestic currencies, into a common numeraire currency, such as the U.S. dollar or the SDR. As market exchange rates are often subject to fluctuations that do not fully reflect fundamentals and can result in inconsistent cross-country comparisons of real economic activity, it is often recommended to use purchasing power parity (PPP) rates instead. In this context, PPP refers to the purchasing power of a country's currency. This paper reviews the data and methodology underlying the construction of PPP indices (based on extensive price surveys conducted by the International Comparison Programme in selected countries) and examines some of the issues associated with the potential use of PPP-based estimates of GDP for the Fund's operational purposes. The paper concludes that, in general, because of unresolved data and methodological issues, the use of PPP-adjusted estimates would seem inappropriate for the Fund's operational purposes at this time.

Although it is generally agreed that PPP rates are appropriate conversion factors from a conceptual viewpoint, their practical implementation has been hampered by the uneven quality of the PPP indices currently available. Perhaps the most critical problem with the ICP data base is its incomplete coverage of countries and even entire regions. Other data-related problems include extrapolations of current price data from constant price growth rates and difficulties in comparing baskets of goods and services across widely diverse countries (a particularly acute problem with nontradables).

Apart from data deficiencies, a number of methodological issues remain unresolved. The method most commonly used by the ICP has been criticized for imparting an upward bias in GDP estimation for those countries whose price structures differ significantly from price structures in the high-income industrial countries. However, alternative methodologies have also been subject to criticism on other grounds. The various methodological choices produce substantially different results, and no consensus has emerged as to the appropriate estimation procedure.

JEL Classification Numbers:
011, 055, C23

Summary of
WP/95/19

"Public Policies and Private Savings and Investment in Sub-Saharan Africa:
An Empirical Investigation" by Michael T. Hadjimichael and Daneshwar Ghura

Economic performance in sub-Saharan Africa as a whole has lagged behind that of other developing regions during the past two decades. Nonetheless, the performance indicators have masked noticeable differences among subgroups of countries in the region; countries that have effectively implemented broadly based adjustment policies have done better than the others. The adjustment experience of sub-Saharan Africa during 1986-92 demonstrates that expanding private savings and investment is essential for achieving gains in real per capita GDP. The divergence in the private sector and overall economic performance among the various country groups primarily reflected differences in their policy response to the deterioration in the terms of trade--in particular, in the progress made toward promoting macroeconomic stability, improving external competitiveness, and alleviating structural and institutional impediments to private sector activity.

Total and private savings and investment in sub-Saharan Africa are still too low to facilitate a sustainable expansion in output at a satisfactory rate. Furthermore, in view of the modest share of foreign direct investment currently channeled to sub-Saharan Africa and the increasing competition for direct investment, more of the resources needed to boost economic growth would need to be generated by the domestic private sector of the countries in the region. In this context, the domestic private sector would have to play a major role in accelerating output growth and gradually narrowing the gap in per capita incomes relative to other developing countries.

Accordingly, public policies would need to be aimed at creating an environment that is conducive to private sector development. Therefore, a critical question is, to what extent would changes in public policies be effective in stimulating the rates of private savings and investment in the region? This paper attempts to answer this question by empirically investigating the relationships between public policy indicators on the one hand and private savings and investment on the other, using pooled data for a large sample of sub-Saharan African countries during 1986-92. It finds that public policies can indeed promote private savings and investment in the region, particularly policies aimed at maintaining low inflation, reducing macroeconomic uncertainty and the external debt burden, and promoting financial intermediation. The empirical results also indicate that, although efforts to lower the budget deficit would help stimulate private investment, achieving this objective by lowering government investment would be counterproductive, given the complementarity between government and private investment. Thus, alternative ways of reducing budget deficits to sustainable levels would have to be considered, such as lowering unproductive current expenditure and strengthening revenue mobilization.

JEL Classification Numbers:
E24, F13, F42

Summary of
WP/95/20

"Trade Liberalization and Unemployment"
by Pierre-Richard Agénor and Joshua Aizenman

Increasing attention is being devoted to the role of labor markets in the design of macroeconomic and structural adjustment programs. This paper attempts to provide a theoretical framework for understanding the impact of labor market imperfections on the short- and medium-run effects of trade liberalization. The analysis considers a small open economy producing exportable and nontradable goods, with imperfect labor mobility across sectors. Firms in the export sector face significant labor turnover costs, with the quit rate depending on the wage differential across sectors. In equilibrium, wages in the export sector are shown to be positively related to the market-clearing wage in the nontraded goods sector. Private consumption expenditure depends linearly on "expected" disposable income, with the weight attached to current income (as opposed to permanent income) being positively related to the intensity of liquidity constraints faced by households.

A reduction in tariffs, coupled with an increase in lump-sum taxes to equilibrate the government budget, is shown to lower wages in all production sectors in the short and the medium run but has an ambiguous effect on unemployment in the export sector. Although employment and production of exportables expand in the medium run, the steady-state unemployment rate may rise or fall depending on whether the elasticity of wages in the export sector with respect to wages in the nontraded goods sector is lower or greater than unity. On impact, trade reform may lead to a reduction in the unemployment rate if (as a result of tight liquidity constraints) household consumption is a function mostly of current income. In addition to formal derivations, the paper provides a detailed intuitive discussion of the role of the relative wage elasticity and imperfect mobility of labor in determining the direction of the short- and medium-run effects of trade liberalization on employment and unemployment.

The analytical framework presented in the paper focuses on the short- and medium-term effects of trade reform programs that do not modify the set of production activities carried out in the economy. However, it is emphasized that a drastic trade liberalization package (or a package embedded in a comprehensive restructuring program) may, over the long term, encourage the formation of new activities, changing over time the sectoral composition of output. Under such conditions, even if trade liberalization entails significant adjustment costs in the short or the medium term, it may still be highly beneficial in the long run.

JEL Classification Numbers:
F34, H63

Summary of
WP/95/21

"The Role of Foreign Currency Debt in Public Debt Management"
by Patrick de Fontenay, Gian Maria Milesi-Ferretti, and Huw Pill

This paper focuses on the choice between domestic currency and foreign currency debt. This aspect of public debt management is of interest because, among highly indebted countries, significant differences exist in the currency composition of outstanding public debt. While in Italy the share of foreign currency debt in total debt has been negligible until recently, in Ireland it is over one-third. Borrowing in foreign currency removes the incentive to reduce ex post the real value of government debt through unexpected inflation. However, it exposes the domestic currency value of government liabilities to fluctuations in exchange rates.

The paper examines the theoretical determinants of the choice between domestic and foreign currency debt and presents an empirical analysis of the behavior of the share of public debt denominated in foreign currency in a group of member countries of the Organization for Economic Cooperation and Development, including Belgium, Denmark, Ireland, Italy, New Zealand, and Sweden. The theoretical analysis focuses on time consistency issues, the possibility of confidence crisis, the role of incomplete information, and the hedging role of public debt management. Practical considerations relate to, inter alia, portfolio management and the balance of payments situation. The empirical analysis examines the covariance between real interest payments on domestic and foreign currency debt on the one hand, and productivity and public spending shocks on the other hand. It also reports correlations of the share of foreign currency debt in total debt with the interest differential on domestic versus foreign debt instruments.

JEL Classification Numbers:
H20, H26, H30, K4, P35

Summary of
WP/95/22

"The Reform of Tax Administration" by Vito Tanzi and Anthony Pellechio

Reforming tax administration requires an understanding of its problems. Often, tax laws are exceedingly complex and opaque, making it virtually impossible for taxpayers to comply. Sometimes, the political system does not pursue the public interest in the development of tax legislation, which results in loopholes and other inequities that undermine the integrity of the tax system and taxpayer compliance. Frequently, problems originate in tax administrations themselves where a lack of resources, a lack of professionalism (corruption), and a lack of a clear strategy for reform play a role.

This paper provides some elaboration and examples, based on country experience, of the six essential elements required for successful tax administration reform: an explicit and sustained political commitment; a team of capable, hardworking officials dedicated full-time to tax administration reform; a well-defined and appropriate strategy; relevant training for staff; additional resources for the tax administration or, at least, some reallocation of resources; and changes in incentives for both taxpayers and tax administrators.

Tax administration reform must strive to enhance both the effectiveness and efficiency of tax administration. The paper discusses interventions to improve effectiveness through promotion of taxpayer self-assessment, provision of taxpayer education, adoption of procedures for minimizing the cost of complying for taxpayers, implementation of systems for tax returns processing and accounting that quickly detect noncompliance and take appropriate action, and establishment of an audit plan to detect violations as efficiently as possible. Also needed are adequate penalties for violations that strike at the heart of the tax system, such as failure to file returns and to pay taxes on time.

The paper finds that, along with a strategy for enhancing effectiveness, tax administrations can adopt a number of measures to focus their scarce resources in the most efficient manner for revenue collection and enforcement. These measures include establishment of a large taxpayers unit; adoption of a threshold for tax registration that exempts small enterprises from major taxes; the imposition of an alternative tax on small enterprises with limited revenue potential; use of final withholding of taxes on individual taxes; and use of banks for receiving tax payments.

The measures discussed in the paper for improving the effectiveness and efficiency of tax administration suggest an organization of the tax administration to support five principal functions: taxpayer education; registration, accounting and returns processing; collection enforcement; auditing; and legal services and appeals.

JEL Classification Numbers:
F15, F36, F47

Summary of
WP/95/23

"Regional Integration in Eastern and Southern Africa:
The Cross-Border Initiative and its Fiscal Implications"
by Ferdinand Bakoup, Abdelrahmi Bessaha, and Luca Errico

Attempts at regional integration in independent Africa can be traced back to the early 1960s. Recently, efforts at building or strengthening regional integration were renewed, reflecting not only a growing regionalism in the world economy in general, but also a strong commitment by policymakers to reverse the trend of poor growth performance through the design and implementation of regional arrangements and robust adjustment programs. New initiatives are being undertaken in West and central Africa. Similarly, countries in east and southern Africa have recently launched the Cross-Border Initiative (CBI) for promoting trade, investments, and payments in eastern and southern Africa.

