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increase (see page 38).

Managing Director's Statement

Indonesia Announces Comprehensive Reforms; Seeks to Rehabilitate Banking Sector

On January 26, IMF Managing Director Michel Camdessus welcomed the Indonesian government's announcement of a comprehensive reform program. The program seeks to rehabilitate the Indonesian banking sector and to put in place a framework for creditors and debtors to deal, on a voluntary and case-by-case basis, with the external debt problems of Indonesian corporations. Excerpts from Camdessus's statement follow.

These programs continue and extend the implementation of the reinforced set of economic reforms announced by President Suharto on January 15. A wide range of measures to eliminate structural distortions and restrictions

has already been put in place before their committed date of February 1. In particular, all special privileges granted to the National Car Program have been eliminated; special funding for IPTN, the aircraft manufacturer, has been rescinded; restrictive marketing arrangements have been abolished; domestic trade in agricultural products liberalized; and the BULOG monopoly restricted solely to rice. Also, a revised budget was submitted to Parliament.

To prevent the further erosion of confidence in the banking system, which has been under severe pressure in light of the extraordinary depreciation of the rupiah, the government has decided that from today it will guarantee the obligations of depositors and creditors. At the same time, the government is (Please turn to the following page)

These programs continue and extend the economic reforms.

-Camdessus

Disbursements Total \$23 Billion

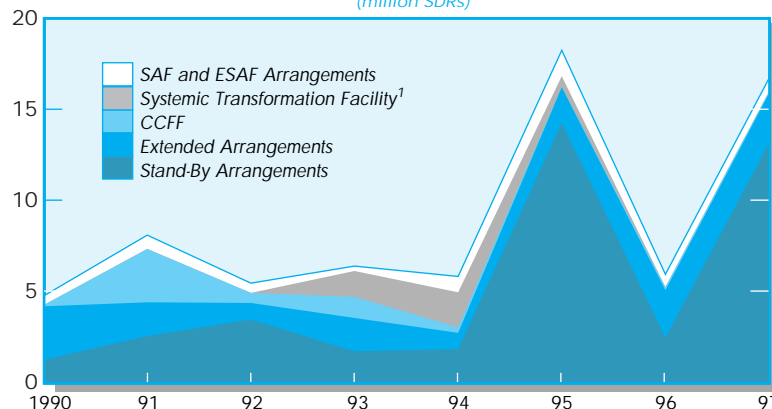
IMF Lending in 1997 Soars to Near-Record Level As Asian Countries Make Large Drawings

Member country use of IMF resources in 1997 almost tripled from its level in 1996, to more than SDR 16.8 billion (about \$23.0 billion). This total is close to the record level of SDR 18.4 billion (\$25.0 billion) in 1995. The sharp increase in lending during 1997 was the result primarily of drawings (disbursements) by members affected by the Asian crisis. Korea drew SDR 8.2 billion (\$11.0 billion); Indonesia, SDR 2.2 billion (\$3.0 billion); and Thailand, SDR 1.8 billion (\$2.4 billion). These funds were all disbursed under Stand-By Arrangements and accounted for almost all of the IMF's lending under Stand-By Arrangements during the year.

In July, the Emergency Financing Mechanism was activated for the

first time in support of a request by the Philippines for an extension and augmentation of its three-year Extended Arrangement. (Please turn to the following page)

IMF Lending (million SDRs)



¹Access to the Systemic Transformation Facility concluded at the end of 1995.

Data: IMF Treasurer's Department

(Continued from front page) moving decisively to resolve the underlying financial difficulties of the banking system by establishing the Indonesian Bank Restructuring Agency (IBRA), which will be given broad powers to restructure all financially weak banks.

As the exchange rate has depreciated excessively, many corporations have found it increasingly difficult to service their external debt. To restore orderly debtor-creditor relations, a private initiative is under way to put in place a framework for negotiations between individual creditors and debtors to work out viable debt restructuring arrangements on a voluntary and case-by-case basis. Agreements under this framework would not involve funds from the public sector. In addition, action to strengthen bankruptcy procedures would support effective solutions.

