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Special Summit of the Americas

High levels of public debt may imperil economic recovery in Latin America



With the global economy poised for a return to robust growth, decision makers in Latin America should seize the opportunity to consolidate and extend reforms in their economies, IMF Managing Director Horst Köhler said, speaking at the Special Summit of the Americas in Monterrey, Mexico. But he also warned that persistent high levels of public debt remained a key risk to sustained economic growth and rising living standards.

With the U.S. economy leading the recovery, the Western Hemisphere is once again an economic locomotive for the world, Köhler said. But widespread poverty in many countries stands in sharp contrast to the region's enormous potential. Although every country must find its own blueprint for success, Köhler pointed to three fundamental elements that all governments must seek to put in place:

- *Good institutions.* Successful market-based economies have institutions that uphold the rule of law, protect property rights, *(Please turn to the following page)*

Sugisaki lauds progress made on fortifying global financial system

At the end of January, Shigemitsu Sugisaki departs as IMF Deputy Managing Director, a post he has held since 1997. Before that, he served as Special Advisor to the IMF Managing Director for 2½ years and held a variety of posts in the Japanese government, including Deputy Vice Minister of Finance for International Affairs in 1990–91 and Deputy Director General of the International Finance Bureau in 1991–92. Sugisaki spoke with Laura Wallace about his eventful years in top management at the IMF.

IMF SURVEY: What do you consider to be your greatest accomplishment?

SUGISAKI: I prefer to focus on the accomplishments of the institution, which reflect the collective decisions of management and the Executive Board, and the work of the staff. From this perspective, I would highlight the efforts the IMF has made to improve the international financial architecture since Mexico's financial

crisis in the mid-1990s. Former IMF Managing Director Michel Camdessus called it the first crisis of the 21st century. By this, he meant that this was a balance sheet crisis, highlighting the importance of improving our analysis of the capital account and financial sector weaknesses.

As a result, in 1999, he launched the Financial Sector Assessment Program [FSAP]—basically a health check of a country's financial system. This concern was picked up by his successor, Horst Köhler, who created the IMF's *(Please turn to page 2)*



Sugisaki: "I haven't seen a single country that took the antiglobalization approach and was better off for it."

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IMF's financial support for Latin America stands at unprecedented levels

(Continued from front page) combat corruption, and promote social stability. There is also scope for strengthening the role of the banking sector in domestic financial intermediation between savers and investors, which will benefit especially small and medium-sized companies and low-income households.

- *Sound long-term management of public finances.* Persistent high levels of debt in the region could imperil what has been achieved so far. Köhler expressed understanding for the pressing infrastructural and social needs in many countries in the region and underlined that the IMF is committed to work with countries to address these needs. But, he said, there are no magic formulas: fiscal discipline remains indispensable, and governments will continue to face tough choices.

- *Trade expansion.* Trade is the most important engine for economic growth in the region. Leaders should seize the initiative to eliminate intraregional barriers to trade. Their removal could help pave the

way for a successful conclusion of the Doha Round of global trade talks.

The IMF's financial support for the Latin American region currently stands at unprecedented high levels, Köhler said, adding that the institution remains committed to helping countries build a better future for their people. The IMF has programs in place with 13 countries in the Western Hemisphere—Argentina, Bolivia, Brazil, Colombia, Dominica, the Dominican Republic, Ecuador, Guatemala, Guyana, Nicaragua, Paraguay, Peru, and Uruguay.

Crisis prevention remains the IMF's top priority. The institution is seeking to further improve its ability to provide rapid support to countries that have good policies but may face unexpected economic shocks. He noted that a strong IMF safety net is in the best interest of both the region and global financial stability. ■

The full text of Köhler's speech at the Special Summit of the Americas is available on the IMF's website at www.imf.org.

Sugisaki stresses value of open markets

(Continued from front page) International Capital Markets Department, along with the Capital Markets Consultative Group, a forum for dialogue with private financial sector leaders. Over the years, we've also tried to strengthen crisis prevention and management efforts, but we still need to do more to sharpen our surveillance and ensure that programs are appropriately tailored to address individual crisis cases.

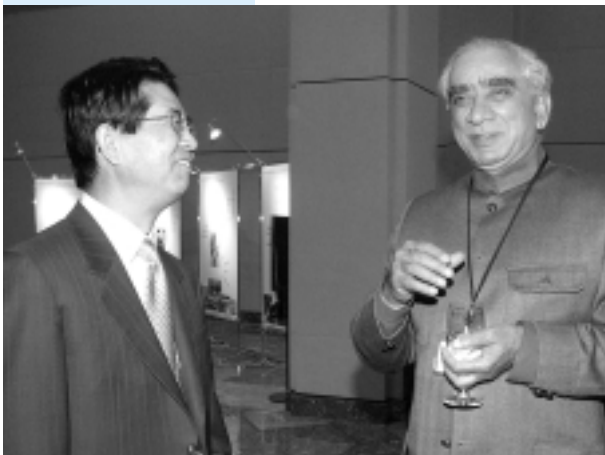
More personally, I've tried my best to ensure that the IMF continues to be a good place to work for our staff, as well as being fully responsive to the concerns and wishes of our shareholders, our member countries. It's essential that we be able to recruit and retain top-quality staff. But we can't be extravagant, and we have to stay in line with international standards on wages and benefits.

IMF SURVEY: How about your biggest disappointment?

SUGISAKI: My biggest disappointment has probably been Zimbabwe. In 1999, I was closely involved in the IMF's decision to support it with a successor Stand-By Arrangement. The previous loan had been approved only a year earlier and quickly went off track, in part because of the fallout from Zimbabwe's involvement in the Democratic Republic of the Congo and a series of policy decisions that had undermined market confidence.

Against this background, our decision to support Zimbabwe with a successor loan was very much a leap of faith, based on the authorities' commitment to corrective policies, including a major land reform. Already at the time, there was disquiet over the government's issuance of acquisition orders to farmers who had contested the earlier compulsory purchases. Nonetheless, we decided to give the government the benefit of the doubt and go ahead.

This proved to be the wrong judgment. The program went off track after a single drawing, and the situation has continued to deteriorate, with great damage to Zimbabwe's economy and the impoverishment of its people. Formal relations between the country and the IMF have also deteriorated. Zimbabwe has accumulated arrears, and, as a result, the IMF has initiated procedures



At the 2002 IMF–World Bank Annual Meetings, IMF Deputy Managing Director Shigemitsu Sugisaki talks with India's Finance Minister Jaswant Singh.

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for its compulsory withdrawal from the membership. It is still my hope that this can be avoided and that the situation can be turned around before too much more damage is done to Zimbabwe's economy and the region. Whether things would have turned out any differently had we decided not to support Zimbabwe in 1999 is difficult to say, but it is a decision that I regret.

IMF SURVEY: You've been called upon to troubleshoot in recent financial crises. Have we learned any critical lessons that will help us safeguard the stability of the international financial system?