The move to economic regional integration, if pursued in a spirit of mutual benefit, stimulates trade by freeing it from restrictions and barriers, promotes growth through economies of scale, improves the institutional environment, strengthens the external discipline that sustains appropriate policies, and allows for timely responses to changing circumstances. The move to integration also entails temporary costs, although these can be minimized and/or absorbed if trade liberalization is supported by adequate macroeconomic, structural, and social policies. One such cost would be the reduction in government revenue from customs duties following regional integration. A sound fiscal policy response, including tax system reforms, could help ensure that short-term pressures on revenue are addressed adequately.

The main objectives of this paper are (1) to assess the gains that Burundi, Kenya, Tanzania, and Uganda could achieve by participating in the current regional integration process; (2) to analyze the fiscal implications of the tariff reform for these countries, within the framework of the CBI, by providing quantitative estimates of government revenue losses that would stem from changes in tariffs--through elimination (for intraregional trade) and reduction (for extraregional trade)--as well as estimates of the additional fiscal efforts needed to maintain the same overall fiscal policy stance despite the move to regional integration; and (3) to suggest possible fiscal policy responses for the short term, such as adjusting sales tax rates, and for the medium term. The latter include improving the management of fiscal exemptions and tax smuggling, adopting a value-added tax (VAT), and increasing indirect taxes under the destination principle to make up for revenue forgone and to comply with the tax harmonization process induced by the regional integration.

JEL Classification Numbers:
E43, F21

Summary of
WP/95/24

"Current Account Surpluses and the
Interest Rate Island in Switzerland" by Paolo Mauro

This paper describes the various components of the Swiss balance of payments in historical perspective and compares them to those of other countries. It also describes the long-run evolution of Switzerland's net foreign asset position as a proportion of GDP.

Two macroeconomic phenomena make Switzerland stand out among other countries: first, it has had a persistent current account surplus and the largest ratio of net foreign assets to GDP in the world; and second, its real interest rates have been significantly lower than those of most other industrialized countries, earning it the label "interest rate island."

The paper attempts to bring these two distinctive features of the Swiss economy within a consistent framework. It argues that they may be related and that ultimately both may result from an excess of national savings over investment for many years. The paper also briefly discusses possible determinants of the Swiss investment and saving ratios, both of which are high by international standards.

The real interest differential is decomposed into deviations from uncovered interest rate parity (UIP) and deviations from ex ante relative purchasing power parity. In common currency terms, assets denominated in Swiss francs have yielded less than similar safe assets denominated in other currencies over the past two decades. Thus, the sign and large magnitude of this deviation from UIP suggest that a foreign exchange rate risk premium compensates Swiss residents for holding net assets in foreign currency and foreign residents for bearing net liabilities in Swiss francs.

JEL Classification Numbers:
E62, F15, H87

Summary of
WP/95/25

"Fiscal Policy Coordination in the West African Economic
and Monetary Union After the Devaluation" by Christoph B. Rosenberg

The devaluation of the CFA franc--effective January 12, 1994--provides new impetus for a thorough re-evaluation of the conduct of fiscal policy within the West African Economic and Monetary Union (WAEMU). There seems to be a consensus that some mechanism for coordinating fiscal policies must be put in place; this need is recognized in the new WAEMU economic integration treaty, which was signed by the heads of state of the member countries the day before the devaluation. The purpose of the treaty is mainly to promote political integration in the region and to achieve domestic policy goals through the peer pressure of the union. However, fiscal harmonization may also be warranted on purely economic grounds. This paper attempts to provide an economic rationale for such fiscal policy coordination in the CFA franc zone and to investigate its implications.

First, the conduct of fiscal policies in the WAEMU's predecessors since the mid-1980s is examined. To a large extent, these policies, which still prevail today, were characterized by a severe lack of policy coordination. The paper identifies the main (negative) fiscal externalities and intrazone policies that distort trade at both the microeconomic and the macroeconomic levels. This analysis shows that (1) distortive tax and tariff systems reduced trade and prevented the region from reaping all the benefits of a monetary union; and (2) some countries used their fiscal instruments to conduct beggar-my-neighbor policies vis-à-vis their partner countries. Thus, the lack of fiscal coordination and the resulting divergences in economic performance may well have exacerbated the problems that the CFA franc zone has faced in recent years.

The second part of the paper is devoted to the prospects and possibilities, as well as the implications, of fiscal harmonization in the new WAEMU. In the light of the January 1994 devaluation of the CFA franc, closer coordination of indirect taxation, customs duties, and budget policies is more desirable than ever if the countries in the region are to achieve their economic objectives, including the expansion of trade. Moreover, coordination of fiscal policies will mitigate any harmful fiscal externalities. Based on the analysis in the first part of the paper, recent efforts to coordinate fiscal policies in the zone area are reviewed and evaluated. The paper concludes that, despite the overall merit of the general harmonization strategy, tax rates, tariff rates, and convergence criteria require some modification. Finally, the paper offers recommendations for reinforcing this strategy.

JEL Classification Numbers:
E42, E58

Summary of
WP/95/26

"The Design and Printing of Bank Notes:
Considerations When Introducing a New Currency" by Richard K. Abrams

Planning for the new issue or replacement of a national currency has, for many countries, been made more difficult by the lack of consistent published information on the various aspects of this process. This paper attempts to ameliorate part of this problem by reviewing the main issues in designing, producing, and printing a new currency.

The paper discusses the problems that may arise when introducing or changing a national currency. Since many people view the currency as an important national symbol, design decisions may become emotional and contentious, resulting in long production delays. Yet the object of this exercise is usually to establish or restore confidence in the currency. Thus, the design selection process should minimize delays and seek to ensure that the currency is "user friendly," durable, easily recognizable, and reasonably secure against counterfeiting. Key aspects of these design decisions are outlined, as are such issues as the initial value of the currency, the denominations to use, and the broadest considerations regarding the quantity of bank notes to print.

The paper also addresses the choice of who should print the currency. In the short run, it is often better to use a private printer, especially if the country lacks a bank note printing works. In the longer run, many countries may prefer to produce their own bank notes. However, the bank note printing industry appears competitive, partly because many countries have excess capacity at their bank note printing works.

Issues including the time involved in designing and printing bank notes, as well as the costs of producing various types of bank notes, are then outlined. The paper also argues that an educational campaign should be a prerequisite for introducing a new currency. While the primary objective should be to reduce the risk of counterfeiting, such a campaign will also help ensure that the currency gains immediate acceptance.

The paper reviews alternative steps that can be taken when there is inadequate time to produce new bank notes in an orderly manner. The favored alternatives include modifying the plates of the country that formerly printed the notes to print "new" bank notes and overprinting or affixing stamps to existing notes. However, each method may have its difficulties. The next best alternative is to print near-bank-note quality coupons. A country should avoid printing low-quality bank notes or hand stamping existing notes because of the risk of counterfeiting.

JEL Classification Numbers:
F34, N20

Summary of
WP/95/27

"Historical Experience with Bond Financing to Developing Countries" by Juan Jose Fernandez-Ansola and Thomas Laursen

Over the past five years, bonds placed by developing countries in international markets have accounted for a substantial portion of the funds raised by these countries. Historically, bonds were the predominant means by which countries raised foreign financing. Only during the 1970s, when relatively small amounts of bonds were issued, did bank lending play a predominant role. In order to put recent developments in perspective, the paper reviews experiences with bond financing in the early part of this century and in the 1970s and early 1980s.

The paper examines the sources and role played by bonds in providing financing to developing countries in the early part of this century. Also examined are the payments difficulties encountered during the 1930s, and the steps taken to resolve them. During that decade, a number of countries partially or totally defaulted on their foreign bonds. These defaults were generally settled through protracted formal negotiations between the debtor countries and representatives of the bondholders. In most cases it took more than five years, and in a few instances more than ten years, to reach a debt-restructuring agreement. As a result, most of the countries that defaulted on bond obligations during the 1930s took almost forty years to regain substantial access to international capital markets; when they did re-establish access in the 1970s, these countries generally had to pay higher rates than other developing countries.

During the 1970s and early 1980s, developing countries issued only a limited number of bonds; by the mid-1980s, bond debt amounted to only \$17 billion. During the ensuing debt crisis, the incidence of payments difficulties on these bonds was small relative to other forms of debt, perhaps pointing to some preferential treatment afforded by developing countries to bonds. The paper describes a distinctive feature of the restructurings that did take place: in lieu of extended, formal negotiations between debtors and bondholders or their representatives, debtor countries made unilateral offers based on informal contacts with creditors. Exchanges of new bonds for defaulted ones were made at par, and interest rates on the new instruments were generally higher than on the original bonds, although maturities were longer.

The paper finds that, after these defaults, new access to international markets has been quite limited for all of the countries that restructured bonds in the 1980s and 1990s. Where countries have managed to raise new funds, the amounts involved have been small, the interest rate premiums high, and the maturities short.

JEL Classification Numbers:
F22, O47, O56

Summary of
WP/95/28

"Paradise Lost? Growth, Convergence and Migration
in the South Pacific" by Paul Cashin and Norman Loayza

This paper examines the growth experience of seven developing island economies of the South Pacific--Fiji, Kiribati, Papua New Guinea, Solomon Islands, Tonga, Vanuatu, and Western Samoa--and their developed neighbors, Australia and New Zealand, during the period 1971-93. The Solow-Swan neoclassical growth model provides the analytical framework for this study, and the implications of this model are tested using both the cross-sectional and time-series dimensions of the data. The econometric technique employed in the paper is Chamberlain's II-matrix estimator, which accounts for unobserved country-specific heterogeneity in the growth process and any bias resulting from errors in the measurement of real per capita GDP.

After controlling for investment and migration, as well as for unobserved country-specific effects, the paper finds that the nine island economies have been converging at a relatively rapid speed--about 4 percent per year--toward their respective steady-state levels of per capita GDP.

When analyzing measures of the cross-sectional dispersion of national income, the paper finds that net private and official transfers have ensured that the dispersion of real per capita national disposable income in the region has remained relatively constant over the 1971-93 period. However, the dispersion of countries' real per capita GDP, which excludes such transfers, clearly widened over this same period.

JEL Classification Numbers:
E60, H6, I30

Summary of
WP/95/29

"Poverty Alleviation in a Financial Programming Framework:
An Integrated Approach" by Sheetal K. Chand and Parthasarathi Shome

Poverty alleviation has usually been addressed in financial programming models by adding social safety net programs to the financial programs but without modifying the underlying stabilization and adjustment targets. Despite its convenience, this traditional approach may be less effective than an integrated approach in which the settings of financial program instruments are chosen in such a way as to minimize adverse implications for poverty.