Other developments related to the Asian crisis and the future level of IMF resources include:

- On January 29, 13 international banks, meeting in New York, reached an agreement to restructure some

\$24 billion of Korea's short-term debt due this year and convert it into government-backed loans. William Rhodes, Vice Chairman of Citibank and coordinator of the bankers meeting in New York, called the agreement "a key step forward toward Korea's goal of returning shortly to the international capital markets."

- Thailand posted current account and trade surpluses for the third straight month in November, reflecting continued economic recovery, according to a January 30 statement by Kleo-thong Hetakul, the Bank of Thailand's chief economist. Also on January 30, Thai central bank governor Chaiyawat Wibulsawadi announced the abolition of the country's two-tier currency trading system.

- On February 2, U.S. President Bill Clinton submitted a \$17.9 billion supplemental fiscal 1998 budget request to the U.S. Congress to meet U.S. commitments to the IMF—\$3.5 billion for the U.S. contribution to the IMF's New Arrangements to Borrow and \$14.5 billion to cover the U.S. share of the IMF's quota increase. ■

IMF Lending at Near-Record Level

(Continued from front page) A total of SDR 508.8 million (\$688.0 million) was disbursed under the augmented arrangement (*IMF Survey*, August 5, 1997, page 250). The mechanism was used again in August for Thailand, (*IMF Survey*, September 17, 1997, page 283).

In December 1997, the IMF approved the Supplemental Reserve Facility (SRF) (*IMF Survey*, January 12, 1998, page 7). Korea was the first member country to receive assistance under the facility, amounting to SDR 4.1 billion (\$5.5 billion) of the total amount of SDR 15.5 billion (\$21 billion) approved under the

Stand-By Arrangement (*IMF Survey*, December 15, 1997, page 385, and January 12, 1998, page 1).

Asian crisis countries were not the sole recipients of IMF lending under Stand-By Arrangements. Other countries receiving large disbursements included Argentina (SDR 321.0 million, \$434.0 million), Bulgaria (SDR 247.6 million, \$335.0 million), Ukraine (SDR 207.3 million, \$280.0 million), and Romania (SDR 120.6 million, \$163.0 million). Disbursements under the Extended Fund Facility (EFF) increased slightly in 1997 and were dominated by drawings totaling SDR 1.5 billion (\$2.0 billion) by Russia. Other members receiving large disbursements under the EFF included the Philippines (see above), Algeria (SDR 337.6 million, \$456.0 million), and Peru (SDR 160.5 million, \$217.0 million). Bulgaria received the only disbursement under the Compensatory and Contingency Financing Facility (CCFF) (SDR 107.6 million, \$145.0 million). Lending under the Enhanced Structural Adjustment Facility (ESAF) rose somewhat in 1997. Members receiving large ESAF disbursements included Pakistan (SDR 113.7 million, \$154.0 million), Tanzania (SDR 61.4 million, \$83.0 million), Azerbaijan (SDR 55.6 million, \$75.5 million), and Georgia (SDR 55.5 million, \$75.0 million).

At the end of 1997, 58 member countries were implementing macroeconomic and structural programs supported by IMF credits (*IMF Survey*, January 26, 1998, page 28). A total of SDR 43.5 billion (\$59.0 billion) in IMF financing was committed as of the end of the year, of which SDR 22.7 billion (\$31.0 billion) was undrawn. (On January 28, 1998, SDR 1=US\$1.35170.) ■

Use of IMF Credit (million SDRs)

	1995	1996	1997
General Resources Account	16,967.92	5,270.96	16,112.86
Stand-By Arrangements	14,382.11 ¹	2,471.06	13,255.39
Of which: Supplemental Reserve Facility	—	—	4,100.00
EFF Arrangements	1,965.16	2,625.29	2,749.87
CCFF	8.93	174.62	107.60
STF	611.73	—	—
SAF and ESAF Arrangements	1,431.44	708.64	730.59
Total	18,399.36	5,979.60	16,843.45

Note: EFF = Extended Fund Facility
CCFF = Compensatory and Contingency Financing Facility
STF = Systemic Transformation Facility
SAF = Structural Adjustment Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals shown owing to rounding.

¹Includes credit tranche purchase by Zambia of SDR 651.7 million on December 6, 1995, which was subsequently repurchased on December 18, 1995, following disbursement from the ESAF Trust.