SUGISAKI: One lesson is that strong country ownership of an economic program matters a great deal. Among the Asian crisis countries, Korea enjoyed the strongest leadership once Kim Dae-Jung was elected president in late 1997, and it was the first country to get out of crisis. In contrast, Indonesia's leader was in quite a weak position toward the end of his tenure. Although President Suharto signed the Letter of Intent with the IMF—which was actually quite exceptional for a president to do—it didn't mean that he had strong ownership of the program, and the initial outcomes were not good. Members of his economic team were committed to and, indeed, pushed for the program that was agreed on, but this commitment was not shared at the highest level.

Of course, ownership by itself does not guarantee a strong program. If the IMF had agreed to the program that Suharto ideally would have liked, would it have led to a better outcome? I don't think so. And if we had failed to agree, this would not have resolved Indonesia's crisis either. So the reality can be very difficult at times. What is important in all cases is that the IMF does its very best to work with the crisis country to reach agreement on a truly effective program, one that the authorities are committed to implementing.

IMF SURVEY: We've also seen the rise of the anti-globalization movement. What do you make of it?

SUGISAKI: I haven't seen a single country that took the antiglobalization approach and was better off for it. In fact, quite the opposite: it's clear that economic liberalization will, in the end, produce better living standards on average. The questions really are how to minimize the negative transitional element in globalization, and how to ensure that it works for the benefit of all. Here, the IMF will do what it can to help.

IMF SURVEY: The IMF's Deputy Managing Directors share country responsibilities, and you have had a broad range of countries—some 70 spread throughout the world—to watch over.

Have you learned lessons in one country that you've been able to apply to other countries?

SUGISAKI: China's experience offers several valuable lessons. It faces a lot of challenges, including in the banking and state-owned enterprise sectors, but its economic achievements have been remarkable. It's been very eager to attract foreign direct investment,



which has played a tremendous role in its economic development. The leadership recognizes that an open trade policy is in China's interest, and this is helping to move forward a great civilization and make its enterprises internationally competitive. This open door policy is a good lesson for others.

Another fascinating case is Mozambique, which has successfully emerged from a prolonged internal conflict. I had the opportunity to see the reconciliation process firsthand when I visited there in 1999. I saw that opposition groups were represented in parliament and were participating actively in the policy discussions, however tense. This is as it should be. The leaders in Mozambique realized that continued internal conflict was damaging their country, and they succeeded in bringing it to an end. This is a lesson to other countries—too many are still in conflict. Without peace, there can be no real progress in improving the economic conditions of the people.

IMF SURVEY: Are you hopeful that your own country has finally begun to turn the corner economically?

SUGISAKI: Japan's economic growth rate has recently picked up, but it's hard to say how much of the improvement is cyclical or structural. I do see some positive moves on the structural side. For example, there's been a lot of restructuring, and mergers and

IMF Deputy Managing Director Sugisaki greets French President Jacques Chirac (left). With them are former IMF Managing Director Michel Camdessus and former IMF First Deputy Managing Director Stanley Fischer.

acquisitions, especially in the manufacturing sector, which would have been unthinkable just 10 years ago. But some sectors need further restructuring, such as banking, real estate, construction, and retail.

IMF SURVEY: Do you think the IMF's recent review of Japan's financial system helped convince policymakers to tackle bank and corporate restructuring?

SUGISAKI: In the end, the authorities appreciated our FSAP analysis, and the staff's recommendations and analysis weren't so different from those of the authorities. The authorities worried that if there were a lot of publicity,

this would magnify the chances of the report having a negative impact on the market. As it turned out, even after the main recommendations became public, the market reaction was rather calm.

IMF SURVEY: What do you think of this trade-off between transparency and candor in the case of the FSAP?

SUGISAKI: We should be very candid with the authorities about an FSAP's findings but recognize that the findings can be quite sensitive and maintain some element of confidentiality. Perhaps the answer is to just release the summary of the FSAP recommendations in the form of the Financial System Stability Assessment that is carried out as part of the Article IV discussion—as increasingly countries are doing.

IMF SURVEY: You've been responsible for staff safety. What can the IMF do to provide greater security and still carry out its necessary work? What changes have been made since 9/11 and the bombing of the UN office in Baghdad in August 2003?

SUGISAKI: We have strengthened our security at headquarters as well as in the field, especially over the past year. One concrete step is that we've tightened our procedures for mission clearance, sending our own security teams to assess whether UN phase 3 and phase 4 countries—those designated by the UN as most dangerous—are safe for missions to visit.

I must say that it was a shock to me that the UN became a target for terrorist attack. The attack resulted in the tragic deaths of many UN officials, including a good friend of mine, Sergio de Vieira Mello. His death was a great loss to the world. The attack also caused serious injuries to several IMF staff, and I pay my tribute to them. We certainly appreciate their courage and their understanding of our mission and mandate. We relied on the UN security umbrella. But since that attack and subsequent attacks on international relief organizations, such as the Red Cross, it is clear that we can no longer presume that international relief agencies will be free from terrorist attacks.

IMF SURVEY: How are we managing to help Iraq without physically being there?

SUGISAKI: We are meeting with Iraqi authorities and the Coalition Provisional Authority economic team in nearby countries, such as Jordan, and we're able to take advantage of such technologies as e-mail. We'll continue to carry out our mandate to help Iraq formulate and implement an economic program. We're actively working on the economic outlook for the year ahead, budgetary needs, and the debt picture, and we are also providing considerable technical assistance.

IMF SURVEY: You have also been watching over developments in Angola, Sri Lanka, and Timor-Leste. Is the IMF able to make an effective contribution to postconflict countries?

SUGISAKI: Certainly in Sri Lanka and Timor-Leste we've done a lot in collaboration with other international organizations and bilateral donors, and this has been greatly appreciated by those countries. Of course, there's more to be done. In Angola, we need to pursue transparency, especially within the oil industry. The authorities are aware of the need to ensure that all of the revenues and expenditures are reported in the budget. In that respect, a U.K. initiative on extractive industries that requires the government and the private sector to make all information public would be very important.

IMF SURVEY: What are your future plans?

SUGISAKI: After nearly a decade with the IMF—an opportunity I've enjoyed tremendously—I've decided it's time to go back to my home country and be reunited with the family. Obviously, given my background, I will continue to have an active interest in issues related to public service and the financial sector, so I imagine that's the path I will follow. You know I can't simply choose an entirely new life as an artist. Well, maybe as a hobby, I'll take up pottery. ■



IMF Deputy Managing Director Shigemitsu Sugisaki welcomes Timor-Leste Prime Minister Mari Alkatiri after his country joined the IMF on July 23, 2002.

Financial sector checkups: how are they working?

The IMF and the World Bank have evaluated the soundness of financial sectors in 46 developing, 19 transition, and 16 advanced economies. What has been learned from the joint Financial Sector Assessment Program (FSAP), and how can this diagnostic tool be improved? In a December 16 Economic Forum, Stefan Ingves (Director, IMF Monetary and Financial Systems Department), Larry Promisel (Director, World Bank Financial Sector Global Partnerships), George Kaufman (Professor of Finance, Loyola University), and Roberto Zahler (President, Zahler & Company) distilled five years of experience, underscoring, among other recommendations, the crucial importance of follow-up and the need for more emphasis on financial sector development aspects in FSAPs.

The world has learned the hard way, the IMF's Stefan Ingves said, that strong and resilient financial systems are crucial for growth, and when things go wrong in these systems, crises can result that may indeed be costly. It was largely the fear of global contagion from domestic financial crises that prompted the IMF and the World Bank to create the FSAP in 1999.

