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Research Summaries

Population Aging and International Capital Flows

Robin Brooks

The population of the world is aging. The United Nations projects that the global old age dependency ratio—the number of people 65 and older relative to those between the ages of 15 and 64—will rise from the current 11 percent to 25 percent by 2050. How will this trend affect saving and investment rates around the world? What are the implications for international capital flows? To answer these important questions, this article reviews recent IMF research on how the global population shift will affect international capital markets.

Empirical work suggests that there is a systematic association between demographics and saving and investment. Brooks (1998) uses data for industrial countries to establish that saving rates are negatively related to youth and old age dependency. Chinn and Prasad (2003) use cross-section and panel regressions to investigate the medium-term determinants of current accounts around the world using data for 18 industrial and 71 developing countries. They find that youth and old age dependency are negatively associated with current account balances. *(continued on page 2)*

Rent Seeking, Institutions, and Policy Effectiveness

Era Dabla-Norris

A large body of earlier theoretical and empirical research at the IMF analyzed the impact of corruption and rent seeking on economic efficiency, equity, and growth, while providing insights into its origins, effects, and possible remedies. Recent IMF research has focused on the nexus between rent seeking and weak institutions, as well as on ensuing implications for the effectiveness of government policies. This article provides a selective review of research in this area.

Chakraborty and Dabla-Norris (2005) develop an economic model of the relationship between rent-seeking behavior, distribution of wealth, and economic performance in order to address the question of what drives entry into rent-seeking activities. They show that in the presence of weak institutions for property rights protection, imperfect credit markets, and a fixed cost to rent seeking, only wealthy agents choose to engage in rent-seeking activities, as this enables them to protect their wealth from expropriation by others. In this environment, simply taxing the rich and redistributing tax revenues to the poor may be counterproductive if it raises the post-tax endowments of the poor and gives them incentives to engage in rent seeking. *(continued on page 4)*

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Population Aging and International Capital Flows

(continued from page 1)

The IMF (2004) confirms these results, based on the empirical relationship between demographics and saving and investment for 115 countries from 1960 to 2000, and explores how projected population trends may affect current account positions going forward. It finds that in advanced countries, the aging of populations will result in deteriorating current account balances. For Japan, the effect could be around 2.5 percent of GDP by 2050. For Europe, it would be smaller, at less than 0.5 percent of GDP over the same period. The major exception is the United States, where it is predicted that demographic effects will boost the current account by more than 1 percent of GDP. Elsewhere, demographic change could contribute to an improvement in Africa (close to 3 percent) and the Middle East (around 0.5 percent), but a deterioration in central and eastern Europe (around 1 percent) and emerging Asia (less than 0.5 percent). Heller and Symansky (1997), surveying the existing literature, forecast how the aging of populations will affect the "Asian tiger" countries. These countries will contribute to world saving as their populations move into prime saving years. Beyond 2025, however, they will drag down the global saving rate, as their populations begin to dissave in retirement.

The empirical analysis discussed above, however, is constrained by the fact that an important equilibrium condition—that saving must equal investment at the global level—is difficult to impose. In addition, historical correlations may not reflect causality. To address these issues, Brooks (2003) simulates the effects of population change on external balances in an overlapping generations model with eight regions. The model explicitly incorporates the population age structure and assumes that households accumulate wealth as they work to finance consumption in retirement. Capital is assumed to be perfectly mobile across borders. The simulations suggest that the European Union and North America will run large current account surpluses around 2010, exporting capital to Latin America and Africa where population growth will be faster. Around 2030, dissaving by baby boomers switches the current accounts in the EU and North America to deficit. Both regions will in effect be repatriating foreign assets from regions such as Latin America and the rest of the world.