This paper addresses the issue by setting up a general version of the financial programming model that can be used to explore possible trade-offs between targets, such as for the balance of payments, inflation, and output growth. The Sen Poverty Index is explicitly introduced into this model and consists of the following: (1) head-count ratio (the proportion of a population below a predetermined poverty line, (2) poverty gap or the degree of poverty (the gap between the average income for the poor and the poverty line), and (3) the Gini coefficient (distribution of income) among the poor.

At the macroeconomic level, the poverty index may be affected either by the outcomes of the model with respect to output and inflation or by the policy measures that may be enacted, such as a devaluation or a fiscal consolidation. By reference to factors inducing a change in the Sen Poverty Index and with a view to containing their effects, the preferred short-term macroeconomic outcome of an adjustment program would be for (1) the rate of output growth not to be unduly depressed, (2) the balance of payments to be improved, (3) inflation to be reduced, and (4) fiscal outlays, especially those that benefit the poor, not to be excessively suppressed.

The paper presents a simulation in which an externally delivered shock (20 percent decline in export prices) is assumed. Although the economy will be impoverished by the terms of trade shock, the results indicate that the poverty index could be held at a lower (better) level with a better output and balance of payments performance. The cost would be a temporarily slightly higher fiscal deficit and higher inflation than with the traditional model, in which poverty programs are simply added on.

JEL Classification Numbers:
E43, F21, F32, F36

Summary of
WP/95/30

"World Public Debt and
Real Interest Rates" by Robert Ford and Douglas Laxton

Aside from perhaps unemployment or inflation, no other recent macroeconomic policy issue has attracted as much attention as government deficits. Robert Barro and others have demonstrated that the long-term effects of government debt on real interest rates will depend on the extent to which consumers view government debt as wealth. If consumers are connected to all future generations and can borrow against their future income streams, changes in government debt will not crowd out private consumption and investment because consumers adjust their savings to offset the effects of government deficits on their future tax liabilities. This invariance proposition is referred to as Ricardian equivalence, although David Ricardo himself did not believe that the economic consequences of deficits were unimportant. Although there exists considerable empirical evidence that rejects the notion that consumers offset completely the effects of government deficits, there is a paucity of direct empirical evidence that higher levels of government debt will result in higher real interest rates. Indeed, a significant body of empirical research, for example, that by Robert Barro and Paul Evans, has concluded that government deficits and government debt have not had any significant effects on interest rates.

This paper estimates the effects of aggregate fiscal developments in the industrial world on real interest rates in nine industrial countries with liberalized capital markets. The results imply that the increase in OECD-wide government debt since the late 1970s was responsible for the rise in real interest rates in all of these countries. The fact that increases in government debt in any one country will increase real interest rates in other countries suggests that some countries with high levels of government debt may be imposing significant negative externalities on other countries. The results of this paper have two implications for policy. First, they suggest that policymakers should care as much about debt targets as they do about deficit targets. Second, since debt reduction in one country provides long-term benefits for the world economy, there may be an important role for coordination of fiscal policies across countries.

JEL Classification Numbers:
F21, F32

Summary of
WP/95/31

"Economic Effects and Structural Determinants of
Capital Controls" by Vittorio Grilli and Gian Maria Milesi-Ferretti

This paper examines capital controls from a long-term perspective, it analyzes theoretically and empirically their determinants and their economic effects. With regard to the determinants of capital controls, the paper investigates whether certain political and structural features of an economy make the imposition or removal of capital controls more likely. With regard to the effects of foreign exchange restrictions, it investigates whether limitations on capital mobility, together with other economic, political, and institutional features, help explain the behavior of key macroeconomic variables, such as inflation, real interest rates, and growth.

The theoretical part of the paper presents a simple and widely used overlapping generations model. Although no formal test of propositions derived from the model is performed, the theoretical framework helps to identify some of the key issues examined in the empirical analysis. The empirical part of the paper is based on a panel of 61 developing and developed countries. Dummy variables are constructed from the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* as proxies for capital controls. These proxies include restrictions on payments for current and capital account transactions and multiple currency practices.

Several interesting empirical regularities are identified in the paper. Capital controls are more likely to be in place when income is low, the share of government in economic activity is large, the exchange rate is managed, and the government has a relatively free hand in monetary policy because the central bank is not very independent. As for the economic impact of capital controls, restrictions on capital account transactions tend to be associated with higher inflation, a higher share of seigniorage revenue in total revenue, and lower interest rates. This study finds no robust impact of capital controls on the rate of growth, although there is evidence that countries with large black-market premiums (themselves correlated with foreign exchange restrictions) grow more slowly.

JEL Classification Numbers:
C22, C52, E44, G14

Summary of
WP/95/32

"Nonlinearity and Endogeneity in
Macro-Asset Pricing" by Craig Hiemstra and Charles Kramer

Linear asset-pricing relations, with macroeconomic factors as state variables, have found wide use in empirical finance. Applications of such relations range from academic studies of market efficiency and market anomalies to practical uses such as risk management and estimation of the cost of capital. These applications make two key assumptions: that the relationship is exclusively linear and that the macroeconomic factors are exogenous to returns. For the set of macro factors commonly used in these applications, both assumptions run counter to economic intuition.

This paper demonstrates that the assumptions are also counter to empirical evidence by testing for linear and nonlinear Granger causality. The tests work as follows. Given two forecasts of a time series--a forecast from its own lags and a forecast from its own lags and the lags of a second series--if the second is more accurate than the first (if the improvement is statistically significant), the second time series is said to Granger cause the first. When two time series Granger cause one another, feedback is said to exist between them.

Linear and nonlinear feedback are found between stock returns and commonly used macroeconomic pricing factors as well as between residuals from linear pricing relations and returns. In addition, there is little evidence to suggest that neglected autoregressive or autoregressive conditionally heteroscedastic dynamics are responsible for these findings, implying that the underlying dynamics are complicated.

The evidence strongly suggests that macroeconomic factors are neither exogenous nor related to stock returns in a solely linear way. Thus, linear asset pricing relations omit interesting and potentially useful aspects of the relationship between stock returns and the macroeconomy. The evidence also sheds light on the literature on univariate nonlinear dynamics in stock returns. It suggests that such dynamics result from a complicated interrelationship between the stock market and the macroeconomy.

JEL Classification Numbers:
H55, H53

Summary of
WP/95/33

"The Italian Public Pension System: Current Prospects
and Reform Options" by Patricia Canziani and Dimitri G. Demekas

Public pension expenditure in Italy grew from about 5 percent of GDP in the early 1960s to over 15 percent in the early 1990s, outpacing all other categories of primary government expenditure and making Italy one of the biggest spenders on pensions among industrialized countries. In the future, the adverse demographic dynamics are expected to increase the pressures on the pension system. Against this background, a reform of the pension system was undertaken in 1992, aimed at stabilizing the share of pension spending in GDP and at reducing the distortions and inequities of the system. This reform was insufficient to restore the system to equilibrium, and further reforms are currently being prepared on the basis of an agreement reached between the Italian government and the trade unions in November 1994.

The paper reviews the current state of, and outlook for, the Italian public pension system, focusing primarily on its financial aspects. A pension system has, of course, other important implications, notably for the labor market, savings, and income distribution; these, however, lie outside the scope of this study. In view of the impending pension reform in Italy and the current public debate on this topic, the paper also simulates the quantitative effects of four possible reform options: lowering the accrual rate; raising the retirement age for women; introducing an early retirement penalty; and reducing survivors' benefits. These options do not exhaust the menu of possible reforms, but any package intended to restore the long-term equilibrium of the system would have to include at least some of them.

One thing that the simulations underscore is that there is no quick fix: in all cases, the effects of the measures on pension spending would be relatively limited in the next three to five years, and in some cases it would be negligible. However, some of the measures would generate substantial savings in the long term. The paper therefore suggests that the ideal package would contain a mix of some measures with immediate impact and some with a growing effect over time.

JEL Classification Numbers:
C42, C82, E52, F31

Summary of
WP/95/34

"Measurement of Co-Circulation of
Currencies" by Russell Krueger and Jiming Ha

"Co-circulation" involves the regular use of two or more currencies within a country. This paper covers measurement and policy issues associated with the physical movement of currencies between countries and use of multiple currencies within a single economy. Co-circulation is common in Latin America and Eastern and Central Europe, and it also occurs in several Middle Eastern, East Asian, and African countries. Co-circulation causes statistical measurement problems in the balance of payments and money stock estimates.

The paper reviews a number of methods used to measure co-circulation. Some current research indicates that US\$200 billion or more may be in use outside the United States, and large amounts of other currencies may also be involved. In general, better techniques are available to measure currencies that leave their country of issue than to estimate the amount of foreign currencies circulating within an economy.

The penultimate section of the paper reviews some implications of co-circulation for statistical measurement and economic policy. Co-circulation is found to result in a loss of seigniorage to the host country, affect monetary policy control, and create foreign currency exposures within a country. Moreover, statistical errors may be created that could affect policy decisions.

An appendix discusses changes in demand for foreign currency that may occur when a country permits free circulation of foreign currency. A second appendix, contributed by Roman Zyttek, discusses how market segmentation might affect statistical estimates of co-circulation.

JEL Classification Numbers:
E62, H62

Summary of
WP/95/35

"Fiscal Restructuring in the Group of Seven Major
Industrial Countries in the 1990s: Macroeconomic Effects"
by Leonardo Bartolini, Assaf Razin, and Steve Symansky

This paper studies the effects of the ongoing fiscal restructuring in the seven major industrial countries. It first presents and calibrates a simple model of the labor market that incorporates the effects of distortionary taxes and then integrates this framework into the IMF's multicountry model (MULTIMOD), which has been extended to account for the effects of various tax instruments. The resulting framework is then used to simulate recent and prospective changes in fiscal policies in this group of countries and to estimate the impact of these policies on output, employment, and other macroeconomic variables during the 1990s.