Now, a half decade after the program's introduction, Ingves described the lessons learned for each of the main country groups. Most of the advanced economies, he observed, have sound financial systems, in terms of both financial indicators and institutional and regulatory frameworks. But "credit risk truly continues to be relevant, particularly when banking sectors run into deep trouble," and the large dispersion in ownership of publicly traded companies and financial institutions can leave the way open for governance problems and difficulties running the banks. The main challenges for these economies are the regulatory and supervisory problems posed by the proliferation of financial instruments and markets and by the increased concentration and agglomeration of financial institutions.

Although emerging market economies have made progress with reform, financial sectors in some still have significant short-term vulnerabilities. For these economies, too, the rapid growth of new instruments adds considerably to the demands on supervisory capacity. And some of them also suffer from a lack of consolidated risk-based supervision. Weak inter-agency cooperation and deficiencies of supervision in the nonbank area present further challenges.

In developing countries, weak regulatory and supervisory frameworks often mean that "there are few rules of the game, and there are even fewer people keeping track of them." Ingves added that the inability of credit markets to function effectively is a critical challenge for many developing economies, which tend to be characterized by weak legal and institutional settings and an underdeveloped financial sector dominated by banking. A lack of economic diversification can compound these problems and increase an economy's—and its banking sector's—vulnerability to external shocks.

Going forward, Ingves indicated that the FSAP will need to sharpen its focus and refine the selection of issues and standards to be assessed. Increasing country requests for updates of initial FSAPs will place further demands on the program. "We will need to think hard," he said, about how to deploy new tools in financial sector surveillance, carry out various kinds of follow-up, develop new methodologies for looking at developmental issues, conduct more research on financial stability issues, ensure that standard setters have the benefit of FSAP-acquired knowledge, and work on better mechanisms for the provision and follow-up of technical assistance.

Best practices and swift follow-up

Taking up Ingves's point that a swifter mechanism is needed to provide follow-up technical assistance, Loyola University's George Kaufman noted that the FSAP and other financial surveillance are important and necessary, but must be accompanied by "best practices" and advance planning for turning around near-insolvent banks and for resolving insolvent ones at minimal social costs.

One example of a best practice for dealing with troubled but not yet insolvent banks, Kaufman noted, is the type of prompt corrective action that the United States adopted as part of its response to the savings and loans crises in the 1980s. Its carrot-and-stick approach offered greater powers and more freedom for financially sound institutions (the carrots) and placed progressively harsher and more mandatory sanctions (the sticks) on institutions whose financial positions continued to deteriorate. Of course, he added, such a system requires careful, continuous monitoring and effective intervention.

For an insolvent bank, Kaufman explained, the first step toward recovery is to close it legally,

although not physically. This means changing senior management and terminating the interest of existing shareholders while keeping the bank operating and open for business through, for example, recapitalization or merger and acquisition. Steps need to be taken to minimize two types of losses: credit loss, which is the negative net worth of the institution, and liquidity losses to depositors, which occur if their access to the market value of their accounts is frozen or blocked.

How do these steps mesh with the FSAP? Kaufman emphasized the importance of following up on, and building upon, surveillance—whether international or domestic—by aiming for best practices and tailoring them to country institutions, as well as through advance planning for the effective rehabilitation or resolution of problem banks.

More emphasis on development

While the FSAP has put considerable emphasis on stability and given priority to systemically important countries, the World Bank's Larry Promisel noted that the program has not ignored longer-term struc-

tural or development issues or countries that are not systemically important. In fact, he said, 15 African countries have already participated, with only South Africa considered systemically important.

But if the FSAP is to be equally useful for countries with less well developed financial systems, it must change its emphasis, Promisel indicated, and give more attention to underdeveloped markets and institutions and to how residents can be given better access to a wider range of financial services. These assessments for low-income countries are indeed placing increasing priority on financial sector developmental issues. Promisel earmarked five issues that might usefully be addressed more thoroughly in the FSAP:

Infrastructure for access. Access to credit is a key to private sector development and balanced, sustainable growth, but certain conditions must be present for credit providers to lend with confidence. These conditions include appropriately designed and well-functioning collateral and bankruptcy laws, competent and impartial courts, and an information infrastructure. Developing a stand-alone

FSAPs and good regulatory governance

Good governance on the part of financial sector regulators is increasingly recognized as an essential building block of financial stability. In a recent address to the International Association of Deposit Insurers in Seoul, Korea, Stefan Ingves, head of the

IMF's Monetary and Financial Systems Department, underscored this point, stressing that the quality of regulations and supervisory practices, including the treatment of bank closures, has a critical role to play in ensuring the stability of the financial sector.

Ingves noted that good regulatory governance is rooted in four essential institutional components—*independence, accountability, transparency, and integrity*—which reinforce each

other in guaranteeing sound governance practices. For instance, accountability makes independence effective, transparency enhances the effectiveness of the three other elements, and independence and integrity are also mutually reinforcing.

The joint IMF–World Bank Financial Sector Assessment Program (FSAP) provides a means to

collect information on governance practices, albeit mainly in an indirect way—by assessing country observance of several financial sector standards and codes. The assessment of nearly eighty countries to date, Ingves acknowledged, reveals that there is a lot of work ahead to improve governance practices in supervisory agencies.

The FSAPs reveal that the governance practices of the supervisory functions are generally weaker than those of the monetary policy functions. Less than 50 percent of the agencies assessed are reasonably independent from the government. Some form of accountability arrangement is present in most cases, but the standards and codes, in their current form, do not request the type of information needed to assess the quality of those arrangements. Transparency and integrity arrangements are satisfactory in only 60 percent of the countries assessed. In general, advanced countries score better than transition and developing countries on all accounts. But transition countries score better than developing countries, mainly because their institutions were reshaped in the 1990s.

In recognition of the importance of good governance, post-FSAP technical assistance is increasingly focusing on improving the institutional basis for good governance. The current trend toward unified supervisory structures, Ingves concluded, offers a great opportunity to strengthen governance practices as part of a comprehensive reorganization.



private credit information industry is very important for small businesses. Promisel recommended that the FSAP pay greater attention to the status, performance, and potential of this industry.

Monopolies and related distortions. While a small financial system dominated by a handful of institutions with substantial market power may appear to be a stable model, it can be severely deficient in allowing local firms to grow and compete in both the local and the international markets. Among other things, assessors need to be aware of collusive behavior, cross-segment ownership structures, and regulations and laws whose design is dominated by bank-centric central banks.

Nonbank intermediaries and organized markets. While more prone to failure and more volatile than the traditional banking sector, a strong and healthy nonbank financial sector and organized capital and money markets play a potentially important role in increasing available sources and types of financing.

Specialized institutions. In many countries, specialized financial institutions have been formed to serve traditionally underbanked groups, such as small businesses. Specific issues affecting specialized microfinance institutions, including appropriate regulation, may need to be included in these assessments.

Corporations and households. Analysis at the level of borrowers—the nonbank corporate sector and households—is needed to give a complete assessment of vulnerabilities and development needs, but FSAP teams will need to determine the appropriate amount of resources to be given to this effort.