The main result of the simulations—that current accounts in industrial countries will increasingly move into surplus before switching into deficit as the baby boomer generation retires—is remarkably robust. Faruqee (2002a)—using a multiregion model that has a very different specification for population dynamics that extends Faruqee (2002b)—shows that the current account of an industrial country like Japan will gradually swing into deficit as an aging population consumes the net foreign assets it accumulated earlier. Studies that focus on individual countries, typically treating them as small and open economies with the world interest rate exogenous, also provide supportive evidence. Cheng (2003) builds an overlapping generations model for China and finds that low fertility rates will imply future capital outflows if capital mobility is high. If capital is less mobile, low fertility today will lower the domestic return to capital and raise the domestic return to labor. Brooks (2004) builds an overlapping generations model for a small and open economy to assess how much of Singapore's present current account surplus can be explained via demographic factors. He finds that up to half of Singapore's current account surplus could be due to demographic factors alone and that the surplus will decline in the years ahead as the population ages.

Of course, the model-based literature is subject to several caveats. First, it typically assumes perfect capital mobility and perfect foresight, ignoring the presence of capital account restrictions and political risk in developing countries. As a result, the magnitude of flows to and from developing countries is likely overstated. Another common assumption is that labor is not mobile, which again tends to overstate the role of capital flows.

Second, the magnitude of current account swings depends significantly on how governments respond to the aging of their populations. Schimmelpfennig (2000) argues that tax financing, which is equivalent to prefunding, is the best path for pension reform in a small and open economy with a weak current account position. This is because debt financing leaves the current account unchanged, while tax financing improves the current account. Faruqee and Mühleisen (2001) argue that public investment cuts, measures to broaden the base for income taxes, some increase in the consumption tax, and reductions in social security benefits are the best way to promote orderly fiscal and current account adjustment in Japan. In addition, the multiregion model in IMF (2004) shows that a reduction in the replacement rate of pay-as-you-go pension systems in Europe would boost the European current account substantially relative to the baseline scenario, as it forces households to save more for retirement, which spills over into increased net foreign asset accumulation.

Third, and perhaps most importantly, these models generally fail to explain the current constellation of external balances. Notably, they tend to suggest that the US current account should be moving into surplus, when in fact there is a widening deficit. This is in part due to omitted factors, such as monetary and fiscal policies, but it also reflects the deeper problem, which is that, at best, these frameworks provide an incomplete description of actual saving behavior.

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Visiting Scholars, April–June, 2005

Adeola Adenikinju; University of Ibadan, Nigeria; 2/22/05–4/1/05

Marco Aiolfi; University of California, San Diego; 6/15/05–6/24/05

Joshua Aizenman; University of California, Santa Cruz; 3/28/05–4/1/05, 4/25/05–4/29/05

Lloyd Amaghionyeodiwe; University of Ibadan, Nigeria; 2/28/05–4/8/05

Michael Atingi-Ego; Central Bank of Uganda; 3/21/05–4/29/05

Jushan Bai; New York University; 4/18/05–4/22/05

Gian Luca Benigno; London School of Economics; 4/4/05–4/15/05

Sami Bennaceur; IHEC, Carthage, Tunisia; 2/28/05–4/1/05

Fernando Broner; Universitat Pompeu Fabra, Spain; 3/21/05–4/1/05

Anetta Caplanova; University of Economics, Bratislava, Slovakia; 3/14/05–4/15/05

James Cassing; University of Pittsburgh; 4/11/05–4/13/05, 4/25/05–4/29/05

Luis Cespedes; Banco Central de Chile; 3/21/05–4/1/05

Oluwatoyin Chete; Nigerian Institute of Social and Economic Research; 5/2/05–6/10/05