Data: IMF Treasurer's Department

Private Capital Flows to Emerging Markets Show Sharp Decline in 1997, IIF Reports

The financial crisis in Asia led to a major decline in net private capital flows to leading emerging markets in 1997 and may prompt a further moderate decline in 1998, according to *Capital Flows to Emerging Markets*, a report issued by the Institute of International Finance (IIF) on January 29. Net private capital flows to 29 emerging market economies fell to an estimated \$200 billion in 1997, down from their peak of \$295 billion in 1996. This marked the first major retrenchment of capital flows to emerging markets this decade.

The sharp fall in private capital flows was due almost entirely to capital flow reversals in the five countries most affected by the Asian crisis—Indonesia, Korea, Malaysia, the Philippines, and Thailand (see table). In contrast, flows to other leading emerging market countries not directly affected by the Asian crisis held up well, increasing modestly to \$212 billion in 1997 from \$202 billion in 1996. Major developments included:

- The five affected Asian economies suffered net private capital outflows of \$12 billion in 1997, compared with an inflow of \$93 billion in 1996.

- The sharpest decline in net private flows to the five economies was in flows from commercial banks. As confidence eroded toward the end of 1997, maturing short-term debt was not fully rolled over for several economies, especially Indonesia and Korea. This resulted in an estimated net outflow of \$21 billion in 1997 for the five economies as a group, compared with inflows of about \$56 billion in 1996.

- Foreign direct investment in the five economies remained at about \$7 billion, approximately the same as in 1996. The relatively small role of direct investment in financing for these five economies in recent years has increased their vulnerability to capital flow reversals.

- Portfolio equity investment suffered a significant outflow in 1997—perhaps as much as \$12 billion—in contrast to an inflow of comparable magnitude in 1996, as economic prospects weakened and exchange rates came under pressure.

- The combined current account deficit of the five Asian economies narrowed by nearly \$30 billion in 1997, in response to exchange rate depreciation and domestic adjustment. The decline, however, was much smaller than the reduction in external financing, causing reserves to fall by about \$20 billion, following a comparable buildup in 1996.

- Borrowing by the five countries as a group from private lenders, which has increased steadily in recent

years, rose to \$74 billion in 1996 from about \$28 billion in 1994.

- In Indonesia, Korea, and Thailand, payment delays by individual private debtors, including bond issuers, occurred recently, owing to depreciating exchange rates and deteriorating economic prospects.

- Official flows to the five Asian countries rose to \$27 billion in 1997 from virtually zero the previous year, as the IMF, the World Bank, the Asian

Five Asian Economies: External Financing
(billion U.S. dollars)

	1994	1995	1996	1997*	1998**
Current account balance	-24.6	-41.3	-54.9	-26.0	17.6
External financing, net	47.4	80.9	92.8	15.2	15.2
Private flows, net	40.5	77.4	93.0	-12.1	-9.4
Equity investment	12.2	15.5	19.1	-4.5	7.9
Direct equity	4.7	4.9	7.0	7.2	9.8
Portfolio equity	7.6	10.6	12.1	-11.6	-1.9
Private creditors	28.2	61.8	74.0	-7.6	-17.3
Commercial banks	24.0	49.5	55.5	-21.3	-14.1
Nonbank private creditors	4.2	12.4	18.4	13.7	-3.2
Official flows, net	7.0	3.6	-0.2	27.2	24.6
International financial institutions	-0.4	-0.6	-1.0	23.0	18.5
Bilateral creditors	7.4	4.2	0.7	4.3	6.1
Resident lending/other, net ¹	-17.5	-25.9	-19.6	-11.9	-5.7
Reserves excluding gold (- = increase)	-5.4	-13.7	-18.3	22.7	-27.1

Note: The five economies comprise Indonesia, Korea, Malaysia, the Philippines, and Thailand.
*Estimate.

**IIF forecast.

¹Including resident net lending, monetary gold, and errors and omissions.

Data: Institute of International Finance

Development Bank, and governments provided financial support for adjustment programs.