Like Ingves and Kaufman, Promisel underscored how crucial follow-up is to the overall effectiveness of the FSAP exercise. The real work, he said, is in the actions of the national authorities and the private sector in strengthening their financial systems, and in data gathering, in-depth analytical work, and technical assistance that the World Bank, the IMF, and others provide.

No easy remedies

Roberto Zahler, who headed Chile's newly independent central bank in the early 1990s and now runs a consultancy firm, praised the FSAP for having achieved very good results and having dealt with extremely important issues, particularly in emerging market countries. While a great variation in country financial systems and in issues addressed made cross-country comparisons difficult, he offered several broad observations.

The FSAP, Zahler said, tend to take the international context as a given and to propose remedial measures only for the country assessed. He also pointed to the problems many emerging market countries have with the lack of access to formal financing for small and medium-sized enterprises. There are no ready remedies, Zahler admitted, because many of the problems have to do with evaluating risk for these enterprises, and “we are very far away from how to deal with that problem.”

He also suggested that stress testing, an important component of FSAP assessments, take into account that certain domestic financial institutions in emerging market economies, as they become more open to the global economy, are becoming major players in terms of their influence on exchange rates. He cited as a concrete example Chile's pension funds, which can invest nearly 20–25 percent of total assets abroad and whose investments proved a “significant source of exchange rate vulnerability in 1998 and 1999.” He therefore cautioned that it had to be taken into account that some movements in exchange rates, interest rates, and asset prices could be induced by a country's own domestic financial institutions.

Finally, Zahler suggested that the FSAP might pay closer attention to “regulatory arbitrage,” and to the need for communication and consistency among national supervisory authorities. ■

The full text of the Economic Forum “Ensuring Financial Stability: The IMF's Role” is available on the IMF's website (www.imf.org).

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
December 15	1.59	1.59	2.10
December 22	1.58	1.58	2.09
December 29	1.57	1.57	2.07
January 5	1.59	1.59	2.10
January 12	1.58	1.58	2.09

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2004).

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

Data: IMF Finance Department

Examining crisis-driven and orderly exits from pegged regimes



Otker-Robe: "A good candidate for a pegged regime may choose to float if its most pressing problem is external adjustment and it lacks sufficient reserves to credibly defend the peg."

In choosing an exchange rate regime, countries must consider the confidence and stability provided by a pegged exchange rate, versus the control over monetary policy offered by a floating rate. Vulnerability to external shocks, such as a sudden shift in commodity prices, influences the choice. A floating currency allows a country to adjust to external shocks through the exchange rate. A pegged exchange rate provides a nominal anchor, thereby requiring domestic wages and prices to adjust in the face of external shocks.

Over the past decade, global exchange rate arrangements have undergone momentous changes—some voluntary and orderly, others in response to exchange market pressures. In a recent IMF Working Paper, Rupa Duttgupta of the IMF's Monetary and Financial Systems Department and Inci Otker-Robe of the IMF's Policy Development and Review Department analyze the determinants of exits from pegged regimes. They spoke with Christine Ebrahim-zadeh of the *IMF Survey* about their findings.

IMF SURVEY: Why did you focus on exits from pegged exchange rate regimes?

OTKER-ROBE: For quite some time, more rigid forms of pegs were praised for their contribution to countries' stabilization efforts. More flexible pegged regimes, such as horizontal or crawling bands, were viewed as a way to address the fundamental trade-off between anchoring inflation expectations and providing some flexibility in coping with external shocks and safeguarding competitiveness.

Following some major currency crises over the past decade, pegged regimes fell out of favor—with a growing perception that pegs may not be sustainable, especially in the context of high capital mobility. This controversy motivated us to look at the factors that contribute to the manner of exits from pegged exchange rates.

DUTTGUPTA: We also felt that analyzing the factors that led countries to abandon pegs and examining the nature of the exits would yield a better understanding of the conditions under which countries could make orderly exits and help minimize the risk of crisis-driven exits.

Recent publications

IMF Working Papers (\$15.00)

- 03/201: "Puttable and Extendible Bonds: Developing Interest Rate Derivatives for Emerging Markets," Salih N. Neftci and Andre O. Santos
- 03/202: "Pricing Debit Card Payment Services: An IO Approach," Wilko Bolt and Alexander F. Tieman
- 03/203: "Macro Effects of Corporate Restructuring in Japan," Se-Jik Kim
- 03/204: "Real and Distributive Effects of Petroleum Price Liberalization: The Case of Indonesia," Benedict J. Clements, Hong-Sang Jung, and Sanjeev Gupta
- 03/205: "Financial Development in the CIS-7 Countries: Bridging the Great Divide," Gianni De Nicolò, Sami Geadah, and Dmitriy Rozhkov
- 03/206: "The United States and the New Regionalism/Bilateralism," Alvin D. Hilaire and Yongzheng Yang
- 03/207: "Of Openness and Distance: Trade Developments in the Commonwealth of Independent States, 1993–2002," Katrin C. Elborgh-Woytek
- 03/208: "The Term Structure of Interest Rates and Monetary Policy During a Zero-Interest-Rate Period," Jun Nagayasu
- 03/209: "Priorities for Further Fiscal Reforms in the Commonwealth of Independent States," Henri R. Lorie
- 03/210: "China's Labor Market Performance and Challenges," Ray Brooks and Tao Ran
- 03/211: "Mauritius: Unemployment and the Role of Institutions," Calvin A. McDonald and James Y. Yao
- 03/212: "Modeling Inflation in Georgia," Wojciech Maliszewski
- 03/213: "Early Birds, Late Risers, and Sleeping Beauties: Bank Credit Growth to the Private Sector in Central and Eastern Europe and in the Balkans," Carlo Cottarelli, Giananni Dell Ariccia, and Ivanna Vladkova-Hollar
- 03/214: "Dynamics of Corporate Performance in Thailand," Vikram Haksar and Piyabha Kongsamut
- 03/215: "Understanding the Costs of Deflation in the Japanese Context," Taimur Baig
- 03/216: "Social Incidence of the General Sales Tax in Pakistan," Saadia Refaqt
- 03/217: "Growth and Recovery in Mongolia During Transition," Kevin C. Cheng
- 03/218: "Greater Monetary Policy Transparency for the G3: Lessons from Full-Fledged Inflation Targeters," Mark R. Stone

OTKER-ROBE: The downside of focusing only on pegged regimes, of course, is that we miss some interesting cases that involve exits from floating regimes to soft or hard pegs. Ecuador's switch from a float to full dollarization after the financial crisis of 1999 comes to mind, for example, as does Malaysia's move to a fixed peg in 1998. Looking at the determinants of such exits could be an interesting extension to this paper.

IMF SURVEY: What types of exits did you focus on?

DUTTAGUPTA: We distinguish among five kinds of exits from a given pegged spell—that is, the period during which a given peg level is in effect:

Exits caused by exchange market pressure—these involve either depreciations or shifts to other regimes.

Exits involving orderly adjustments within the same regime—for example, step devaluations or revaluations within fixed or crawling pegs or bands.

Orderly shifts to more flexible regimes—for example, shifts from pegged to floating regimes, hard to soft pegs, fixed or crawling pegs to bands, and also widening of bands within band regimes.