Ehsan Choudhri; Carleton University, Canada; 4/4/05–4/8/05

Jeffrey Chwieroth; Syracuse University; 5/16/05–7/15/05

Mario J. Crucini; Vanderbilt University; 4/12/05–4/14/05

Betty Daniel; University of Albany; 4/27/05–4/29/05

Allan Drazen; University of Maryland; 4/1/05–4/29/05

Todd Gormley; Massachusetts Institute of Technology; 4/4/05–4/8/05

Pierre-Olivier Gourinchas; Princeton University; 6/6/05–6/17/05

Stephen Haber; Stanford University; 6/27/05–7/1/05

Franz Hamann; Bank of Colombia; 6/8/05–6/21/05

Jiandong Ju; University of Oklahoma; 4/25/05–4/29/05

Michel Juillard; CEPREMAP, France; 4/18/05–4/25/05

Arvind Krishnamurthy; Northwestern University; 5/18/05–5/20/05

Kenneth Kuttner; Oberlin College; 2/25/05–4/29/05, 6/2/05–6/3/05, 6/8/05–6/10/05, 6/13/05–7/29/05

Philip Lane; Trinity College Dublin; 4/21/05–4/29/05

Chia-Hui Lu; Academia Sinica; 4/15/05–7/15/05

Jane Mariara; University of Nairobi, Kenya; 3/21/05–4/29/05

Enrique Mendoza; University of Maryland; 4/11/05–4/22/05, 6/6/05–6/6/05, 6/9/05–6/10/05

Enrico Minelli; CORE, Belgium; 4/5/05–4/6/05

Alessandro Missale; Università di Milano; 3/30/05–4/8/05

Peter J. Neary; University College, Dublin; 4/25/05–4/29/05

Christopher Otrok; University of Virginia; 4/14/05–4/29/05, 5/11/05–5/13/05, 5/23/05–5/27/05, 6/7/05–6/8/05, 6/16/05–6/17/05

Sandra Poncet; University of Clermont-Ferrant and University of Paris XIII; 5/9/05–5/13/05

Jay Shambaugh; Dartmouth College; 4/4/05–4/8/05

Jeremy Stein; Harvard University; 6/15/05–6/17/05

Phillip Swagel; American Enterprise Institute; 3/21/05–4/29/05

Allan Timmermann; University of California, San Diego; 6/15/05–6/21/05

Eric van Wincoop; University of Virginia; 5/9/05–5/13/05, 6/6/05–6/10/05

Thierry Verdier; Delta, France; 4/4/05–4/15/05, 4/25/05–4/26/05

Randall Wright; University of Pennsylvania; 4/21/05–4/22/05, 4/28/05–4/28/05

Pierre Yared; Massachusetts Institute of Technology; 6/7/05–6/10/05

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The Internal Job Market of the IMF's Economist Program
Greg Barron and Felix Vardy

Banking on Foreigners: The Behavior of International Bank Claims on Latin America, 1985–2000
Maria Soledad Martinez Peria, Andrew Powell, and Ivanna Vladkova-Hollar

Assessing Early Warning Systems: How Have They Worked in Practice?
Andrew Berg, Eduardo Borensztein, and Catherine Pattillo

Domestic Debt Markets in Sub-Saharan Africa
Jakob Christensen

Does SDDS Subscription Reduce Borrowing Costs for Emerging Market Economies?
John Cady

Special Data Section

Domestic Debt Markets in Sub-Saharan Africa
Jakob Christensen

Rent Seeking, Institutions, and Policy Effectiveness

(continued from page 1)

A better policy option would to use tax revenues to subsidize production directly, since this raises the return to investment for all. Ruhashyankiko and Yehoue (forthcoming) develop an occupational model embodied in an agency framework to analyze whether rent-seeking behavior is an outcome of a lack of outside options for public officials. They show that technologically-induced private sector expansion leads to a decline in public rent seeking, as it provides an outside option to public officials who might otherwise engage in such activities. They distinguish between public and private rent seeking, and provide empirical evidence that suggests that a decline in public rent seeking outweighs any potential increase in private rent-seeking activities that could accompany private sector expansion.

The availability of natural resources in developing countries is frequently cited as a factor that contributes to rent seeking. Sala-i-Martin and Subramanian (2003) find that the presence of natural resources that generate rents and are easily appropriable, such as oils and minerals, can exert a negative and nonlinear impact on a country's long-run growth through its deleterious impact on the quality of institutions.