- Reserves in the five Asian countries fell sharply by \$23 billion in 1997, despite official assistance and a substantial narrowing of their combined current account deficit. Korea and Thailand's current account has moved into surplus in recent months.

Outlook for 1998

The outlook for the five Asian economies in 1998 remains uncertain, the IIF study states. Prospects depend in large part on the authorities' ability to stabilize their external financing positions. Forecasts for 1998 include the following:

- Net private flows could become substantial again—if modestly lower than in 1997—at about \$170 billion. Equity investment is expected to dominate, with flows of about \$130 billion, while private credit

flows are expected to fall further to \$40 billion in 1998 from \$66 billion in 1997.

- Foreign direct investment is expected to strengthen slightly as indebted companies seek to raise cash and foreign companies purchase Asian corporate assets at depreciated prices.

- The bulk of commercial bank lending to these economies is expected to be renewed or refinanced in 1998.

- Official financing flows are assumed to reach about \$25 billion in 1998, including \$5 billion of bilateral assistance disbursed as part of the support package for Korea and further IMF disbursements totaling \$11 billion in Indonesia, Korea, and Thailand. With strong current account adjustment likely in the Asian economies in crisis and assuming refinancing of most maturing debt, the IIF study suggests that it should not be necessary for the entire \$100 billion available under official support packages to be disbursed.

- The five Asian countries are expected to move into substantial current account surplus in 1998, possibly approaching \$20 billion. Thus, the aggregate current account balance will swing from a deficit equivalent to 6.5 percent of GDP in 1996 to a surplus equivalent to 3 percent of GDP in 1998.

- Real GDP for the five countries as a group is projected to contract by 2.7 percent in 1998, compared with a growth of 4.8 percent in 1997 and 7.2 percent in 1996. The IIF study projects positive growth of nearly 2 percent in Malaysia and the Philippines in 1998, but output is expected to fall in the other three countries.

- Inflation is likely to increase markedly in 1998 in all five countries, reflecting exchange rate depreciations. The extent to which the depreciations may be partly reversed through tight monetary policies and a rebound of confidence and the degree to which the exchange rate changes will feed through to expectations of inflation remain uncertain.

This outlook, the study cautions, is subject to substantial risks. If financial restructuring and adjustment support packages fail to stabilize the external situation, then financing flows to the five Asian economies could be substantially lower. Some economies that have so far weathered the crisis remain vulnerable and could run into difficulties, with the effects extending beyond Asia. ■

The Complete text of *Capital Flows to Emerging Markets* may be found at the following address on the Institute of International Finance, Inc., web site: <http://www.iif.com/PressRel/1998pr1.html>.

Address to Transparency International

Good Governance Has Become Essential in Promoting Growth and Stability



Camdessus: Corruption undermines the confidence of the most serious investors.

Following is an edited excerpt of an address given by IMF Managing Director Michel Camdessus at a meeting of Transparency International, in Paris, on January 21.

Good governance has taken on increasing importance in the IMF's traditional mandate of promoting economic stability and what I call high-quality growth. Today, not only have governance issues moved to the forefront of discussion, but in many cases government reform has moved to the top of the policy agenda. What has changed?

One important change has been in the perception of what constitutes sound economic policy. As more and more evidence has come to light about the adverse consequences of governance problems on economic performance—among them, losses in government revenue, lower quality public investment and public services, reduced private investment, and the loss of public confidence in government—a broader consensus has emerged on the central importance of transparency and good governance in achieving economic success.

Numerous studies have shown that where governance is poor, domestic investment and growth suffer. Moreover, in a world in which private capital has become more mobile, there is mounting evidence that corruption undermines the confidence of the most serious investors and adversely affects private capital inflows—this is the case in all too many countries in Africa. Even Asia is no exception; we have seen there that governance problems can also undermine the ability of countries to channel private capital inflows into productive, long-term investment. Moreover, the Asian crisis has demonstrated in a dramatic way how the lack of transparency about underlying economic and financial conditions can feed market uncertainty and trigger large capital outflows that can, in turn, threaten macroeconomic stability. Conversely, progress toward greater transparency can radically alter the very terms of the public debate.