Orderly shifts to less flexible regimes—such as shifts from soft to hard pegs and from band regimes to fixed or crawling pegs.

Orderly shifts to other regimes that cannot be unambiguously ranked vis-à-vis the exited regime in terms of

flexibility of the exchange rate policy—shifts between alternative types of fixed pegs, for example.

IMF SURVEY: And what are the determinants of these exits?

DUTTAGUPTA: We found, as expected, that the determinants are related to the nature of the exits. Crisis-driven exits, in particular, tend to follow a deterioration of economic health, such as a decline in export growth and official international reserves and an appreciation of the real exchange rate relative to its trend. These exits are also more typical of emerging market economies—reflecting, in part, their greater susceptibility to volatile capital flows, which affect the sustainability of pegs.

As for orderly exits, shifts to more flexible regimes are associated with emerging market economies, greater trade openness, and a measure of monetary relaxation proxied by higher government borrowing from banks. Greater trade openness could increase exposure to terms of trade shocks, just as emerging market economies could be more exposed to volatile cross-border flows. In either case, more flexible regimes might absorb financial or trade shocks better.

Shifts to less flexible regimes are associated with a decline in banks' foreign liabilities relative to their foreign assets and an increase in official reserves.



Duttagupta: "Crisis-driven exits, in particular, tend to follow a deterioration of economic health These exits are also more typical of emerging market economies."

IMF Country Reports (\$15.00)

(Country name represents an Article IV consultation)

03/327: The Socialist People's Libyan Arab Jamahiriya

03/328: Canada: Report on the Observance of Standards and Codes—Data Module

03/329: Malawi: PRSP Progress Report

03/330: Republic of Estonia

03/331: Republic of Estonia: Selected Issues and Statistical Appendix

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Orderly exits to less flexible regimes are associated with longer durations with a given peg and improved indicators of economic and financial health.

—Inci Otker-Robe

The former could be indicative of a decline in vulnerability to exchange rate risk, thus supporting a shift to a less flexible regime. In the same spirit, higher official reserves would support the maintenance of a rigid exchange rate anchor.

IMF SURVEY: Does the nature of an exit have anything to do with how long an exchange rate regime has been in place?

OTKER-ROBE: Our empirical analyses suggest that it does. We found that exits to less flexible regimes—compared with other kinds of exits—were preceded by pegged spells of relatively long duration. The probability of an exit to a less flexible regime rises with the duration of the pegged spell, while the probability of adjustments within the same regime declines with duration. Intuitively, you might think that long duration of a peg indicates that the exchange rate anchor is serving the economy well, thereby supporting the shift to a less flexible regime. However, we found that crisis-driven exits, too, are preceded by a relatively long duration of a given peg, implying that any existing inconsistencies between the peg and other economic policies could be exacerbated by longer peg duration.

We should make a note of one point, though. Our analysis focuses on the duration of a given level of peg—what we call “pegged spells”—rather than the duration of the regime associated with this peg. Duration of a given regime could be longer than within a pegged spell. For instance, a spell within a fixed-peg regime ends when there is a devaluation. By contrast, the fixed-peg regime would end only if there were a shift to another exchange rate regime. Exploring the duration of various exchange rate regimes and the nature of exits from them is the subject of an ongoing project.

IMF SURVEY: What broad economic characteristics determine how flexible a country’s exchange rate should be?

DUTTAGUPTA: Our paper does not explicitly address this question, but some general observations can be drawn. For example, our results indicate that, with increases in cross-border trade and financial flows, countries—particularly emerging market economies—have shifted to relatively more flexible regimes, presumably to allow the exchange rate to accommodate external shocks. Alternatively, with a long period in a pegged spell, accumulation of “sufficient” foreign reserves, and low foreign exchange exposures of banks, countries have tended to shift to more rigid pegs, perhaps because these factors bolster the suitability of a relatively rigid regime for the country. These results do

not imply, however, that countries with large foreign reserves and low exchange rate risk exposure cannot or should not have flexible regimes.

OTKER-ROBE: More generally, theory suggests that high capital mobility, low labor market flexibility, a lack of fiscal flexibility or sustainability, less economic diversification, and frequency of real shocks are among the most important features that call for more flexible exchange rates. Sound financial policies are, of course, necessary for any exchange rate regime. However, the degree of exchange rate flexibility is influenced by many other factors that are difficult to pin down, theoretically or empirically. For example, a country that seems to be a good candidate for a flexible regime may choose to peg if rapid disinflation is needed. Similarly, a good candidate for a pegged regime may choose to float if its most pressing problem is external adjustment and it lacks sufficient reserves to credibly defend the peg. Some operational factors also come into play: the lack of developed foreign exchange and money markets, a high degree of dollarization, and low implementation capacity make it difficult to adopt a flexible exchange rate regime. Some studies have also found that the actual regime choice may be the result of historical or political factors. That is probably why we sometimes observe two economies with similar characteristics opting for different exchange rate regimes.

IMF SURVEY: What should policymakers take from your results?

OTKER-ROBE: Our two main conclusions are that crisis episodes associated with pegged spells are generally preceded by a deterioration of economic indicators and that orderly exits to less flexible regimes are associated with longer durations with a given peg and improved indicators of economic and financial health. These findings suggest that strong economic and financial conditions are necessary for the sustainability of pegs, in particular, relatively rigid regimes. They also suggest that delaying exit from a peg—when there are indications of inconsistencies between the exchange rate and other policies—could result in a disorderly exit. We also found that having an IMF program plays no role in either disorderly or orderly exits.

DUTTAGUPTA: These results can also help policymakers understand the conditions under which orderly shifts from pegs could be accomplished and how crisis-driven exits could be avoided. ■

Copies of IMF Working Paper No. 03/147, “Exits from Pegged Regimes: An Empirical Analysis,” by Rupa Dutttagupta and Inci Otker-Robe, are available for \$15.00 each from IMF Publication Services. Please see page 9 for ordering details. The full text is also available on the IMF’s website (www.imf.org).