The main conclusions to be drawn from the study can be summarized as follows. First, for the group as a whole, the fiscal adjustments implemented during the early 1990s, as well as those expected to be implemented in the next few years, are estimated to lead to some loss of output and employment in the short run (relative to a baseline path of no fiscal restructuring). However, most of the short-run output losses would be recovered by the end of the 1990s, as the fiscal adjustment is expected to contribute to a shift of resources from public consumption to private investment by lowering debt-financing needs and thereby reducing the burden of distortionary taxes.

The simulations also show that the output cost of various fiscal instruments tends to vary over different horizons. Increases in indirect taxes and expenditure cuts are more costly instruments for deficit reduction in the short run in terms of output losses, but potentially beneficial instruments over longer horizons. Thus, those countries that relied relatively more on indirect taxes and expenditure cuts in their restructuring (such as Canada, France, Japan, and the United Kingdom) are estimated to eventually realize the greatest benefits from the adjustment. By contrast, countries that relied more heavily on tax increases on factor income (Germany, Italy, and the United States), while incurring smaller losses in the short run (relative to the size of their adjustment), are anticipated to incur output losses in the long run.

JEL Classification Numbers:
J0, J3, J4, J5, P2, P5

Summary of
WP/95/36

"Wage Structure in the Transition
of the Czech Economy" by Robert J. Flanagan

Central planning produced distinct distortions in the wage structures of socialist economies, compared with market economies. These wage structures reflected the emphases on vocational training over advanced educational attainment, and on goods-producing industries over service industries. Under central planning, average returns to schooling were lower than in most market economies.

This paper examines the extent to which wage structures have adjusted during the economic transitions to remove such distortions, using microeconomic data from the Czech Republic. Since 1988, returns to schooling have increased, driven by weakening returns to vocational education and sharply increased returns to university education. These changes are led by developments in the private sector and retarded by the sluggish response of state enterprises. This general pattern of changing returns emerges in other transition economies as well. The paper also explores differences between wage policies in the private and state sectors during the transition. The private sector appears to establish steeper career wage profiles and is more likely than the state sector to use past unemployment experience as an indication of a productivity deficit.

Wage structures in market economies are not free of distortions. The reconstitution of eastern European labor unions into genuine collective bargaining organizations has the potential for introducing one source of such distortions into the wage structures of economies in transition. The paper examines the presence and impact of unions, finding that union representation is largely confined to the state sector, and that unions in the Czech Republic have had no impact on relative wages in either the state or private sectors.

JEL Classification Numbers:
J20, J31, Q43

Summary of
WP/95/37

"The Employment and Wage Effects of Oil Price Changes:
A Sectoral Analysis" by Michael Keane and Eswar Prasad

This paper uses micro panel data to examine the effects of oil price changes on employment and real wages in the United States, at the aggregate and industry levels. The paper also measures differences in the employment and wage responses to oil price changes for workers differentiated by skill level. Using a panel data set with detailed worker characteristics enables the efficient estimation of econometric models that correct for various sources of aggregation and selectivity bias.

The main finding of the paper is that oil price increases result in substantial wage declines in virtually all sectors of the economy. However, the magnitude of these wage declines varies considerably by industry and, within each industry, by skill level. On average, real wages fall between 3 and 4 percent in the long run following a single standard deviation around trend increase (approximately 19 percent) in the real price of refined petroleum products. However, oil price increases also result in an increase in the relative wage of skilled workers. The use of panel data econometric techniques to control for unobserved heterogeneity is essential to uncover this result, which is completely hidden in OLS estimates. The results also indicate that changes in labor force composition induced by oil price changes produce substantial bias in estimates of average wage effects based on aggregate data.

Oil price increases are found to reduce aggregate employment in the short run and shift industry employment shares in the long run. The long-run effect of an oil price increase on aggregate employment is positive, possibly indicating substitution between energy and labor in the aggregate production function. These results are consistent with the sectoral shift models of unemployment of Lilien (1982), Hamilton (1988), and others. An additional prediction of sectoral shift models is that workers tend to move toward those sectors where the relative productivity of labor (as reflected in wages) increases following a real shock. A comparison of estimated changes in industry relative wages and employment shares reveals little support for this prediction.

JEL Classification Numbers:
E43, E44, E52, E58

Summary of
WP/95/38

"Bank Lending Rates and Financial Structure in Italy:
A Case Study" by Carlo Cottarelli, Giovanni Ferri, and Andrea Generale

This paper contributes to the empirical literature on the behavior of lending rates by focusing on the Italian bank loan market. The Italian case is particularly relevant for two reasons. First, bank lending still represents the bulk of total financial flows to the private sector. Second, the stickiness of Italian lending rates has long been recognized as a serious impediment to the transmission of monetary policy.

More specifically, the paper provides an econometric measure of the degree of lending rate stickiness in Italy and compares it with the measures obtained for a sample of 30 industrial and developing countries. Then, the paper analyzes the structural factors affecting the stickiness of lending rates, pointing at the effects of constraints on competition within the financial market. The analysis is based not only on cross-country comparisons, but also on microeconomic data on lending rates charged by 63 Italian banks acting in different financial environments within Italy. The paper shows that differences in the degree of lending rate stickiness among Italian banks are mainly due to the different degree of concentration of the local loan markets in which banks operate: banks operating in less concentrated, more competitive markets adjust their lending rates faster.

Next, the paper discusses the implications for lending rates of the liberalization of Italian financial markets that characterized the early 1990s. It argues that this liberalization should lead to a reduction of lending rate stickiness and to a faster transmission of monetary policy. Indeed, there is already evidence that the degree of stickiness, while still high, has substantially declined.

Finally, the paper argues that the stickiness of Italian lending rates is also due to a form of "discount rate addiction" typical of countries in which the discount rate is used as monetary policy signal. De-emphasizing the discount rate is likely to increase the response of banks to money market changes but would deprive the central bank of a powerful instrument to spur banks' reactions, whenever needed.

JEL Classification Numbers:
E21, H55, J11

Summary of
WP/95/39

"Saving Trends in Southeast Asia:
A Cross-Country Analysis" by Hamid Faruquee and Aasim M. Husain

This paper reviews long-run developments in private saving behavior in Indonesia, Malaysia, Singapore, and Thailand since 1970. Over this period, rates of private sector saving in these economies have risen steadily and are presently among the highest in the world. Using cointegration analysis, the paper empirically examines the economic determinants underlying the long-run pattern of saving in these countries and the degree to which these economies share common developments in the factors accounting for their strong saving performance.

Based on country estimates and cross-country analysis, the principal finding of this study is that shifts in the demographic structure of the population appear to be the main factor explaining the sustained rise in the rate of saving in all four countries over the sample period. Fundamental demographic shifts increasing the relative size of the working age population appear to have boosted the rate of saving in these countries. Moreover, the magnitude of these long-run effects appears to be quite comparable across countries with the exception of Indonesia, where the impact has been even more pronounced.

The paper finds that the long-run implications of provident funds and compulsory saving policies are less clear. Compulsory provident fund saving appears to have had little or no consequence for the trend rate of saving in Malaysia, but there is some evidence of a long-run impact in Singapore. These differences may well be tied to each country's differing experience with compulsory saving schemes. Finally, financial deepening appears to be marginally significant for the long-run determination of saving only in the case of Singapore, the country achieving the highest level of financial development over this period.

JEL Classification Numbers:
E32, C32

Summary of
WP/95/40

"Recession and Recovery in the United Kingdom in the 1990s:
A Vector Autoregression Approach" by Luis Catão and Ramana Ramaswamy

The U.K. economy experienced one of its worst postwar recessions in 1990-92, when output declined by a cumulative 3 1/2 percent. This paper uses a vector autoregression (VAR) model to identify the shocks that were instrumental in causing the recession. The VAR approach is particularly useful when there are no strong priors about what caused the recession; it allows competing hypotheses of the recession to be distinguished without imposing many restrictions on the data.

The main finding of this paper is that the recent recession in the United Kingdom was precipitated primarily by shocks to consumption. This stands in marked contrast to the experience in 1979-81, when investment shocks were the main cause of the recession. The VAR analysis indicates that consumption shocks have a long lasting effect on GDP and, hence, offers a potential explanation for the long duration of the recession as well. The nature of the recovery taking place in the United Kingdom is shown to be basically consistent with the results of the model.

The VAR approach also allows a decomposition of the impact of monetary policy and expectational shocks on activity. The results of the paper indicate that the recent recession can be explained only in part by the prior monetary tightening and the subsequent collapse of the housing market. Expectational shocks are shown to have been equally important in bringing about the recession.

JEL Classification Numbers:
E31, F10, F31, F47

Summary of
WP/95/41

"Exchange Rate Movements and Inflation Performance:
The Case of Italy" by Robert Ford and Thomas Krueger

The currencies of several countries in Europe depreciated sharply in the aftermath of the turmoil in the exchange rate mechanism (ERM) of the European Monetary System (EMS) in September 1992. This episode raised fears of increased inflationary pressures and a partial reversal of recent progress toward price stability. In the event, however, inflation remained at historically low levels and in several countries, like Italy, it even continued to decline gradually.

This paper investigates the recent inflation performance of Italy in the context of a four-equation econometric model that highlights the relationships between traded goods prices, the exchange rate, labor market structure, and the business cycle on the one hand, and domestic prices and wages on the other hand. The long-run estimates, derived from cointegrating relationships, are consistent with essentially full pass-through from exchange rates and foreign prices to domestic prices and wages. At the same time, dynamic estimates imply that inflation is significantly influenced by the business cycle, as proxied by estimated output and labor market gaps, and that there may be "pricing-to-market" behavior, which could attenuate the short-term effect of the exchange rate depreciation on imported goods prices in Italy.

Applied to the recent episode, these findings suggest that the pass-through of the exchange rate depreciation to the domestic prices of traded goods was broadly in line with historical experience, but that the business cycle downturn more than offset this effect, resulting in the observed inflation declines.

A key issue for policy is the effect on wage and price formation of the significant changes recently made to labor market institutions in Italy, particularly the abolition of wage indexation (*scala mobile*) and the establishment of a new wage bargaining framework. There is as yet insufficient experience with the new institutional arrangements to address this issue econometrically. Nevertheless, some aspects of the model suggest that a structural break may have occurred. In particular, the wage equation substantially overpredicts wages in 1993.

