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November 17, 1993

To: Members of the Executive Board
From: The Secretary
Subject: Current and Prospective Research in the Fund

There is attached for the information of Executive Directors a paper on current and prospective research in the Fund. This paper, together with the paper on review of research activities in the Fund (SM/93/243, 11/17/93) will serve as background material for the Board discussion on the budgetary outlook in the medium-term (to be issued shortly), which is tentatively scheduled for discussion on Friday, December 10, 1993.

Mr. Mohsin Khan (ext. 34518), Mr. Mathieson (ext. 37662), or Mr. Reinhart (ext. 37732) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

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INTERNATIONAL MONETARY FUND

Current and Prospective Research in the Fund

Prepared by the Interdepartmental Working Group
on Fund Policy Advice

Approved by Mohsin S. Khan

November 16, 1993

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I. Introduction

This paper provides a forward-looking perspective on research activities in the Fund. It is designed to complement the paper "Review of Research Activities in the Fund", which contains a comprehensive description of recent research undertaken by staff.

The paper basically describes research projects that departments have expressed an interest in undertaking in the near term. ^{1/} The output of these projects is expected to be forthcoming over the next 1-2 years in a variety of forms, including inter alia, the standard Fund publication outlets, such as the Working Papers (WP) and Papers on Policy Analysis and Assessment (PPAA) series, as well as in the form of policy and operational papers.

It is apparent from the description below that departments have identified a large number of projects covering a variety of issues of major interest to the Fund. Most of the research projects are aimed at providing the analytical and empirical basis for addressing policy issues arising out of operational work of one kind or another. It is important to note, however, that the proposed research program is tentative and subject to change for at least two reasons. First, many of the projects could be cancelled or postponed due to resource pressures or be crowded out by unanticipated work on other more pressing matters. In that sense, the research program outlined here essentially describes the aggregate demand of departments for research work to assist them in carrying out their operational responsibilities. Whether this demand will be met depends critically, of course, on the availability of staff resources that can be allocated to research activities. And second, the economic and policy issues faced by the Fund and its membership change over time. As the recent surge of research on economies in transition highlights, the research agenda of the institution needs to be responsive to external developments.

The research projects that are currently planned, as well as those on which work has been initiated, fall into three general areas. These include (1) studies to support the surveillance of the international monetary system, the global economic situation, international financial markets, and the analysis of regional trade, financial, exchange rate, and payments arrangements; (2) analyses of macroeconomic adjustment, policy formulation and country-specific issues; and (3) studies dealing with operational issues, including Fund financial operations, technical assistance, and statistical methodologies.

^{1/} The list of projects was compiled from the submissions of the 14 departments represented on the Interdepartmental Working Group on Fund Policy Advice.

II. Fund Surveillance Issues

Since Fund surveillance encompasses the analyses of global, regional and country-specific developments, the supporting research activities are associated with work in each of these areas. First, there are the studies linked to the World Economic Outlook (WEO), the International Capital Markets Report (ICMR), the informal Board sessions on World Economic and Market Developments, and the Fund's analyses for the G-7 policy coordination process. Second, the staff will continue its examination of the global and regional impact of regional trade, financial and payments arrangements. And third, research projects that analyze policy issues in key industrial and developing countries also play an important role in Fund surveillance. The global and regional projects relating to the Fund's surveillance activities are discussed in the rest of this section, while the country-specific projects are considered in Section III below.

1. Surveillance of the international monetary system, the global economic situation, and international financial markets

For the WEO, a number of projects are underway that are either directly related to the Spring 1994 WEO or are undertaken as longer-term research projects on issues of potential relevance for future WEO exercises. These projects encompass industrial country issues related to the general areas of monetary, fiscal and exchange rate policies, sustaining moderate inflation, business cycle developments and structural policy issues. For the developing countries, WEO-related projects include analyses of the links between macroeconomic stability and economic performance, the sources of growth, the role of external finance, the transmission of economic disturbances across countries, and evaluations of trade patterns and current account adjustment.

Additional research on global economy issues, which is likely to be reflected in both the WEO and the ICMR, includes consideration of the influence of capital mobility and capital controls on savings and investment; the development of a global picture of capital flows; the relationship between the savings-investment balance and current account imbalances; capital markets segmentation; the management of systemic risks in international banking; issues relating to capital controls and capital account liberalization; and developments in international commodity markets. The various Board papers and analyses on surveillance issues will also be supported by a series of projects designed to extend and update the macro-economic simulation models used for policy scenarios and analyses of the coordination and transmission of fiscal policies for the G-7 countries.