Stand-By, EFF, and PRGF Arrangements as of November 30

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
(million SDRs)				
Stand-By				
Argentina	September 20, 2003	September 19, 2006	8,981.00	7,151.00
Bolivia	April 2, 2003	April 1, 2004	85.75	21.43
Bosnia and Herzegovina	August 2, 2002	December 31, 2003	67.60	12.00
Brazil	September 6, 2002	December 31, 2003	22,821.12	5,621.48
Bulgaria	February 27, 2002	February 26, 2004	240.00	52.00
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Croatia, Rep. of	February 3, 2003	April 2, 2004	105.88	105.88
Dominica	August 28, 2002	February 27, 2004	3.28	0.62
Dominican Republic	August 29, 2003	August 28, 2005	437.80	350.24
Ecuador	March 21, 2003	April 20, 2004	151.00	90.60
Guatemala	June 18, 2003	March 15, 2004	84.00	84.00
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
Macedonia, FYR	April 30, 2003	June 15, 2004	20.00	12.00
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Turkey	February 4, 2002	December 31, 2004	12,821.20	2,041.20
Uruguay	April 1, 2002	March 31, 2005	2,128.30	652.40
Total			49,835.21	18,072.47
EFF				
Indonesia	February 4, 2000	December 31, 2003	3,638.00	344.06
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	350.00
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Total			4,432.40	817.79
PRGF				
Albania	June 21, 2002	June 20, 2005	28.00	16.00
Armenia	May 23, 2001	May 22, 2004	69.00	29.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	51.48
Bangladesh	June 20, 2003	June 20, 2006	347.00	297.50
Benin	July 17, 2000	March 31, 2004	27.00	1.35
Burkina Faso	June 11, 2003	June 10, 2006	24.08	20.64
Cameroon	December 21, 2000	December 20, 2003	111.42	47.74
Cape Verde	April 10, 2002	April 9, 2005	8.64	4.95
Chad	January 7, 2000	January 6, 2004	47.60	5.20
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Congo, Dem. Rep. of	June 12, 2002	June 11, 2005	580.00	106.63
Ethiopia	March 22, 2001	July 31, 2004	100.28	20.86
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	January 12, 2001	January 11, 2004	108.00	58.50
Ghana	May 9, 2003	May 8, 2006	184.50	158.15
Guinea	May 2, 2001	May 1, 2004	64.26	38.56
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Guyana	September 20, 2002	March 19, 2006	54.55	43.03
Kenya	November 21, 2003	November 20, 2006	175.00	175.00
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	28.68
Lao P.D.R.	April 25, 2001	April 24, 2005	31.70	13.58
Lesotho	March 9, 2001	March 8, 2004	24.50	7.00
Madagascar	March 1, 2001	November 30, 2004	79.43	34.04
Malawi	December 21, 2000	December 20, 2004	45.11	32.23
Mauritania	July 18, 2003	July 17, 2006	6.44	5.52
Moldova	December 21, 2000	December 20, 2003	110.88	83.16
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Nepal	November 19, 2003	November 19, 2006	49.91	42.78
Nicaragua	December 13, 2002	December 12, 2005	97.50	69.64
Niger	December 22, 2000	June 30, 2004	59.20	13.52
Pakistan	December 6, 2001	December 5, 2004	1,033.70	344.56
Rwanda	August 12, 2002	August 11, 2005	4.00	2.86
Senegal	April 28, 2003	April 27, 2006	24.27	20.80
Sierra Leone	September 26, 2001	September 25, 2004	130.84	42.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	49.00
Tanzania	August 16, 2003	August 15, 2006	19.60	16.80
Uganda	September 13, 2002	September 12, 2005	13.50	10.00
Vietnam	April 13, 2001	April 12, 2004	290.00	165.80
Total			4,793.35	2,564.04

Members drawing on the IMF "purchase" other members' currencies or SDRs with an equivalent amount of their own currency.

EFF = Extended Fund Facility.
 PRGF = Poverty Reduction and Growth Facility.
 Figures may not add to totals owing to rounding.
 Data: IMF Finance Department

Does greater transparency lead to better-informed markets?

After the emerging market crises of the 1990s, the IMF introduced a number of reforms to help promote greater transparency. How have capital mar-

kets reacted to this increase in the flow of information? In a recent IMF Working Paper, “Is Transparency Good for You, and Can the IMF Help?” Rachel Glennerster (Senior Economist, Policy Development and Review Department) and Yongseok Shin (Ph.D. candidate, Stanford University) look at the effect of increased transparency on capital markets. Glennerster spoke with Natalie Hairfield of the *IMF Survey* about their study.



Glennerster: “It is not clear whether countries become more transparent when they become rich, or whether being more transparent helps them become rich.”

IMF SURVEY: A number of studies show that greater transparency is good for countries. What sets your study apart?

GLENNERSTER: Previous studies have shown that countries that are more transparent perform better in a number of ways. They have narrower bond spreads, smaller fiscal deficits, and other good outcomes. The problem with these studies is that it is difficult to disentangle what is driving what. For example, it is not clear whether countries become more transparent when they become rich, or whether being more transparent helps them become rich. Also, because many countries that are transparent have usually implemented other good policies, it is difficult to separate the effect of transparency from the effect of these policies. We use a number of techniques to separate out the effect of transparency from these other factors.

First, we examine the effect of a change in transparency on spreads (a good indicator of how the market evaluates a country’s prospects). This solves a lot of the problems associated with simple cross-country comparisons. However, even comparing countries across time you have to worry that often reforms are undertaken in a number of areas at the same time—again making it hard to disentangle the effect of transparency. What is unique about the transparency reforms we studied is that nobody could undertake them before 1999 (the year the IMF introduced voluntary—that is, with the agreement of the country concerned—publication of staff country

reports) and that the timing of the release of certain IMF documents is determined by internal IMF procedures and is unrelated to events in the country. As a result, we can be quite confident that the changes we see at the time of the publication of these documents are really due to a change in transparency and not the result of some other change.

All of the transparency measures used in this paper have been promoted by the IMF. A major advantage of these reforms is that they allow countries to sign up to publish the report of external objective monitoring by the IMF. This provides a credible assessment to the markets. The Article IV report is an independent assessment by the IMF of individual countries’ policies and prospects, while Reports on the Observance of Standards and Codes (ROSCs) assess countries’ institutions, and the Special Data Dissemination Standard (SDDS) allows countries to commit themselves to a common definition of macroeconomic statistics, which the markets trust. Providing this external credibility is especially important for small countries where the markets have less of an incentive to dig beneath the numbers.

IMF SURVEY: What did your study find?

GLENNERSTER: We found that countries that adopted transparency reforms, introduced and encouraged by the IMF after the 1997–98 Asian crisis, saw substantial reductions in their spreads relative to those that did not adopt the reforms. For example, those countries that decided to publish their Article IV report experienced a 7–17 percent reduction in spreads, depending on what else we controlled for. Those that signed up for the IMF’s SDDS experienced a 4–12 percent reduction in their spreads. The size of the effect for publishing a ROSC was similar to that for the SDDS but was not always statistically significant. These are important declines in spreads, which would save these countries a lot of money on their borrowing costs.

IMF SURVEY: Do all countries benefit equally from greater transparency?

Photo credits: Denio Zara, Michael Spilotro, and Eugene Salazar for the IMF, pages 1–4, 6, 8, 9, 12, and 13; and Alexander Natruskin for Reuters, pages 15 and 16.

GLENNERSTER: As we expected, not all countries did benefit equally. In particular, countries with large debt markets saw less of a benefit. These were countries where the private sector already puts a lot of resources into finding out exactly what is going on there. In other words, the IMF had less new information to give the markets in these cases. Also, countries that are already fairly transparent saw less of a decline in spreads from publishing IMF reports or signing up for the SDDS. Again, there was less of an impact because the markets already knew pretty well what was going on in those countries.

IMF SURVEY: Which IMF-related document elicits the greatest response from markets? What sort of information are markets most interested in?

GLENNERSTER: In addition to looking at the long-run effect of becoming more transparent, we looked at the short-run impact of publication to determine whether IMF reports contained new information that markets were not aware of. We used a classic “news effect” methodology that assesses whether spreads move more than usual on the days immediately following publication. If they do, this suggests the publication contains new information. We were surprised to find that markets responded to short summaries produced by the IMF as well as to longer documents with lots of tables and detailed information.