Other factors also come into play. With government budgets under pressure in virtually every country in the world, bilateral aid donors have become more conscious of the need to direct their resources to countries that they believe will use those resources most productively and in which such use can be monitored. The IMF itself has a responsibility to its members to ensure that the

resources they provide to the IMF are put to good use.

For all of these reasons, our member countries have come to recognize the vital importance of good governance, and, at our Annual Meetings in September 1996, a *Declaration on Partnership for Sustainable Growth* was adopted. It reflects a now-universal consensus on these issues and states that “promoting good governance in all its aspects, including ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption” is an essential element of an environment in which countries can achieve lasting prosperity. It may seem like a catch-all, but its words give legitimacy to our efforts in this area and to the “second generation of reform” that we are now trying to promote. Subsequently, the IMF’s Executive Board met a number of times to develop guidance for our staff in dealing with governance issues. The result was a set of guidelines that have been in effect since last July. They confirm and strengthen the approach that the IMF has been taking for some time and also stress the importance of addressing governance issues evenhandedly in all member countries and, of course, the need to work together on these issues with other multilateral institutions, especially the World Bank, since we are jointly confronted with these problems.

The IMF’s Role

How does the IMF go about promoting good governance? Broadly speaking, our approach is to maximize the transparency of government financial operations and create systems that minimize the scope for making decisions on an ad hoc basis and for giving preferential treatment to individuals and organizations. For example, we are helping members simplify their tax systems and business legislation and strengthen tax and customs administration by eliminating special exemptions that apply to a privileged few; this is the best means of ensuring that adequate revenues are received to finance essential public services and that such services are accessible to the general population. Likewise, we are working with countries to strengthen and increase the transparency of budgetary procedures to ensure that government revenues are fully accounted for and used as agreed in the budget. We are also seeking to improve the quality of government expenditure by reducing outlays for unproductive purposes, such as costly military buildups and large projects that benefit influential groups while stroking the egos of the high and mighty. The savings will make room for spending on primary health care, basic education, vocational training, and essential infrastructure.

At the same time, the IMF seeks to promote more effective and accountable economic and financial institutions. To this end, we are working to improve the quality of financial sector regulation and supervision and enhance the transparency of financial sector operations. Similarly, we are encouraging countries to

improve the quality of the data they provide to the public about domestic economic and financial policies and performance. We cannot overemphasize the importance of high-quality statistical data; such data are an influential factor in improving economic policy and an essential aid to potential investors in evaluating countries’ economic policies and performance. They allow the markets to become more informed and selective and constitute a first-class protection for countries with good policies that will be less vulnerable to the often capricious fluctuations and herd behavior on the financial markets.

Regarding corruption, our institution has a macroeconomic mission, and our mandate is restricted to those specific instances that may have a significant macroeconomic impact. We do not hesitate to bring such cases to the attention of the authorities. The macroeconomic nature of corruption may be identified by the large amounts involved or the fear that specific cases of corruption are symptomatic of a wider governance problem. Examples might include tax and customs fraud with the involvement of senior public officials, the misuse of official foreign exchange reserves, and abuses of power by bank supervisors or failure on their part to take action. This has led us in some cases to delay or suspend our support until the member in question has taken appropriate corrective action.

In our view, good governance is essential for countries at all stages of development—from the poorest countries that are still in the process of building up domestic institutions and undertaking the basic reforms needed to accelerate economic growth, to the advanced countries, both as regards their own internal governance and their dealings with developing countries.

Governance in Asia

In recent months, the world has been shocked to see how quickly countries renowned for outstanding economic performance have been engulfed in crisis. Although the causes of the crisis are varied and complex, many of the problems that lie at the heart of Asia’s difficulties are bound up with poor governance. In Korea, for example, opacity had become systemic. The lack of transparency about government, corporate, and financial sector operations concealed the extent of Korea’s problems—so much so that corrective action came too late and ultimately could not prevent the collapse of market confidence, with the IMF finally being authorized to intervene just days before potential bankruptcy.

Good governance is essential for countries at all stages of development.
—Camdessus

The situations in Thailand and Indonesia have forced us to deal with similar problems—although to a lesser or different degree. In each case, the centerpiece of the program is a thorough restructuring of the financial sector. The goal is to ensure that owners and managers are genuinely more accountable for the prudent operation of their banks, that loans are made on the basis of objective commercial criteria, and that banks return to their essential role of mobilizing domestic savings and promoting sound investment. Also required are institutional changes to strengthen financial sector regulation and supervision.