"While economists and policymakers have long recognized that institutions matter in determining economic performance, a more difficult question is why, given the high costs of rent seeking, countries do not improve their institutions and root out such behavior."

While economists and policymakers have long recognized that institutions matter in determining economic performance, a more difficult question is why, given the high costs of rent seeking, countries do not improve their institutions and root out such behavior. A possible reason for the persistence of widespread rent seeking and low economic growth in many countries is that the more widespread the rent seeking, the lower the likelihood of detection and punishment. Such strategic complementarities and the ensuing multiplicity of equilibria that arise—a good equilibrium with low levels of rent seeking and high growth, and a bad equilibrium with pervasive rent seeking and low growth—are investigated by Dabla-Norris and Freeman (2004) and Mauro (2002). They conclude that gradual reforms are less likely to work than more ambitious ones, and that external intervention and support may be required to extract countries from the vicious circle in which they seem to be stuck. Damania, Fredriksson, and Mani (2003) develop a political economy model to examine the persistence of rent seeking and policy distortions. They show that in politically unstable regimes, the institutions necessary to monitor and enforce compliance with regulations are weak, which, in turn, increases incentives for rent-seeking behavior, resulting in a higher level of noncompliance with existing regulations.

The role of rent seeking and weak institutions in undermining policy effectiveness has been analyzed in a wide range of contexts. Gupta and Abed (2002) provide a comprehensive review of the earlier empirical research at the IMF on

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the impact of corruption and rent seeking on public finances and inequality. Recent research has sought to explain why the effectiveness of uniformly provided public programs in achieving redistributive goals—for instance, in education and health—remains questionable in many developing countries. Dabla-Norris and Gradstein (2004) develop a dynamic model of public education spending designed to achieve egalitarian objectives. However, the presence of weak governing institutions allows the rich to engage in rent seeking with regard to public education funds, thereby skewing the incidence of public spending in their favor. This, in turn, has adverse dynamic implications for the distribution of income, intertemporal mobility, and long-run growth. It also provides an explanation for why public spending may not have the desired impact on poverty and social outcomes.

On the revenue side of the budget, Danninger, Cangiano, and Kyobe (2005) analyze how interference and inefficiencies in the revenue forecasting process in low-income countries can be attributed to rent-seeking behavior and state capture. They show that in weak institutional environments, interference in the revenue forecasting process can serve as an instrument to conceal the extraction of public resources. If the public has sufficiently little access to information, the government can hide theft or mismanagement of revenues during the collection process by adjusting revenue forecasts. The analysis highlights the importance of transparency and information disclosure in helping to reduce forecasting interference and improving the effectiveness of the budget formulation process.

Huang and Wei (2003) examine the implications of rent seeking for the design of monetary policy. Under an inflation targeting framework, they show how a socially optimal level of inflation targeting is influenced by rent capture, as measured by an erosion of the government's ability to collect revenues through formal tax channels. They find that the optimal inflation target is higher for countries with a higher degree of rent capture. In addition, they show that the credibility of other monetary regimes, such as a pegged exchange rate regime, currency board, or dollarization, is likely to be undermined, and that these regimes fail in countries with rampant rent seeking. Moreover, the authors find that the notion that a low inflation target or a currency board can be used as an instrument to induce governments to fight corruption is questionable in environments where there are high initial levels of rent seeking.

Finally, Fredriksson and Mani (2002) adopt a common agency framework to analyze the relationship between the rule of law, rent seeking, and environmental policy. They find empirical support for their theoretical prediction that better quality institutions increase environmental stringency, but this effect is lower when rent seeking is more pervasive. Their findings imply that reform of the legal system may have important effects on environmental and, more generally, other structural policy outcomes.