JEL Classification Numbers:
F31, F41

Summary of
WP/95/42

"Exchange Rate Bands and Shifts in the Stabilization Policy Regime:
Issues Suggested by the Experience of Colombia" by Alberto Carrasquilla

For 25 years, Colombia's monetary and exchange rate policies were built around a crawling peg regime aimed at maintaining stable inflation rates in the moderate range. In early 1994, the authorities decided to replace that regime with a system of exchange rate bands. In other countries, exchange rate bands were introduced as part of ongoing stabilization efforts to reduce inflation rates of over 100 percent. In contrast, Colombia viewed them as a mechanism or an initial condition for disinflation. The timing and objectives of the policy shift are interesting in themselves.

The paper argues that the policy shift represents a change in perception about the costs of inflation to Colombia. To test this, a simple analytical model of optimal policy is presented, with the initial results suggesting that inflation is indeed deemed costlier by the Colombian authorities than was the case before. The purpose of the paper, therefore, is to discuss the post-1989 period, evaluating the stated hypothesis and pinpointing general issues of exchange rate policy, and of bands in particular, that may prove to be of broader analytical interest and practical relevance.

Since the early 1970s, Colombia has traded off higher inflation for an institutional setup in which inflation would hover in the 20-30 percent range. Monetary, fiscal, commercial, and exchange rate policies were designed to maintain this situation. In return, the government obtained substantial inflationary finance throughout the period; from average (but volatile) rates of around 0.8 percent of GDP, the inflation tax rose to a (stable) rate of over 2 percent of GDP during 1980-93. These funds were an important component in the financing of central bank credit and help explain why the Colombian public sector debt, at 30 percent of GDP, is low by international standards.

Efforts initiated at the beginning of the 1990s to liberalize the current and capital accounts, the financial sector, and the labor market show that the authorities gradually accepted that inflation could not remain at conventional levels. Furthermore, given that important disinflation was occurring in other countries of the region, they realized that inflation must come down. Accordingly, they set out to make the central bank independent, achieving this goal with the establishment of the new constitution in 1991. The new central bank abandoned active sterilization, began issuing dollar-denominated debt, and decided to abandon the crawling peg in favor of a relatively complex exchange rate regime. In January 1994, explicit exchange rate bands were put in place to allow exchange rate flexibility and to obtain independence for the conduct of monetary policy. At the same time, external and internal shocks--enhanced capital inflows and an expenditure boom--have led to an appreciation of the real exchange rate. Concerns with competitiveness have been traded off against gains in disinflation.

JEL Classification Numbers:
F33, F36

Summary of
WP/95/43

"Who Needs Bands? Exchange Rate Policy Before EMU" by Tamim Bayoumi

The Maastricht treaty marked an important shift in European monetary arrangements. While discussion of a single currency in western Europe was certainly not new even in official circles, none of the earlier plans had been agreed by the relevant national governments. By providing a specific path to European monetary union (EMU), the treaty moved the discussion of a single European currency from the theoretical to the practical. Events since the signing of the treaty, however, in particular the exchange rate problems experienced by a number of countries in 1992 and 1993, have made the exchange rate path to EMU envisioned at that time less tenable.

This paper focuses on two issues associated with EMU. It examines, first, which countries might benefit from entry into EMU before the millennium, and second, which exchange rate policies are best designed to move countries with individual national currencies to a currency union. On the first issue, a considerable amount of empirical work has been done to assess the suitability of EU members' joining EMU, looking at both the potential benefits and costs. The paper provides a brief overview of this literature, concluding that Germany and its immediate neighbors (Austria, Denmark, France, and the Benelux countries) are more suitable for EMU than other members of the EU. However, relatively little is known about whether all, some, or no countries would benefit economically from joining a single currency before the millennium because knowledge of the benefits from EMU, which is an essential part of any assessment of the economic value of membership, is too uncertain to provide the required level of precision.

The second issue that is discussed is the exchange rate path to EMU. A path to EMU was initially provided by the Maastricht Treaty. As far as monetary policy and exchange rates were concerned, the treaty outlined a gradual evolution from a system limiting exchange rate fluctuations between member countries to the permanent and fixed exchange rates implied by a single currency using the existing exchange rate mechanism (ERM). In the autumn of 1992 and 1993, however, the ERM came under market pressures that forced Italy and the United Kingdom to suspend membership, the Nordic currencies to abandon their unilateral pegs against the ECU, Ireland, Portugal, and Spain, to devalue their parities, and the remaining participants to widen the bands of fluctuation of their currencies from 2½ percent to 15 percent.

These developments are inconsistent with the gradual evolution of the exchange rate regime envisioned in the Maastricht treaty. The second part of the paper discusses possible exchange rate arrangements in the transition to EMU. The focus is on the experience of earlier exchange rate regimes, with particular emphasis on the pre-1914 gold standard. These experiences suggest that one potential way of avoiding financial instability during the transition would be to announce at an early stage the parities at which different currencies would enter EMU. Such a policy would work, however, only if governments were willing to accept the implied limitations on domestic policies needed to validate such a commitment.

JEL Classification Numbers:
E63, E65, O57, P52

Summary of
WP/95/44

"Stabilization in the Baltic Countries:
A Comparative Analysis" by Tapio O. Saavalainen

The Baltic countries began their stabilization and reform process in earnest in mid-1992. During the first two years of reform, these countries have made significant progress in macroeconomic stabilization despite serious initial imbalances resulting from two major supply shocks. The systemic shock--the collapse of the centrally planned economy--caused major disruptions in trade, payments, and monetary arrangements with Russia and other states of the former Soviet Union. The terms-of-trade shock, resulting from Russia's sudden move toward world market prices in oil and raw material exports to the Baltic countries, called for a sharp adjustment of real incomes. By 1994 the output decline had bottomed out and economic recovery was under way. Financial policies have been tight and inflation has been brought down. With their rapid success, the Baltic countries have become widely recognized as model cases of stabilization for post-Soviet states.

This paper highlights several factors, some general and some specific, contributing to the success of the Baltic countries' transition process. During the first years of serious reform, inflation has fallen more than it did in Poland, for example, during a corresponding period after that country's "big bang." Also, the output cost of the disinflation process has remained very small in Estonia, and has been rather limited in Latvia and Lithuania.

Strong commitment to sound financial policies has been crucial for these achievements. Fiscal positions in the Baltic countries--unlike those in many Central European countries after their economic reforms--have been solid throughout 1992-94 and helped establish the credibility of strong monetary policies.

While the Baltic countries initially adopted different exchange rate regimes, it appears that the credibility of their policies has been more important than the choice between exchange rate and money-based stabilization per se. Inflation has declined to low levels in each country regardless of the exchange rate regime. To some extent, the choice of regime may be reflected in the timing of the output variations, although the evidence for such causality is weak, given the large number of exogenous factors affecting output developments during the transition. The real exchange rate appreciation in each country, which has continued since the outset of the reforms, appears sustainable so far.

JEL Classification Numbers:
F41, F43

Summary of
WP/95/45

"Growth, Nontradables, and Price Convergence in
the Baltics" by Anthony Richards and Gunnar Tersman

Tight monetary and credit policies have been a cornerstone of the economic policies followed in all three Baltic countries since the adoption of their stabilization and reform programs in mid-1992. These policies have been supported by controlled fiscal outcomes and have yielded stability in the exchange rates of the newly introduced currencies. Inflation has also fallen sharply from the high rates experienced in 1992. However, price increases remain high by industrial country standards, averaging 2 to 3 percent a month in late 1994 and early 1995.

This paper discusses the factors behind this continued high inflation. It is argued that the initial undervaluation of the new currencies is a significant cause of the recent inflation. The initial undervaluation relative to fundamentals may have been due to a range of asset market considerations including risk, incomplete markets and legal arrangements, imperfect information, and the irreversibility of investment. Evidence for the undervaluation of the real exchange rate can be found in price surveys, which suggest that the general price level may be far lower than in industrial countries and lower than would be normal for countries with income levels similar to those of the Baltics.

As the initial real exchange rate undervaluation is eliminated, and growth picks up, inflation in the Baltics is likely to be driven mainly by structural factors related to differential growth rates in the tradable and nontradable sectors. The standard two-sector model of Balassa and others suggests that the tendency for productivity growth to be faster in the tradables sector will result in increases in the relative price of nontradables and an appreciation of the real exchange rate. These effects may be quite important in countries that experience high growth rates, and they would imply that the real appreciation in the Baltics may be a sustained phenomenon.

A simple scenario is presented to shed light on the possible evolution of prices and incomes in coming years. The likelihood of continuing real appreciation implies that it will not, in general, be possible to target both the exchange rate and the price level at the same time. In particular, given an undervalued real exchange rate and a fixed nominal exchange rate, a restrained credit policy in itself will not bring about low inflation outcomes, since balance of payments inflows will lead to monetary growth and price increases. Alternatively, if price stability is targeted, it may be necessary to allow for periodic nominal revaluations.

JEL Classification Numbers:
G1, H2

Summary of
WP/95/46

"The Taxation of Financial Assets: A Survey of
Issues and Country Experiences" by Vito Tanzi and John King

Taxes affect the degree and efficiency of financial intermediation by imposing a "wedge" between the return to an individual who saves and the return on the investment that is ultimately financed by that saving. This wedge is created by particular taxes (or tax reliefs) that are associated with the acquisition of financial assets, the holding of those assets, the income and capital gains that are generated by them, and their disposal. The paper shows that the effect of these tax provisions varies widely in OECD countries according to whether the saving is done directly or through financial intermediaries, such as banks, pension funds, and insurance companies--and also according to whether the savings are channeled to companies (in the form of debt or equity finance) or to the government. The international playing field for financial assets is thus very uneven.

A number of studies have been conducted since the mid-1980s of the overall ex ante "effective tax rate" on different types of saving in different countries. The paper finds that the results of these studies have, however, been very sensitive to the assumptions that they make (for instance, about inflation) and to their treatment of particular details in the tax laws. In addition, the impact of taxes ex post may differ substantially from ex ante tax rates as a result of market responses that lead to capitalization of tax burdens and tax arbitrage.