We also found no significant difference in the magnitude of the news effect for program and non-program countries. You might expect markets to respond more to documents about program countries because these contain information on how much the IMF is going to lend. On the other hand, documents for these countries are produced much more frequently so there tends to be less news in each one. What is interesting here is that markets are responding to IMF reports for countries that are not borrowing from the IMF, which suggests they are interested in the institution’s general evaluation of economic prospects and policies in these countries and that publishing these reports leads to better-informed markets.

IMF SURVEY: Why do you think that markets are reducing spreads for countries that are more transparent?

GLENNERSTER: Although our results are somewhat tentative, we found some evidence that greater transparency encourages countries to follow better policies, and spreads narrow as a result. Transparency may encourage countries to follow better policies (for example, publishing accurate reserves

figures is likely to encourage countries to hold higher levels of reserves). An alternative theory is that countries are transparent when they have good news to share and that the decline in spreads reflects the good news rather than the transparency itself.

In fact, we rule out the possibility that countries publish only when they receive good news and that this is driving our results. We do this by predicting who will publish and when they will publish. We were able to predict this quite accurately using the initial level of transparency and the timing of the last Article IV as predictors and found that spreads declined with predicted publication, not just actual publication. Obviously, we could not predict whether countries were going to receive good news, so this was not what drove our results.

IMF SURVEY: Do markets also react when a country decides not to publish an IMF report?

GLENNERSTER: Over the period that we looked at, the markets knew which countries had decided not to publish an Article IV report because in nearly all cases a Public Information Notice (PIN)—a summary of the Executive Board’s discussion of Article IV reports—was published. When the markets observed that a country had released a PIN but decided not to publish its Article IV report, we saw an increase in spreads. In other words, the markets, to some extent, punished the country for deciding not to become transparent.

IMF SURVEY: Are there any lessons for countries that fear being open?

GLENNERSTER: I can understand some of the concerns that countries have about transparency, but our study indicates that they would be better off sharing more information. Our results suggest that markets tend to fear the worst when they see that a country is not transparent. They are prepared to reward countries for revealing the details of their policies and prospects, warts and all—partly because they think that countries that are honest about any failings are more likely to fix them. The news may not always be good, but, on average, countries that are more open will have significantly lower borrowing costs. ■

Copies of IMF Working Paper No. 03/132, “Is Transparency Good for You, and Can the IMF Help?” by Rachel Glennerster and Yongseok Shin, are available for \$15.00 each from IMF Publication Services. For ordering details, see page 9. The full text of the paper is also available online at www.imf.org.

“Greater transparency encourages countries to follow better policies, which seems to be another reason why spreads fall.”

—Rachel Glennerster

Press Releases

- 03/213: Organizational Meeting of the International Advisory and Monitoring Board for Iraq, December 9
- 03/214: Mozambique Formally Begins Participation in the IMF's General Data Dissemination System, December 9
- 03/215: IMF Statement on The Gambia, December 10
- 03/216: IMF Deputy Managing Director Agustín Carstens's Statement at the Conclusion of His Visit to Lebanon, December 12
- 03/217: IMF Approves 15-Month Extension and \$6.6 Billion Augmentation of Brazil's Stand-By Credit, December 15
- 03/218: IMF Approves 15-Month \$73 Million Stand-By Arrangement for Paraguay, December 15
- 03/219: Dominican Republic Press Statement, December 17
- 03/220: IMF Completes Second Review Under Uganda's PRGF Arrangement, Grants Waivers, and Approves \$3 Million Disbursement, December 17
- 03/221: IMF Completes Fourth Review Under Cameroon's PRGF Arrangement, Approves \$23 Million Disbursement, and Grants Additional Interim Assistance of \$4.4 Million Under the Enhanced HIPC Initiative, December 17
- 03/222: IMF Completes First Review Under Ghana's PRGF Arrangement and Approves \$38.5 Million Disbursement, December 17
- 03/223: IMF Completes Sixth Review, Grants Waivers, and Approves Disbursement of \$502 Million Under Stand-By Arrangement with Turkey, December 18
- 03/224: IMF and World Bank Support \$334 Million Additional Debt Relief for Guyana, December 19
- 03/225: IMF Completes Eleventh and Final Review of Indonesia's EFF Program, Approves \$505 Million Disbursement, December 19
- 03/226: IMF Completes Third Review Under Cape Verde's PRGF Arrangement and Approves \$1.8 Million Disbursement, December 19
- 03/227: IMF Completes Third Review Under Poverty Reduction and Growth Facility Arrangement with the Azerbaijan Republic, December 19
- 03/228: IMF Approves in Principle \$11.4 Million PRGF Arrangement for Dominica, December 22
- 03/229: The Republic of Congo Formally Begins Participation in the IMF's General Data Dissemination System, December 22
- 03/230: Statement by the International Advisory and Monitoring Board on Iraq, December 24
- 03/231: IMF Approves Two-Month Extension of Stand-By Arrangement with Bosnia and Herzegovina, December 31
- 04/1: First Stage of IMF Discussions for the Seventh Review of Turkey's Stand-By Arrangement to Start on January 12; Second Stage of Discussions Expected in February, January 8
- 04/2: IMF Managing Director to Recommend to Executive Board the Letter of Intent of the Authorities for the First Review of the Stand-By Arrangement with Argentina, January 9

- 04/3: IMF Completes First Review of Bangladesh's PRGF Arrangement and Approves \$74 Million Disbursement, January 9
- 04/4: IMF Completes Second Review of Colombia's Stand-By Arrangement, Approves \$145 Million Disbursement and Grants Waivers, January 12

Public Information Notices

- 03/143: IMF Concludes 2003 Article IV Consultation with Saudi Arabia, December 5
- 03/144: IMF Concludes 2003 Article IV Consultation with Equatorial Guinea, December 9
- 03/145: IMF Concludes 2003 Article IV Consultation with Sudan, December 19
- 03/146: IMF Concludes Discussion on the Review of Contingent Credit Lines, December 19
- 03/147: IMF Concludes 2003 Article IV Consultation with the Islamic State of Afghanistan, December 22
- 03/148: IMF Concludes 2003 Article IV Consultation with the Republic of Mozambique, December 22
- 03/149: IMF Concludes 2003 Article IV Consultation with El Salvador, December 22
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- 04/1: IMF Concludes 2003 Article IV Consultation with Mali, January 12

Speeches

- "The Challenge of Poverty: How the IMF Can Help Africa," Anne O. Krueger, IMF First Deputy Managing Director, African Economic Research Consortium, Nairobi, December 4
- "Financing the Future: Why a Thriving Capital Market Matters," Anne O. Krueger, IMF First Deputy Managing Director, National Economic Outlook Conference, Kuala Lumpur, December 9

Statements at Donor Meetings

- Consultative Group Meeting for Vietnam, Seán Nolan, IMF Asia and Pacific Department, December 2

Transcripts

- "Who Will Pay the Bill?" IMF Economic Forum, November 13
- Press Briefings by Thomas C. Dawson, Director, IMF External Relations Department, November 20, December 4, and December 18
- "Russia Rebounds," IMF Economic Forum, December 11
- Press Conference by IMF Deputy Managing Director Agustín Carstens and Lebanese Minister of Finance Fuad Siniora, December 12
- "Ensuring Financial Stability: The IMF's Role," IMF Economic Forum, December 16
- Teleconference Press Briefing on "U.S. Fiscal Policies and Priorities for Long-Run Sustainability," IMF Occasional Paper, January 7

Russia: Quo Vadis?