The programs for the corporate sector are no less ambitious. They include measures to improve the transparency of corporate balance sheets through independent external audits, disclosure, and publication of consolidated statements for business conglomerates so that markets can monitor corporate performance. At the same time, the programs seek to create a more level playing field for private sector activity by dismantling monopolies, eliminating government-directed lending, increasing the transparency of foreign trade procedures, and revising government procurement and contracting regulations.

Just as corporations and financial institutions must become more open and transparent, so too must their governments. All three programs call for governments to improve the publication of key economic data and bring off-budget activities into the budget so as to provide a clearer picture of the financial position of the wider public sector and improve its governance.

The programs are far-reaching and confirm the basic intuition of Transparency International: that anyone

who takes the need for transparency seriously will profoundly change the course of events. Such reforms will require a vast change in domestic business practices, corporate culture, and government behavior. Obviously, this will be a long-term process—one in which the IMF, the World Bank, and others can assist, but whose success depends on the efforts of the countries themselves. The positive effects are already being felt: witness the attitude of the Korean unions, which were persuaded to give up the idea of a general strike in return for a tripartite dialogue with the government and employers regarding the accounts of the chaebols, which are finally more transparent and more widely disseminated.

For the IMF, which for fifty years essentially confined itself—in accordance with its mandate—to helping its member countries accept essential monetary and macroeconomic discipline, these are entirely new frontiers—both vast and promising—as they are for the World Bank and the other major international organizations. However, we must guard against leaving this work to the international organizations, which risks setting them up as the scapegoat for all the world's ills if progress should come too slowly. Like all revolutions, this one will be successful only with the unrelenting and ultimately irresistible pressure of civil society. ■

The full text of this speech is available on the IMF's web site at the following address: <http://www.imf.org/external/np/speeches/1998/012198.htm>. Copies of *Why Worry About Corruption*, by Paolo Mauro, No. 6 in the Economic Issues series, and *Good Governance: The IMF's Role* are available free of charge from IMF Publication Services. See page 42 for ordering information.

Agreement on Rise of 45 Percent

Board of Governors Adopts Quota Resolution; Members Must Take Steps to Consent to Increases

Following is the text of Press Release No. 98/2, issued on February 6, 1998:

The Board of Governors of the IMF has adopted a Resolution proposing an increase of 45 percent in the total IMF quotas to approximately SDR 212 billion (about \$288 billion) from SDR 146 billion (about \$199 billion). The adoption of the Resolution, which required an 85 percent majority of the total voting power of the IMF's membership, completes the Eleventh General Review of Quotas.

A member that does not have overdue obligations to the General Resources Account of the IMF will be able to consent to the increase in its quota at any time before January 29, 1999. In order to meet that deadline, the member will have to have completed before that date whatever action may be necessary under its laws to

enable it to give its consent. No increase in quotas shall take effect before the date on which the IMF determines that members having not less than 85 percent of the total of quotas on December 23, 1997 have consented to the increases in their quotas.

A member's quota cannot be increased until it has consented to the increase and paid the subscription. A member must pay the increase in its subscription within 30 days after (a) the date on which the member notifies the IMF of its consent, or (b) the date on which the 85 percent participation requirement is met, whichever is the later. Twenty-five percent of the increase in each member's quota will be paid in SDRs, or in currencies of other members specified by the IMF, subject to their concurrence (see Press Release No. 97/63, *IMF Survey*, January 12, 1997). ■

Proposed IMF Quotas

(countries ranked by order under current quotas)