The paper describes how tax regimes for financial assets may be assessed according to different standards, such as the "comprehensive income tax" ideal, specific theories of optimal taxation, or more eclectic criteria (including the traditional criteria of fairness, simplicity and transparency, economic efficiency, and administrative feasibility). These different standards often imply different answers to some of the central questions that arise in designing a tax regime for financial assets, such as, what should be the overall tax rate on income from those assets? how should capital gains be treated? and how should tax regimes be adjusted in the presence of significant inflation?

Tax reforms in OECD countries since the mid-1980s have generally tended to broaden tax bases and tax rates. With regard to the tax treatment of financial assets, the clearest common trends have been the further spread of taxes on capital gains, the imposition of restrictions on deductions for interest expense, and the extension of final withholding; in other areas, trends are more difficult to discern. A relatively new development has been the removal (particularly in the Nordic countries) of capital income from the scope of progressive personal taxes and the substitution of flat-rate taxes. The paper concludes that, as the trend toward globalization in financial markets makes it increasingly difficult for individual countries to tax capital income effectively, this approach may offer important advantages.

JEL Classification Numbers:
C15, D44

Summary of
WP/95/47

"Auction Format Matters: Evidence on Bidding Behavior
and Seller Revenue" by Robert A. Feldman and Vincent Reinhart

This paper evaluates empirically the importance of auction format for bidding behavior and seller revenue, focusing in particular on differences in performance under uniform-price and discriminatory-price formats. The analysis is based on a standard benchmark model from which empirically testable hypotheses are derived on the optimal amount of bid shading that generates revenue equivalence between the two formats. More specifically, we apply Vickrey's (1961) model of shading, following closely the presentation of McAfee and McMillan (1987). Statistically significant shading in excess of the theoretically derived optimum under the discriminatory format suggests greater seller revenue under the uniform-price format.

The model is applied to a data set based on IMF press releases issued after each of the IMF's gold auctions in 1976-80. These auctions, which were run using both uniform- and discriminatory-price formats, represent a distinct experiment that has apparently escaped rigorous study in the literature. Thirty-five of the 45 auctions--and 10 of the first 20--followed a discriminatory-price format, while the other 10 followed a uniform-price format.

The appropriate choice of auction format is a matter of great practical concern. For example, in the United States, the Treasury currently sells some government securities in uniform-price auctions and others in discriminatory-price auctions, in an attempt to determine which technique provides higher revenues (lower interest costs) to the U.S. Government in auctioning its debt. Mexico has apparently shared those concerns over the comparative performance of discriminatory- and uniform-price formats, as evidenced by a switch from a discriminatory-price to a uniform-price approach in 1990 for its treasury bill auctions, and then, in 1993, by a return to the discriminatory approach. More generally, the uncertainty with regard to the "best" auction technique is readily apparent in the prevalence of both uniform- and discriminatory-price setups for auctioning similar items; practical advice on auction choice from empirical study is rather limited.

From the paper's findings, it is concluded that Vickrey's benchmark model offers useful and empirically valid insights into bidding behavior. What is particularly relevant and apparent in this regard is that auction participants do, in fact, shade their bids under a discriminatory-price format, as the basic model would suggest. At least as important, the paper also provides statistically significant evidence that the extent of this bid shading is, if anything, even larger than this model would indicate, pointing to the superior revenue-generating properties of uniform-price over discriminatory-price auctions.

JEL Classification Numbers:
F13, F14

Summary of
WP/95/48

"The Burden of Sub-Saharan African Own Commitments
in the Uruguay Round - Myth or Reality?" by Piritta Sorsa

This paper finds that, in contrast to the various statements made on the "cost" or burden for developing countries from their Uruguay Round commitments, the Round is unlikely to burden sub-Saharan countries with many new "obligations". First, apart from South Africa, most sub-Saharan countries made few substantial commitments to liberalizing border protection in agriculture, industry, or services. This was partly a reflection of the nature of the agreements concluded. As many of the reductions in nontariff barriers were designed to cover the types of policies applied in industrial countries, the often different policies in developing countries will be less affected. For example, many developing countries do not subsidize agriculture but tax it; this practice is not covered by the agreement. Partly, however, the lack of change reflected the unwillingness of sub-Saharan African countries to make meaningful commitments to bind protection to reasonable levels (applied rates will not change).

Second, the agreements offer much flexibility in the adoption of the new rules. Their adoption is subject to long transition periods, which in most cases can be further extended. Also, many of the general exemptions, as well as those for balance of payments support, remain available for unwilling liberalizers wishing to seek legal cover for trade restrictions. Apart from the increase in transparency arising from the notification requirements, few changes to policies are required by sub-Saharan countries in the short run. Some review may be required for export subsidies and local content requirements. While the benefits of the intellectual property agreement can be questionable for most of sub-Saharan Africa in the short run, the application of the rules in subsidies in most cases should promote sound economic policies.

The paper notes that the sub-Saharan countries have not used the Round to support domestic efforts at trade policy reform. The Round provided an opportunity for countries to go beyond their unilateral liberalization efforts in exchange for multilateral concessions, or to bind their domestic reforms to an international framework. As most models showed that most gains from the Round would come from countries' own liberalization efforts, not making liberalization commitments in the Round may have cost sub-Saharan countries one opportunity for gains. The exception was the Southern African Union, which used the Round to consolidate ongoing domestic reform programs. In the end, therefore, structural change and trade liberalization in most of sub-Saharan Africa will depend on unilateral initiatives taken independently or in the context of World Bank or Fund-supported adjustment operations. The paper concludes that, unless these are pursued, the ability of sub-Saharan countries to take advantage of the emerging opportunities in their export markets may also be lost.

JEL Classification Numbers:
E43, E63, H5, H62, H63

Summary of
WP/95/49

"Fiscal Deficit and Public Debt in Industrial
Countries, 1970-1994" by Vito Tanzi and Domenico Fanizza

The growth of fiscal deficits and the resulting increase in government debt have attracted the attention of policymakers and financial market analysts. However, the impact of these factors on economic variables remains controversial among economists, with some who blame fiscal imbalances for a number of economic weaknesses, while others consider these factors as largely irrelevant. Empirical tests of the competing hypotheses tend to be inconclusive. In particular, tests of the relation between fiscal variables and real interest rate are problematic in part because of lack of data for a period long enough to test the relation and because they have been conducted on a country-by-country basis in a world where capital markets have become global. This paper presents comparable fiscal data for each of 18 industrial countries for the period 1970-94 and for two groups of countries combined, the G-7 and the 18 industrial countries. These data provide a useful basis for discussing fiscal trends and for allowing econometric tests.

The first two sections discuss fiscal developments over the 1970-94 period looking at four alternative fiscal balance measures: the conventional balance, the structural or cyclically adjusted balance, the inflation adjusted balance, and the primary balance. No country seems to have escaped the trend toward fiscal deterioration even though some countries have experienced far more deterioration than others. The deficits of the various countries were aggregated to show what happened to the groups, the G-7 and the 18 countries combined.

The third section relates the growth in fiscal deficits to trends in private saving. Higher fiscal deficits have been accompanied by declining private saving, leaving a decreasing portion of saving available for financing private investment.

The fourth section focuses on the fast growth of public debt since 1980 and briefly reviews its possible economic consequences. Finally, the fifth section provides evidence in support of a link between public debt and real interest rate. On the basis of a finite horizon overlapping generation model--which is formally developed in Appendix I--an econometric exercise is performed suggesting that the increase in the debt-to-GDP ratio, which took place over the period 1980-93, would have increased real interest rates by more than 1.5 percentage points. The panel data which have been used in the estimation constitute a larger sample than the ones used by earlier studies.

JEL Classification Numbers:
D58, E63, F13, F41

Summary of
WP/95/50

"Fiscal Implications of Trade Liberalization" by David Bevan

A considerable literature devoted to the theory and practice of trade liberalization now exists, as does a rapidly growing literature devoted to fiscal reform in developing countries. To a surprising extent, these two types of policy reform have been considered separately, and relatively few studies have focused on the interaction between them.

This paper analyzes one aspect of this interaction--the relationship between trade liberalization and the budget deficit. It discusses the ways in which this relationship depends on the specifics of a country's economic structure, its fiscal structure, and the trade regime that is being liberalized. Liberalization involves major shifts in the main relative prices in an economy, including those of nontradables, wages, importables, and exportables. The budgetary effect of these shifts depends on how government revenues and expenditures are distributed across these categories and the extent to which these revenues and expenditures are sensitive to price changes. Are those categories in which government spending is concentrated likely to suffer a relative price rise or to benefit from a relative price fall? The response of revenues depends in turn on the reaction of private spending. Are those categories of private activity that are relatively easy to tax likely to expand or contract in the process of liberalization?

The paper sets out to relate some popular but incomplete approaches to assessing this issue (such as analysis of the foreign exchange budget) to a more comprehensive approach using an applied general equilibrium model. The argument is illustrated using data from the most recent of a sequence of abortive, planned liberalizations in Kenya, as well as a number of stylized illustrations. The paper concludes not only that liberalization may have a positive impact on the budget, but also that, in certain circumstances, the effect may be strong. Kenya's economic and fiscal structure and its recent trade regime appear to conform to these circumstances. This offers an interesting perspective on, and possible explanation of, the recent involuntary liberalization in that country, which was triggered by a substantial reduction in aid inflows, but which appears to have led to an appreciation, rather than a depreciation, of the exchange rate.

Another implication of the paper is that countries may have difficulty planning a "conservative" approach to trade reform that is designed to avoid fiscal deterioration without exacerbating the resource misallocations that the reforms are designed to ameliorate. In all cases, policymakers must have some idea of the technical interrelations in the economy before proceeding to the tactical design of policy, even when the strategy is clear.

JEL Classification Numbers:
C33, E21, H30, J11

Summary of
WP/95/51

"International Evidence on the Determinants of
Private Saving" by Paul R. Masson, Tamim Bayoumi, and Hossein Samiei

This paper extends our empirical knowledge of the determinants of private saving for a large sample of industrial and developing countries. Both time series and cross-section information is used, as the explanatory power of potential variables differs widely in those two dimensions.

Several conclusions emerge clearly from the regressions, despite some heterogeneity in the results. First, there seems to be a substantial offset, averaging 60 percent, of changes in the government fiscal position from private saving. This offset, although large, is considerably below unity, implying that changes in the government's fiscal position can have a significant impact on national saving. Moreover, the offset depends on whether those changes are due to government spending or tax changes.