Russia's economy has undergone a remarkable recovery since its financial crisis in 1998, which resulted in a default on government debt and a collapse of the ruble. In fact, if growth continues at its current pace, President Vladimir Putin's goal of doubling GDP in 10 years might be within reach. But the arrest in October of oil magnate Mikhail Khodorkovsky and the gains of nationalist parties in the December parliamentary elections have led to renewed concerns about Russia's commitment to Western-style democracy and capitalism. In an IMF Economic Forum entitled "Russia Rebounds," held on December 11, three panelists—David Owen (Assistant Director in the IMF's European Department), Anders Åslund (Director of the Russian and Eurasian Program at the Carnegie Endowment), and Aleksei Mozhin (IMF Executive Director for Russia)—gave their perspectives on Russia's recovery and where it is headed.

David Owen opened the discussion by summarizing Russia's remarkable economic performance since the crisis. Before 1998, growth rates had been almost entirely negative. Since the crisis, however, growth rates have averaged over 6 percent a year—just below the 7¼ percent required to double GDP over a decade. Russia's international reserves, which had fallen to \$12 billion at the time of the crisis, now stand at over \$70 billion. And public debt has declined from nearly 80 percent of GDP in 1998 to less than 30 percent today. The rebound has been dramatic also in financial markets, as reflected in Moody's recent reclassification of Russian debt as "investment grade," Owen said.

But can this strong economic performance be sustained? Russia's rebound has been fueled in part by a very large depreciation of the ruble, which triggered import substitution on a massive scale, and by rising oil prices, which led to huge gains in Russia's terms of trade—estimated at 10 percent of GDP between 1999 and 2000. But the boost to net trade from the ruble's depreciation is coming to an end, Owen said, and few observers expect current oil prices to be maintained indefinitely.

Russia has also benefited from a dramatic improvement in its macroeconomic policies, especially on the fiscal side, according to Owen. Before 1998, the government had been running a fiscal deficit of about 8 percent of GDP on average. By 2000, that had become a surplus of 3 percent. While

this turnaround was partly due to higher oil prices, it was achieved mainly by expenditure restraint, he said. However, recent slippages in fiscal policy and annual inflation that remains above 10 percent are now hampering development of the non-oil economy. If oil prices were to come down, a significant fiscal tightening might be needed, Owen said. And while many important structural reforms are under way, broader-based reforms are needed to allow the emergence of a dynamic sector of small and medium-sized companies.

On balance, it was not clear that there had been enough fundamental change in policymaking to sustain the strong growth of recent years, Owen said. But he also added that the goal of doubling GDP in 10 years was not unrealistic although it would require a continuation of strong macroeconomic policies and more structural reforms. Bringing inflation down to the level of Russia's main competitors would also be a major challenge. But if President Putin is ready to push reforms through parliament, he clearly has the political mandate to do so, given that the party backing him now holds the majority in the Duma, Owen noted.

Challenges for the future

To many observers, the crash of 1998 appeared to spell the end of Russia's experiment with a market economy, Anders Åslund said. While they were proved wrong, events in the past six months have cast new doubt over the country's commitment to the principles of the market. After the crisis, the government implemented a comprehensive reform program that included the introduction of a flat income tax rate of 13 percent (which has increased income tax revenues from 2 percent of GDP to 3 percent), substantial deregulation, a breakup of natural monopolies (especially in the electricity and railway sectors), and judicial reform.

Turning to the situation today, however, things look less promising, Åslund said. The past six months has essentially seen only bad news. He pointed to six developments that policymakers would need to grapple with in the future:

- Central control, which is on the rise, is replacing a system of checks and balances. There is no reason to think that this new system will work better than the former one.
- The media are subject to increasing censorship, with transparency and openness on the defensive.

The majority of Russians do not recognize the oligarchs as legitimate owners of the natural resources they acquired during Russia's privatization phase. And this represents a huge problem, because it casts doubt on the very concept of private property rights.

—Aleksei Mozhin



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January 19, 2004

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Crude oil pumps owned by Russian oil firm Sibneft near its main production base in Noyabrsk, Western Siberia. The IMF's David Owen noted that if oil prices were to come down, a significant fiscal tightening in Russia might be needed.

- The government is attempting to gain control of the energy sector. This has been a massive failure everywhere, and it will not be any different in Russia.
- The arrest of Mikhail Khodorkovsky—in many ways the symbol of successful private enterprise in Russia—does not bode well for the future rule of law.
- Law enforcement agencies are allowed to run wild. These agencies have been characterized as the most corrupt organizations in Russia in opinion polls and company surveys.
- Following the elections, virtually all good economic legislators have been ousted from parliament.

Åslund concluded that while it would take many mistakes to undo an annual growth rate of 6½ percent, President Putin would have to work hard to contain these negative developments in the near future.

The oligarchs versus society

Aleksei Mozhin said that the December elections should be seen as a backlash against the oligarchs (the name given to a handful of individuals who acquired Russia's largest state-owned companies in the mid-1990s). The two liberal parties—Yabloko and the Union of Right Forces—were not returned to the Duma because they were seen as too closely connected to Russia's new business elite. Anatoly Chubais, who heads the Union of Right Forces, is regarded by many Russians as the father of the oligarchs, Mozhin said. And both Yabloko and the Communist Party (which saw its support drop from 24 percent to 13 percent) had included on their electoral party lists rich businessmen with oligarchic

connections, which tainted them in the eyes of the electorate. At the same time, the very strong performance of United Russia, the main pro-presidential party, is a reflection of a “feel good” factor resulting from the rapid economic growth over the past couple of years, Mozhin said.

The new Duma will provide an excellent opportunity for rapid progress on structural reforms, Mozhin said. For example, it is now more likely that Russia will speed up accession negotiations with the World Trade Organization (WTO) because the new

Duma will make it easier for President Putin to resist pressure from vested interests opposed to WTO membership.

But the political conflict between the oligarchs and Russian society is still unresolved, Mozhin said. The majority of Russians do not recognize the oligarchs as legitimate owners of the natural resources they acquired during Russia's privatization phase. And this represents a huge problem, he said, because it casts doubt on the very concept of private property rights.

In the question-and-answer session that followed, the panel was asked to speculate on how the conflict between the oligarchs and society would play out. Mozhin said there were two extreme views on how to resolve the issue. The first view, held by communists and nationalists, is that “everything that has been stolen must be returned to the people.” The second view, held by probusiness politicians, including some of the liberals, is that Russia should “forgive and forget” and draw a line under past misdeeds. Since both ideas seem to be unworkable politically, a solution would have to lie somewhere in between, Mozhin said.

The oligarchs try to insure themselves against expropriation during each new election, Åslund added. This means that Russian elections cost far more than U.S. elections, even though U.S. GDP is about 25 times larger than that of Russia. ■

The full text of the Economic Forum “Russia Rebounds” is available on the IMF's website (www.imf.org).