The preparation of the forthcoming ICMR is to be supported through a number of projects examining government securities and derivatives (e.g., futures and options) markets, the globalization of money and capital markets, the role of central banks in money and capital markets, and alternative deposit insurance schemes. To further the surveillance of the international monetary and financial systems, the staff will examine in

the near term the macroeconomic effects of the imperfections in the international capital markets, the use of currency options to extract market-based forecasts of exchange rate variability, and developments in equity markets in developing countries.

Research on developing countries' access to international capital markets includes studies on the institutional and regulatory reforms affecting foreign investors and techniques to reduce informational asymmetries in developing country finance. As part of the preparation of the report on private financing to developing countries, work has also begun on the nature and implications of increased reliance on portfolio inflows in financing for developing countries.

Global trade policy issues will be analyzed in the triennial comprehensive trade paper to be reviewed by the Executive Board before the 1994 Annual Meetings. The paper will examine major trade policy developments and issues, the likely post-Uruguay Round agenda including competition policies, social dumping and labor standards, and trade and the environment. It will also consider the design of trade reform in Fund-supported programs, trade policy coverage in surveillance (Article IV consultations), and collaboration on trade matters with other institutions (the World Bank, OECD, and the GATT). Thereafter work will focus on shorter papers on issues emerging from post-Uruguay Round trade developments, especially as they affect surveillance and operational work.

2. Regional trade, financial, and exchange rate arrangements

The staff expects to continue its analyses of the global and regional impact of regional trade, financial and payments arrangements. This will involve analyses of monetary and exchange rate policy issues in the Exchange Rate Mechanism (ERM) of the EMS. The staff will also review interstate issues for the countries of the former Soviet Union (FSU) related to monetary and payments arrangements in the FSU, and intra-FSU balances of payments. Regional trade, labor migration and economic policy issues in Africa, Asia, the Middle East and North America could also receive attention.

III. Macroeconomic Adjustment, Policy Analysis, and Country-Specific Issues

Many of the research projects that departments have proposed are tied directly to issues related to macroeconomic adjustment and the design of Fund programs and surveillance procedures. These studies can be grouped into eight broad areas: (1) monetary and financial sector policies; (2) fiscal policy; (3) exchange rate and payments arrangements; (4) external trade and payment policies; (5) structural policies; (6) economies in transition; (7) evaluation of Fund-supported programs; and (8) other analytical (country-specific) issues.

1. Monetary and financial sector policies

Since monetary and financial policies are key elements in stabilization programs, the staff plans to initiate a broad range of studies on monetary and financial policy issues. These include estimating the demand for money in various countries, examining the transmission mechanism for monetary policy, evaluating the usefulness of direct and indirect monetary policy instruments, and the coordination of monetary and debt management policies. There are also studies planned to examine alternative monetary policy strategies for achieving price stability and strong macroeconomic performance, policies that would enhance the credibility of the monetary authorities during a stabilization program, the influence of financial liberalization on money demand and monetary policy, the soundness of the financial system and the efficiency of monetary policy, and the usefulness and informational content of money, credit, and real interest rate targets. For transition economies specifically, projects will examine the transmission mechanism for monetary policy, the inflationary process, and the demand for money in a number of these countries.

The staff is also examining how to implement financial policies in the most effective manner. The staff's analyses of financial reforms would encompass the evaluation of banking supervision issues, assessing the soundness of the banking systems in various countries and regions, financial reform strategies, the analysis of banking crises in the Nordic countries, the development of capital markets and the role of financial innovation, the role of foreign competition in the banking system, the implications of large-scale capital inflows for the regulation of domestic financial markets, and the influence of factors affecting the demand and supply of credit on real GDP and instability in money-income relationships.

For transition economies, the staff is considering the development and operation of financial markets, the demand for financial assets, the development of a theoretical framework for the analysis of arrears and other credit market anomalies, alternative strategies for financial restructuring in Eastern Europe and the FSU, the effectiveness of direct credit controls during the transition, the special role of savings banks in FSU financial systems, and the experience in resolving the bad asset problems of newly-formed commercial banks.

2. Fiscal policy

The staff's analyses of fiscal policy are to be focused on issues relating to the overall stance of fiscal policy, intragovernmental fiscal relationships, tax policy and administration, and public expenditure policy and management. A number of studies are concerned with analyzing sustainable overall fiscal positions, including the evaluation of alternative fiscal deficit reduction strategies, the use of fiscal rules in industrial and developing countries, and the linkages between fiscal sustainability and external viability. In addition, there is to be consideration of the causes and implications of the widening of fiscal imbalances throughout Europe and

the long-term impact of demographic trends on public finances. In light of the deteriorating fiscal positions in many countries, the staff is also studying how to overcome the difficulties that countries have had in meeting long-term structural adjustment goals due to revenue shortfalls and weak expenditure control. For transition economies, studies are planned on the relationship between inflation and budgetary stability and the causes and implications of widening fiscal deficits. The relevance of the theory of fiscal federalism for intragovernmental fiscal relationships is to be examined for a number of countries in Asia (including China), the FSU, and Latin America.