Demographic effects are also an important determinant of private saving rates. This conclusion suggests that the projected aging of the population in most industrial countries will generate significant downward pressure on private saving rates over the next three decades. However, developing countries show an opposite trend in the overall dependency ratio, as an increase in those over the age of 65 will be offset by a decline in the proportion of those under the age of 20. Therefore, the net effect on world saving could be a small positive figure.

Other variables also influence saving, in particular income growth, which operates through several channels. A direct positive association between GDP growth and private saving emerges from most of the specifications, while increases in the level of per capita income (relative to the United States) tend to influence saving positively in low- to middle-income developing countries. Finally, a composition effect of changes in the relative sizes of the countries concerned can also affect the aggregate rate of saving. If countries with high saving rates continued to grow faster, their increasing share of world output could induce an upward trend in world saving of several percentage points.

The paper finds that the real interest rate has a positive, and significant, coefficient for industrial countries and for the combined panel of data; however, the results are not very robust, owing to data problems and shifts in the relationship due to financial liberalization. It was found that changes in the terms of trade have a significantly positive effect on saving for industrial countries, for which a longer sample (including the two major oil price shocks) was available, and that, for developing countries, higher foreign saving (a current account deficit) tends to depress private saving.

JEL Classification Numbers:
C51, F31

Summary of
WP/95/52

"Hysteresis in Exports" by Giorgia Giovannetti and Hossein Samiei

Fluctuations in exchange rates have been large and frequent in the floating exchange rate period. The response of trade flows and current accounts to these fluctuations, however, has been limited. This seems at odds with the traditional view that the real exchange rate is a principal determinant of the volume of trade. Movements in the dollar and the U.S. current account provide an interesting example. The dollar appreciated by about 50 percent with respect to a basket of currencies in the span of five years (1980-85), and then fell to its 1980 value in only three years. In the meantime, the U.S. current account deficit soared and then continued to widen despite the huge dollar depreciation that followed the Louvre and Plaza agreements. The slow and confused response of trade flows to exchange rate changes is difficult to explain even after allowing for J-curve effects, information and transportation lags, and the increased uncertainty resulting from higher exchange rate volatility.

The persistence of trade imbalances, in particular between the United States, Japan, and Germany, and their apparent unresponsiveness to exchange rate changes, have led to a re-examination of the traditional adjustment processes. There have been a number of attempts to explain this persistence by allowing for a combination of strategic interaction in oligopolistic markets, sunk costs, and uncertainty in foreign trade. It has been argued that these factors adversely affect the working of the adjustment mechanism and cause hysteresis in trade flows, for example, by making trade flows dependent not only on the current value of the exchange rate but also its past history.

This paper attempts to examine the issue from an econometric point of view by distinguishing two types of hystereses: that arising from limited exchange rate pass-through and that arising from regime switches in supply. It starts with a benchmark model where export prices and quantities are determined along traditional lines, and then develops a model where the presence of sunk costs generates discontinuous behavior by individual firms. Such a behavior at the firm level gives rise to nonlinearities at the aggregate level. The models are then estimated using data for the United States, Japan, and Germany. The paper finds strong evidence in favor of the presence of pricing-to-market and hysteresis only in the case of Japanese exports.

JEL Classification Numbers:
O41, O47

Summary of
WP/95/53

"The Peace Dividend: Military Spending Cuts and
Economic Growth" by Malcolm Knight, Norman Loayza, and Delano Villanueva

Conventional wisdom suggests that reduced levels of military spending are associated with a "Peace Dividend" in the form of stronger economic growth performance. Yet available empirical studies have yielded only partial support for this view.

To unravel the ambiguous empirical findings, this paper estimates an extension of a standard growth model using a panel-data procedure that delivers robust estimates of the effect of military spending on economic growth. The model assumes that high levels of military spending detract from growth both by reducing productive capital formation and by acting more generally to distort resource allocation. In contrast with earlier empirical work, the current panel-data estimates of these adverse effects are statistically significant and sizable.

The recent, marked trend toward lower levels of military spending in many regions of the world augurs well for a future Peace Dividend in terms of a higher growth path of capacity output. The likely quantitative impact of these effects for different geographic regions is simulated. The study finds that the military spending cuts that occurred in most regions in the late 1980s will eventually lead to substantial gains in per capita capacity output, particularly for developing countries in Asia, North Africa, and the Middle East, where military spending ratios were reduced markedly. By contrast, in Eastern Europe and sub-Saharan Africa, where military spending ratios rose in the late 1980s, the output path will eventually be lower than it would have been if military expenditures had remained steady.

The results of a second set of simulations undertaken in this paper suggest that economic growth would be enhanced substantially by deeper cuts in military spending that could become feasible if a generalized international peace were achieved in the future. Furthermore, these Peace Dividend effects, while sizable, may understate the potential gains in economic growth, since a generalized peace would almost certainly result in improvements in other economic determinants of growth. For example, a generalized peace would permit fuller liberalization of trade regimes in a number of developing countries as well as higher expenditures on infrastructure, education, and health.

The major policy implication of this study is that reductions in military spending are potentially attractive elements of macroeconomic adjustment and structural reform programs designed to achieve strong and durable increases in per capita capacity output.

JEL Classification Numbers:
E31, P22, R32

Summary of
WP/95/54

"Relative Price Convergence in Russia" by Paula de Masi and Vincent Koen

It is commonly accepted that relative prices in Russia were highly distorted under central planning and that liberalization prompted major shifts in the price structure. However, no systematic empirical analysis of the realignment of relative prices has yet been undertaken that would show to what extent and how fast prices have converged to some market economy benchmark since the onset of the transition. This question is explored in this paper for consumer prices, using several large data sets ranging from 1980 to 1994.

An empirical investigation confirms that after liberalization the structure of relative prices in Russia changed significantly. For goods, most of the permanent domestic realignment seems to have taken place by the end of 1992, even though some further shifts occurred in 1993 and 1994. For services, convergence to market levels is a more protracted process; by mid-1994, notwithstanding sharp increases in relative domestic terms, the prices of many important services remained far below advanced market economy levels. The gap between the domestic overall price level and the level prevailing abroad was huge in January 1992, narrowed substantially thereafter, but still loomed large in 1994. At the same time, the degree of integration of the domestic goods market, particularly for nonfood items, seems to have increased since early 1992. In addition, price-setting has become more synchronized as agents adapt to a high-inflation environment.

The large gap between domestic and international price levels that remains two to three years after price liberalization implies that convergence, inasmuch as it does proceed, will be accompanied by real exchange rate appreciation. The latter may take the form of a strengthening of the nominal exchange rate. However, the relative price of services can be expected to rise significantly in the years ahead, as cost-recovery ratios are still low for many of them. Thus, even if tight financial policies and foreign competition contain price increases in the tradable goods sector, the process of real exchange rate appreciation is likely to involve persistently higher measured inflation than in Western Europe.

JEL Classification Numbers:
F31, F32

Summary of
WP/95/55

"Asset Market and Balance of Payments Characteristics: An Eclectic Exchange Rate Model for the Dollar, Mark, and Yen" by Ronald MacDonald

Recently there has been a resurgence of interest in modeling "long-run" real and nominal exchange rates. In large part, such interest has arisen because the stylized fact that freely floating exchange rates are rarely, if ever, at their equilibrium levels has generated a desire to understand just how far away from equilibrium a current exchange rate might be. For bilateral exchange rates, a growing body of evidence suggests that some form of stable 'long-run' relationship exists between exchange rates and fundamentals, particularly relative prices. This latter relationship, however, does not conform exactly to what would conventionally be regarded as purchasing power parity (PPP), in that often, particularly for U.S. dollar bilateral rates, standard symmetry and degree one homogeneity restrictions (implied by absolute PPP) are strongly rejected and the implied mean reversion of the real exchange rate is very slow. There would therefore appear to be more to exchange rates than simply relative prices.

In this paper, the recent work on long-run exchange rate relationships is taken as the point of departure and combined with a theoretical model of exchange rate determination--a "hybrid asset market" or "balance of payments" model--to examine the determinants of nominal exchange rates. From an empirical perspective, the model has two appealing features. It incorporates a key element of the asset approach to exchange rate modeling, namely, that an asset price is related to the present value of expected future fundamentals, along with elements of a more traditional balance of payments or portfolio balance approach, in which real factors can have an important bearing on the nominal exchange rate, even in equilibrium. A key aspect of this latter feature is the issue of sustainability.

The hybrid asset market or balance of payments model considered in this paper, labeled an "eclectic exchange rate model" (EERM), is implemented for the effective exchange rates of the deutsche mark, Japanese yen, and U.S. dollar over the period 1973 Q3 to 1993 Q4. It is demonstrated that the EERM produces sensible estimates of the long-run values of these exchange rates, whereas simple PPP does not. Interestingly, the actual value of the Japanese yen stays very close to its equilibrium value throughout the period, whereas both the deutsche mark and dollar are often quite far away; this is especially so for the U.S. dollar in the period coinciding with its dramatic appreciation in the early 1980s. The short-run dynamic equations implied by the long-run exchange rate systems are deemed reasonably successful on the basis of standard criteria. The paper concludes by arguing that the approach adopted warrants further attention, particularly in terms of the data requirements necessary to implement it for bilateral exchange rates.

JEL Classification Numbers:
E31, O40

Summary of
WP/95/56

"NonLinear Effects of Inflation on Economic Growth" by Michael Sarel

It is now widely accepted that inflation has a negative effect on economic growth. This negative effect, however, was not detected in data from the 1950s and the 1960s. Until the 1970s, many studies found this effect to be nonsignificant, or even positive. The change in view came only after many countries experienced severe episodes of high and persistent inflation in the 1970s and the 1980s. As more data became available on these episodes, studies confirmed repeatedly that inflation has a significant negative effect on economic growth.

The abrupt change in the view regarding the effects of inflation on growth raises three important questions: (i) Why did it take so long and so many studies to uncover such an obvious link between two of the most important and most closely watched macroeconomic variables? (ii) As the estimated effect of inflation on growth is relatively small, should the results of these studies affect policy priorities and institutional arrangements? and (iii) If a specific range for inflation is adopted as a policy target, what should this range be?