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Country Study

France

Werner Schule

Over the past decade, France's economic growth has on average outperformed that of the euro area. Significant reforms have been implemented, though progress in labor and services markets has been slow. Consequently, labor utilization remains unsatisfactory and unemployment high. Looking forward, the key policy question is how to increase trend growth and secure fiscal consolidation in the face of the impending demographic shock. Recent IMF research has focused on this challenge.

The recovery in French trend growth in the 1990s resulted mostly from capital deepening and an increase in structural employment, as has been pointed out by Nadal de Simone (2003). Total factor productivity growth, however, declined from an average of 2 percent per year during the 1980s to 1.2 percent during the 1990s (Everaert and Nadal de Simone, 2003). Capital deepening was due to investment in new technologies. With the notable exception of computers and software, however, labor-saving investment decelerated sharply during the 1990s (Estevão and Levy, 2000).

Despite a gradual decline in the nonaccelerating inflation rate of unemployment, the French economy was nearing its potential at the beginning of this decade (Ubide-Querol, 2000). However, given the high degree of synchronization between the French cycle and that of the rest of the world (Nadal de Simone, 2002), GDP growth was affected by the global downturn in 2001–02. Furthermore, inflation persisted due to idiosyncratic factors and higher-than-expected labor costs following introduction of the 35-hour work week (Weisfeld, 2002; Nadal de Simone, forthcoming). In stark contrast to Germany, the subsequent recovery in France was entirely driven by domestic demand, including private consumption. While French consumption closely tracks households' disposable income, financial wealth effects are smaller than in the United States, and housing wealth does not seem to have a measurable impact (Schule, 2004). Limited wealth effects may explain why France did not experience a significant decline in the private household savings rate.

On the external side, France's trade balance moved into deficit in 2004, after net trade contributed negatively to GDP growth for the third year in a row. This happened against a backdrop of booming world trade, sluggish demand within the euro area, and continued appreciation of the euro. Allard (forthcoming) looks at the divergent export performances of France, Germany, the United Kingdom, and Italy and finds that French export weakness relates to regional and product specialization, relative cyclical positions, and price and cost competitiveness.

France's strong employment performance in the second half of the 1990s can be partly explained by labor market policies. Estevão (2003) finds that direct subsidies for job creation are the most effective labor market policies to raise employment rates, while expenditures on training programs seem to be largely ineffective. The effectiveness of employment subsidies in the 1990s was associated with overall wage moderation (Detragiache and Estevão, 2002a). This moderation of wages could be explained both by a change in the preferences of union members toward favoring employment policies, and by weaker overall union bargaining power. However, the reasons for the change in wage bargaining behavior are hard to pin down (Estevão, 2001; Estevão and Nargis, 2002).

"Despite the liberalization of France's financial sector since the mid-1980s, state intervention remains widespread and often creates distortions."

Looking forward, there is uncertainty as to whether wage moderation can be sustained. At the same time, employment subsidies have become an increasing burden on the budget (Mahfouz, 2000), and the focus of employment policies is shifting to labor market structures. Young and unskilled workers are those most affected by current labor market institutions, including employment protection legislation, high minimum wages, and unemployment benefits. Giuliano (2004) finds that high unemployment in France is not driven by mobility-induced search. Increasing training, with costs shared between employer and employees, may thus be a valid avenue to improve the employment experience of low-skilled workers. Zhou (forthcoming) analyzes the consequences of employment protection legislation on unemployment in France. Calibrating a search matching model with hiring and firing restrictions, she argues that a partial reform that facilitates the use of fixed-term contracts—but keeps the stringent permanent job security provision unchanged—is more likely to raise unemployment. A single contract with low firing costs would be a more effective way to lower unemployment.