	Amount (million SDRS)	Share (percent)		Amount (million SDRS)	Share (percent)		Amount (million SDRS)	Share (percent)
United States	37,149.3	17.521	Zimbabwe	353.4	0.167	Kyrgyz Republic	88.8	0.042
Germany	13,008.2	6.135	Slovak Republic	357.5	0.169	Somalia	81.7	0.039
Japan	13,312.8	6.279	Kazakhstan	365.7	0.172	Haiti	81.9	0.039
France	10,738.5	5.065	Trinidad and Tobago	335.6	0.158	Tajikistan	87.0	0.041
United Kingdom	10,738.5	5.065	Vietnam	329.1	0.155	Rwanda	80.1	0.038
Saudi Arabia	6,985.5	3.295	Côte d'Ivoire	325.2	0.153	Congo, Republic of	84.6	0.040
Italy	7,055.5	3.328	Sudan	315.1	0.149	Burundi	77.0	0.036
Canada	6,369.2	3.004	Uruguay	306.5	0.145	Togo	73.4	0.035
Russia	5,945.4	2.804	Ecuador	302.3	0.143	Nepal	71.3	0.034
Netherlands	5,162.4	2.435	Syrian Arab Republic	293.6	0.138	Fiji	70.3	0.033
China	4,687.2	2.211	Angola	286.3	0.135	Malawi	69.4	0.033
Belgium	4,605.2	2.172	Tunisia	286.5	0.135	Macedonia, FYR	68.9	0.032
India	4,158.2	1.961	Jamaica	273.5	0.129	Barbados	67.5	0.032
Switzerland	3,458.5	1.631	Uzbekistan	275.6	0.130	Niger	65.8	0.031
Australia	3,236.4	1.526	Kenya	271.4	0.128	Turkmenistan	75.2	0.035
Brazil	3,036.1	1.432	Qatar	263.8	0.124	Mauritania	64.4	0.030
Venezuela	2,659.1	1.254	Myanmar	258.4	0.122	Estonia	65.2	0.031
Spain	3,048.9	1.438	Yemen, Republic of	243.5	0.115	Benin	61.9	0.029
Mexico	2,585.8	1.220	Dominican Republic	218.9	0.103	Burkina Faso	60.2	0.028
Sweden	2,395.5	1.130	Guatemala	210.2	0.099	Chad	56.0	0.026
Argentina	2,117.1	0.998	Slovenia	231.7	0.109	Central Arican Republic	55.7	0.026
Indonesia	2,079.3	0.981	Brunei Darussalam	215.2	0.101	Lao People's Dem. Republic	52.9	0.025
South Africa	1,868.5	0.881	Panama	206.6	0.097	Mongolia	51.1	0.024
Nigeria	1,753.2	0.827	Tanzania	198.9	0.094	Botswana	63.0	0.030
Austria	1,872.3	0.883	Lebanon	203.0	0.096	Swaziland	50.7	0.024
Norway	1,671.7	0.788	Luxembourg	279.1	0.132	Albania	48.7	0.023
Iran, Islamic Republic of	1,497.2	0.706	Cameroon	185.7	0.088	Equatorial Guinea	32.6	0.015
Denmark	1,642.8	0.775	Uganda	180.5	0.085	Lesotho	34.9	0.016
Ukraine	1,372.0	0.647	Bolivia	171.5	0.081	Gambia, The	31.1	0.015
Kuwait	1,381.1	0.651	El Salvador	171.3	0.081	Belize	18.8	0.009
Poland	1,369.0	0.646	Jordan	170.5	0.080	Vanuatu	17.0	0.008
Algeria	1,254.7	0.592	Bosnia and Herzegovina	169.1	0.080	Djibouti	15.9	0.007
Iraq	1,188.4	0.560	Afghanistan, Islamic State of	161.9	0.076	Eritrea	15.9	0.007
Finland	1,263.8	0.596	Oman	194.0	0.091	St. Lucia	15.3	0.007
Malaysia	1,486.6	0.701	Costa Rica	164.1	0.077	Guinea-Bissau	14.2	0.007
Libya	1,123.7	0.530	Senegal	161.8	0.076	San Marino	17.0	0.008
Korea	1,633.6	0.770	Azerbaijan	160.9	0.076	Antigua and Barbuda	13.5	0.006
Pakistan	1,033.7	0.488	Georgia	150.3	0.071	Grenada	11.7	0.006
Hungary	1,038.4	0.490	Gabon	154.3	0.073	Samoa	11.6	0.005
Romania	1,030.2	0.486	Lithuania	144.2	0.068	Solomon Islands	10.4	0.005
Egypt	943.7	0.445	Cyprus	139.6	0.066	Cape Verde	9.6	0.005
Israel	928.2	0.438	Namibia	136.5	0.064	Comoros	8.9	0.004
New Zealand	894.6	0.422	Ethiopia	133.7	0.063	St. Kitts and Nevis	8.9	0.004
Turkey	964.0	0.455	Liberia	129.2	0.061	Dominica	8.2	0.004
Philippines	879.9	0.415	Nicaragua	130.0	0.061	Seychelles	8.8	0.004
Chile	856.1	0.404	Papua New Guinea	131.6	0.062	St. Vincent and the Grenadines	8.3	0.004
Czech Republic	819.3	0.386	Honduras	129.5	0.061	Maldives	8.2	0.004
Greece	823.0	0.388	Bahamas, The	130.3	0.061	São Tomé and Príncipe	7.4	0.003
Thailand	1,081.9	0.510	Latvia	126.8	0.060	Tonga	6.9	0.003
Colombia	774.0	0.365	Madagascar	122.2	0.058	Bhutan	6.3	0.003
Portugal	867.4	0.409	Moldova	123.2	0.058	Kiribati	5.6	0.003
Ireland	838.4	0.395	Iceland	117.6	0.055	Micronesia, Federated States of	5.1	0.002
Peru	638.4	0.301	Mozambique	113.6	0.054	Marshall Islands	3.5	0.002
Bulgaria	640.2	0.302	Bahrain	135.0	0.064	Palau, Republic of	3.1	0.001
Morocco	588.2	0.277	Guinea	107.1	0.051			
Congo, Dem. Republic of the	533.0	0.251	Sierra Leone	103.7	0.049			
Bangladesh	533.3	0.252	Mauritius	101.6	0.048			
United Arab Emirates	611.7	0.288	Paraguay	99.9	0.047			
Zambia	489.1	0.231	Mali	93.3	0.044			
Singapore	862.5	0.407	Suriname	92.1	0.043			
Sri Lanka	413.4	0.195	Armenia	92.0	0.043			
Belarus	386.4	0.182	Malta	102.0	0.048			
Ghana	369.0	0.174	Guyana	90.9	0.043			
Croatia	365.1	0.172	Cambodia	87.5	0.041			
						Total	212,029.00	100.00