Because of their importance to program design and technical assistance, government tax and expenditure policies are the focus of a number of studies. Tax policy and administration are to be examined in terms of the implications of shifting from income to consumption taxes, financial sector taxation, the tax treatment of bad loans in the financial sector, and income tax reform and the role and scope for environmentally-related taxes. In addition, the staff is considering the relationship between alternative tax policies and economic growth as well as preparing a handbook to provide guidance for tax policy in a wide range of member countries. The pros and cons of alternative organizations of tax administration are also being evaluated.

Public expenditure policy and management are to be analyzed in terms of the appropriate scope for public sector expenditures, the creation of a framework for evaluating public expenditure efficiency and its effect on growth, an examination of cross-country trends in major government expenditure components, the development of a common methodology for the treatment of on- and off-budget expenditures, the treatment of unfunded public sector liabilities, and the development of public expenditure management systems for developing countries. In addition, studies will examine the relationship between social security and social safety nets, with particular emphasis on the role of unemployment benefits in the context of adjustment programs.

3. Exchange rate and payments arrangements

Exchange rate arrangements have played a central role in the design of Fund-supported programs, and payments arrangements have been shown to have important effects on the transmission of monetary policy, especially in the former centrally planned economies. As a result, the research program includes studies of alternative theories of exchange rate determination, the consequences of real exchange rate targeting policies, and the use of the exchange rate as a nominal anchor. Moreover, studies are planned on the determinants of real exchange rates, issues pertaining to multiple exchange rate systems, and the interaction between exchange rate policy, domestic financial markets liberalization, international capital flows, and the formulation of monetary policy. There are also to be examinations of regional exchange rate issues in South Asia and exchange market pressures and speculative capital flows in selected European countries. In addition,

the staff is to evaluate exchange market mechanisms, and the management of foreign exchange reserves.

More generally, the staff is considering a number of issues relating to global foreign exchange markets. These issues include the role of institutional investors in foreign exchange markets and capital flows, the micro-structure of foreign exchange markets, and the interaction between foreign exchange and money markets during an exchange rate crisis.

In view of the large increase in global capital flows, the staff will also examine how capital flows affect the volatility of world exchange markets, the effectiveness of central bank foreign exchange market intervention, and empirical models of speculative capital flows. The intention is to develop a methodology to identify exchange market pressures before they develop into the crisis stage.

Payments systems and accompanying accounting methodologies are to be examined in the context of technical assistance to economies in transition.

4. External trade and payments policies

External trade and payments policies continue to be the focus of research projects across most departments in the Fund. Some of the issues were considered in earlier sections of this paper that discussed regional trade and payments arrangements, the use of capital controls, and exchange rate arrangements and external payments systems. Other projects will focus on trade and current account developments in a number of countries and the determinants and impact of foreign direct investment. In addition, the staff is analyzing the effect of the trade practices and protectionist measures adopted by some countries, the relationship between structural unemployment and trade policies, the implications of trade reforms for the fiscal and external accounts, and the reaction of the economy to trade liberalization.

5. Structural policies

Structural policies being considered by the staff include analyses of the functioning of labor markets, regional labor migration, the relationship between structural unemployment and trade policies, and the relationship between investment and unemployment in the sectoral reallocation process. More generally, the staff is to investigate the effects of government intervention (e.g., taxes, international trade and credit market incentives) on growth and efficiency, the supply-side effects of stabilization programs, the determinants of long-term growth, and the relationship between macroeconomic and structural policies and the distribution of income. In addition, the staff is reviewing the relative importance of government interventions in the growth of Asian countries and is to consider the structural policy implications of Western European reform and the integration of Central and Eastern Europe.