Motivated by these questions, this paper explores the possibility of nonlinear effects of inflation on economic growth. It finds evidence of the existence of a structural break in the function that relates growth rates to inflation. When inflation is low, it has no significant negative effect on economic growth; the effect may even be slightly positive. But when inflation is high, it has a powerful negative effect on growth. The structural break is estimated to occur where the average annual rate of inflation is 8 percent.

The existence of such a structural break can explain why the negative effect of inflation on economic growth was not detected for such a long time: before the 1970s, there were not many episodes of high inflation. It also suggests a specific numerical target for policy: keep inflation always below the structural break. Most important, the existence of a structural break implies that previous studies seriously underestimated the negative effects on economic growth of higher rates of inflation. This study demonstrates that when the existence of the structural break is ignored, the estimated effect of inflation on economic growth for the higher rates of inflation decreases by a factor of three. Taking the structural break into account, the paper finds evidence that the effects of inflation on growth are much more powerful than previous studies had estimated.

JEL Classification Numbers:
F41, G1, P1

Summary of
WP/95/57

"Capital Flows in Central and Eastern Europe: Evidence
and Policy Options" by Guillermo Calvo, Ratna Sahay, and Carlos Végh

In contrast with the previous decade, capital has flowed in abundance from industrial to developing countries in the early 1990s, most prominently in Latin America and Asia, and with a lag in Central and Eastern Europe. This paper examines emerging trends in capital flows in selected countries in Central and Eastern Europe and analyzes policy options for these countries.

The paper documents the pattern and composition of capital flows in the region during 1987-93 and finds that, in many ways, 1992-93 was a common turning point. In a remarkable turnaround, the capital account of the region improved by about \$20 billion in 1992-93, mostly reflecting a reversal in external borrowing. The capital inflows have increasingly been used to finance widening current account deficits. These large current account deficits mainly mirror increases in consumption (predominantly private consumption) rather than investment. Another common phenomenon has been the appreciation of the real exchange rate during the capital inflows episode.

It is argued that the rise in consumption and the real exchange rate appreciation may not necessarily be a cause for concern on several grounds. The higher consumption may reflect a move toward an equilibrium level from artificially depressed levels rather than a temporary binge in consumption. The real exchange rate appreciation may be a temporary phenomenon, reflecting the relative inelasticity of the supply of nontraded goods, as consumption and direct foreign investment rise. However, the real exchange rate appreciation may have a permanent component if the productivity of labor is rising as a result of qualitative changes in capital stock.

To the extent that capital inflows are financing temporary rises in consumption and causing real wages to overshoot, the inflows may need to be discouraged. In laying out the options facing policymakers, the paper points to the inherent problems of pursuing second-best policies like imposing capital controls, levying taxes, and raising interest rates on government debt to attract capital away from the private sector. The advantages and disadvantages of sterilized versus nonsterilized intervention are also examined.

JEL Classification Numbers:
C52, E21, G12

Summary of
WP/95/58

"Informational Efficiency in Developing
Equity Markets" by Paul Cashin and C. John McDermott

The issue of informational efficiency in the evolution of asset prices is examined using data on equity markets in Jordan, Turkey, and Pakistan. These three markets are of interest because, for the sample periods analyzed, they represent a market that remained relatively open and where, in particular, no special regulations affected investment by nonresidents (Jordan during 1986-92); a market that underwent substantial liberalization, including the withdrawal of restrictions on foreign investors trading in listed equities (Turkey during 1988-93); and a market where restrictive financial market regulations remained in place, with foreign investors prohibited from trading in equities (Pakistan during 1986-91).

The analysis is carried out in two steps. First, the key determinants of agents' dynamic consumption and investment decisions (the coefficient of relative risk aversion and subjective discount rate) are estimated for each country. The values of these parameters, along with data on market fundamentals (current and future levels of aggregate private consumption and the stream of current and future dividends), are then used to construct an implied equity market price. This price is based, at any time t , on the assumption that consumers know the future time path of consumption, dividends, and the terminal price of the equities. Next, this implied price is compared with the actual evolution of equity market prices for each country to assess the informational efficiency of these markets by checking for the presence of excess volatility.

A key finding is that while the informational efficiency of each of the three markets is deficient, the causes of the inefficiency vary. While it appears that a large negative shock to economic activity in the late 1980s caused Jordanians to discount market fundamentals, in Turkey and Pakistan the illiquidity of equity markets influenced the determination of actual equity market prices. This result highlights the important role that financial market liberalization, and particularly the opening up of previously autarkic equity markets to foreign investors, can play in improving the efficiency with which equity markets mobilize resources for growth-enhancing investment.

JEL Classification Numbers:
F21, F23

Summary of
WP/95/59

"Foreign Direct Investment in the World Economy" by Edward M. Graham

Foreign direct investment surged during the 1980s as firms from many nations expanded their international operations. This paper surveys a number of aspects of foreign direct investment and its role in the "globalized" world economy. The precise nature of foreign direct investment is examined from both microeconomic and macroeconomic perspectives. Historic patterns of foreign direct investment are explored, with emphasis on the large surge that took place following 1985. The (correct) proposition that foreign direct investment is not synonymous with international transfer of capital is analyzed from both a theoretical and empirical perspective.

Key characteristics of foreign direct investment and the multinational corporations that generate it are examined in detail. These include the determinants of foreign direct investment and the international expansion of firms as best as they are understood. Also analyzed are the relationships between foreign direct investment and capital formation, technology transfer, international trade, and the economic growth of both host (recipient) and home (investor) nations.

The paper concludes by surveying the policy issues that figure in current efforts to put international direct investment under the aegis of the multilateral trading rules. It is likely that in the near future some sort of "multilateral agreement on investment" will be negotiated. Issues of both substance and venue (that is, the question of whether the agreement will be negotiated within the World Trade Organization or some other negotiating body) are discussed.

JEL Classification Numbers:
G15, G28, H29, H87

Summary of
WP/95/60

"International Financial Flows and
Transactions Taxes: Survey and Options" by Paul Bernd Spahn

Analysis has shown that the original Tobin tax is not viable. First, it is virtually impossible to distinguish between normal liquidity trading and speculative "noise" trading. If the tax is generally applied at high rates, it will severely impair financial operations and create international liquidity problems, especially if derivatives are taxed as well. A lower tax rate would reduce the negative impact on financial markets but not mitigate speculation where expectations of an exchange rate change exceed the tax margin. The assertion that reducing the level of trading would automatically reduce volatility can be contested.

Second, because of the high substitutability of financial products, taxing only spot transactions would create tax loopholes and reduce the effectiveness of the tax as an antispeculation device. However, including derivatives, particularly forward transactions, poses substantial conceptual problems as no fixed relationship between cash and derivative transactions can be established readily.

Third, even with a very low rate, the tax would raise substantial revenue given the high and increasing volume of trading. The high level of revenue ultimately generated by a low-rate tax may constitute a considerable problem for tax assignment.

Most of the difficulties of the Tobin tax could be resolved, possibly with a two-tier rate structure consisting of a low-rate financial transactions tax and an exchange surcharge at prohibitive rates. The latter, dormant in times of normal financial activities would be activated only in the case of speculative attacks. The mechanism allowing the identification of abnormal trading in world financial markets would make reference to a "crawling peg" with an appropriate exchange rate band, within which the exchange rate would move freely. Only transactions effected at exchange rates outside the permissible range would be subject to tax. This would automatically induce stabilizing behavior on the part of market participants. The effect should be strengthened through contingent claims to insure against eventual taxation as exchange rate volatility is likely to occur only under market imperfections.

Tax administration seems to be a minor problem although it requires international cooperation. A remaining problem with the proposed tax is related to political coordination and the assignment of the tax at the international level. Coordinating fundamental policy decisions at the international level will be crucial and will ultimately determine the long-term feasibility of the tax. However, the proposed policy seems to be feasible even on a unilateral basis.

JEL Classification Numbers:
E44, G21, G28

Summary of
WP/95/61

"The Nordic Banking Crises: Pitfalls in Financial
Liberalization?" by Burkhard Drees and Ceyla Pazarbasioğlu

The banking industries in three Nordic countries, Finland, Norway, and Sweden, underwent considerable changes in the 1980s. The period was marked by increased competition in financial services, economic deregulation, the removal of cross-border restrictions on capital flows, and financial innovation. After a sharp credit boom, it also proved to be a period of financial fragility, as lower asset quality and declining profitability deteriorated banks' balance sheets to the point where governments had to support some of the largest banks to preserve financial stability.

A financial crisis in the aftermath of financial liberalization does not necessarily imply that the crisis was caused by the deregulation itself. The paper notes that the Nordic financial crises, similar to experiences in other countries, were associated with macroeconomic circumstances, such as economic downturns, declines in incomes, and depressed asset markets, that typically follow domestic credit booms. The parallel developments in the Nordic countries are striking, yet there are at the same time significant differences in the performance of their financial systems and their regulatory environments, and in the macroeconomic shocks that impacted on their economies.

This paper presents a survey of the Nordic banking systems in an attempt to examine competing hypotheses about the causes of the banking problems and to provide some policy lessons. A key conclusion of this paper is that factors in addition to business cycle effects explain the financial problems that the Nordic countries have experienced. Although the timing of the deregulation in all three countries coincided with a strongly expansionary macroeconomic momentum, other contributing factors, such as the delayed policy responses, the structural characteristics of the financial systems, and--last but not least--banks' inadequate internal risk management controls, determined the consequences of the transition from tightly regulated to more or less competitive financial systems.

Against the background of these enhanced competitive pressures, the paper concludes from the Nordic experience that a negative shock may put the stability of the financial system at risk if economic incentives are distorted by policy measures and by the inherent structure of the financial sector. In the absence of strengthened prudential banking supervision, these incentives, coupled with expectations of government intervention in the event of a crisis and a booming macroeconomic environment, prompted many Nordic banks to increase their lending and risk taking excessively, leading to a loss of efficiency in allocating capital. As the distortive tax incentives that strongly favored debt financing were not corrected, borrowers responded to the lifting of credit rationing by incurring debt burdens that, at least ex post, turned out to be unsustainable. Monetary policy was largely unable to stem the credit expansion, owing to pegged exchange rate regimes, while fiscal policy was not tightened sufficiently.