Labor, product, and services market reforms have mutually reinforcing benefits. Despite the liberalization of France's fi-

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nancial sector since the mid-1980s, state intervention remains widespread and often creates distortions. For instance, the sluggish adjustment of interest rates on consumer credits and administered saving schemes has hampered the pass-through of monetary policy. Allard and Fonteyne (2004) estimate that about 3¼ percentage points of consumption growth has been temporarily forgone during the European Central Bank's recent easing cycle. Schule (forthcoming) measures the macroeconomic effects of increasing competition in labor, product, and services markets. Simulations using the IMF's global economic model show that the long-run effects on the level of GDP are large, up to 15 percent. Comprehensive reforms across all markets ensure a more equal distribution of the gains, measured in consumption units, while coordinating structural reforms among the large euro-area countries allows monetary accommodation. As a result, transitory adjustment costs are significantly lower.

Finally, it is worth mentioning that the "fiscal dividend" from strong employment growth has been negligible because of an expansion of social programs and public sector jobs for youth, along with the growing fiscal costs of reductions in social security (Detragiache and Estevão, 2002b). Mahfouz (2000) recommends that efforts to alleviate the tax burden target supply and focus on well-identified distortions that result in disincentives to work. Within the boundaries of the Stability and Growth Pact, more emphasis should also be placed on spending rules, which do not require discretionary measures to offset cyclical fluctuations in revenues, allowing automatic stabilizers to work (Di Bella, 2002; Daban and others, 2003).

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IMF Pre-Conference on Strategies for Changing Institutions

Arvind Subramanian

There is growing evidence that institutions influence a country's ability to accumulate capital and improve productivity, and hence its level of income and development in the long run. But it is also true that institutions are persistently conditioned by such factors as history, geography, and culture. They do change, but not very rapidly, and in ways that are still not fully understood. Yet, when and how institutions change is a question of crucial importance for countries seeking to improve their development prospects.

Strategies for changing institutions were the focus of a pre-conference held at IMF headquarters in Washington on July 6–7, 2005. Hosted by the IMF's Research Department and cosponsored by the United Kingdom's Department for International Development (DFID), the pre-conference was attended by economists from the IMF, World Bank, academia, and think-tanks, as well as by participants from nongovernmental organizations. The event served as a lead-up to a final conference on related issues to be held in Washington on December 1–2, 2005. The aim was to draw on lessons from the experiences of low-income countries, particularly in Africa but also in South Asia and Latin America, in order to determine the optimal role of the Fund in these countries.

Ben Olken of Harvard University and the National Bureau of Economic Research presented a paper based on the monitoring of corruption in Indonesia. The main finding was that centralized monitoring of projects in the form of audits tended to reduce corruption, whereas grassroots monitoring of such projects changed the nature of corruption without altering its overall level.

Sarah Wykes of Global Witness made a presentation on managing oil revenues in Brazzaville, Republic of Congo' that described the extent to which transparency initiatives, including those undertaken with the help of the Fund, had been effective. She also outlined additional steps that needed to be taken.

Daniel Kaufman of the World Bank presented some new data that he and his colleagues had compiled on disaggregated indicators of political institutions, including those relating to transparency. Kaufman viewed as strong the evidence that better political institutions were robustly correlated with a country's economic performance.

In his paper on Uganda, Jonathan di John of the London School of Economics argued that President Yoweri Museveni had followed a highly heterodox and gradual reform strategy that took into account the fragile nature of domestic institutions and the country's latent social conflict. In comments on the paper, Jim Adams of the World Bank suggested that the reform package was actually quite orthodox, based on securing macroeconomic stabilization and opening up the economy. The discussion that followed focused on the prospects for political succession and economic reform in the period ahead.

A number of other case studies were also presented. Esther Duflo of the Massachusetts Institute of Technology (MIT) examined rent seeking at the local government level in the Indian state of West Bengal; Dean Yang of the University of Michigan looked at corruption in customs services in the Philippines; Rachel Glennerster of the IMF and the MIT Poverty Action Lab discussed transparency in Sierra Leone; and Michael Kremer of Harvard University reviewed experiences with the contracting out of health services.

Details of the pre-conference and the papers presented there are available at *www.imf.org/external/np/res/seminars/2005/weak/index.htm.*

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