6. Economies in transition

The staff's research on economies making the transition from centrally-planned to market-based systems will focus on key issues in the stabilization process for those economies, as well as on the design of structural reforms, institution-building and financial policies. Many of these projects have already been described in the subsections of this summary on regional trade and payments (II.2), monetary and fiscal policies (III.1 and III.2) and exchange rate and payments arrangements (III.3). The staff is also considering the extent of real resource reallocation that has already occurred in Eastern Europe; the growth and medium-term prospects for potential output in these economies; the links between real exchange rate movements, the current account, and growth in the countries of the FSU; the dynamics of unemployment in transition economies; and the experience with privatization, as well as the role of financial and nonfinancial institutions in the privatization process. In addition, there are proposed projects on the impact of price liberalization on the inflationary process, forced savings and repressed inflation, the role of bank reforms in transition economies, the budgetary and accounting aspects of fiscal policy for transition economies, trade and labor market reforms, and approaches to address the statistical problems faced by transition economies.

7. Evaluation of Fund-supported programs

The staff is continuing its ex post evaluation of Fund-supported programs in two main ways. First, it is preparing papers for the Review of Stand-by and Extended Arrangements scheduled for early 1994. These will consist of an overview of developments under Fund-supported programs approved between mid-1988 and mid-1991, and selected analyses of problems in the design of these programs. These analyses will address the use of nominal anchors, developments in and policies affecting private savings, the evolution of interest rates, objectives for the monitoring of fiscal policy, and the role of incomes policies in transition economies. A second channel for ex post evaluation is periodic reviews of countries' experiences with common policy problems. These tend to take a case study approach, attempting to identify the framework within which countries work and comparing their experiences with a variety of policy actions.

8. Other analytical issues

In addition to the policy topics already discussed, the staff anticipates undertaking projects on a number of country-specific issues. These include the relationship between agricultural and macroeconomic policies, policies for improved targeting of food subsidies, health care reform, civil service reforms to improve efficiency, and indicators of the size and determinants of the informal economy. Moreover, the staff is studying the economic implications of military spending and economic growth and the macroeconomic effects of defense conversion, the linkage between macroeconomic policy and environmental issues, the design and effectiveness of macroeconomic policies in the presence of informal markets, and the

output-employment effects in adjustment and reform programs. For oil exporting economies, there is the intention to build a macroeconomic model of an oil economy that will allow assessments to be made of the effects of a variety of shocks. The staff will also examine co-movement of prices, output, unemployment and wages during the business cycle in industrial countries, the impact of uncertainty on stabilization programs, the behavior of consumption and interest rates during stabilization programs, the role of saving and investment in the macroeconomic adjustment process, and the role of asset price freezes and price controls in stabilization. In addition, the effects of debt and demographic factors on the cost of capital, as well as the policy options to deal with population aging, are to be analyzed.

IV. Fund Operational Issues

1. Fund financial operations

A number of projects will be undertaken by the staff to support Fund financial policies and operations. In preparation for the Tenth General Review of Quotas, work is underway to evaluate the formulas used in making quota calculations, including an evaluation of the time series properties of the variables in the formulas, the stability of the quota formulas, and the overall relevance of the multivariate approach to quota determination. Work in connection with the forthcoming review of the SDR interest rate basket will, inter alia, evaluate the factors that have made the U.S. dollar the dominant currency in the international monetary system and examine the future role of the U.S. dollar. In addition, the staff will undertake a comparative analysis of the SDR and ECU baskets, including proposals to "harden" the assets. In the area of overdue obligations to the Fund, the staff will analyze the economic, financial, and other attributes of the group of countries with overdue obligations to the Fund, compared to those that have made timely repayments to see what factors can be used for predictive purposes in the future. The next phase of work will analyze arrears and non-arrears members using two sovereign creditworthiness-type models.

2. Technical assistance

The research projects in this area are designed to update and expand the staff's technical expertise, thereby improving the quality of the technical assistance provided to the authorities of member countries. Such technical assistance will be provided in the course of country missions. In addition, some departments have organized seminars and workshops for the staff of central banks, other governmental ministries, and other international organizations to provide direct training on such issues as program design, monetary operations and payments systems, foreign exchange market operations, debt management, and fiscal operations. Papers are being prepared to support these technical assistance and training activities.

3. Statistical methodologies

The staff is undertaking a number of projects to support the development and revision of basic statistical manuals prepared in the Fund. A new Manual on Monetary and Financial Statistics will be prepared, which is intended to give comprehensive guidance to the conceptual, definitional and analytical aspects of monetary and financial statistics and to provide detailed direction on this compilation. A detailed outline has been circulated to Fund members for comments and a full draft is expected before the end of 1994. Work will also begin in 1994 on a revision of the Manual on Government Finance Statistics. Both of these manuals will be closely harmonized with the recently completed Balance of Payments Manual and the new UN System of National Accounts. In conjunction with the revision of the BPM, a Balance of Payments Compilation Guide and a Balance of Payments Textbook are also being developed; publication of these is expected in 1994.