Memorandum Item:

Federal Republic of
Yugoslavia
(Serbia/Montenegro) 467.7 0.221

Can Monetary Policy Achieve Credibility Without Rules?

The international monetary system has undergone profound change since the Bretton Woods system collapsed in 1971. Occasional Paper No. 154, Credibility Without Rules? Monetary Frameworks in the Post-Bretton Woods Era, by Carlo Cottarelli and Curzio Giannini, chronicles changes in the theory and practice of monetary policy over the past 25 years. In a sweeping examination of 100 countries or country unions, it analyzes the evolution of the basic principles and institutional rules that guide the execution of monetary policy. Cottarelli spoke with the IMF Survey about the findings of their study.

IMF SURVEY: *Why was the study done?*

COTTARELLI: There has been extraordinary change in the international monetary system over the past 25 years. We wanted to understand what prompted this evolution, which interestingly came about sponta-



Cottarelli: One of the clearest trends we found was a shift to more flexibility in the framework of monetary policies.

neously—not as the result of any fundamental decision. After a quarter century, we felt it would be good to look at what had happened and where the world had moved.

One of the clearest trends we found was a shift to more flexibility in the framework of monetary policies—particularly in the movement of countries toward more flexible exchange rates. The shift has been gradual, but it is clear from the data that the number of countries now pegging is much smaller than it was in the early 1970s. Of course, there have been other forms of more formally rigid monetary frameworks—notably, monetary targeting in a number of industrial countries. But this, too, has been gradually abandoned.

And other, more flexible forms of monetary management have emerged.

But is this trend toward flexibility consistent with economic theory, which since the early 1970s has stressed the important role that achieving credibility plays in reducing inflation? One way to achieve credibility is to announce rules and stick to them, but clearly countries have been achieving credibility without adherence to formal rules. So we explored empirically the ways in which countries had been able to enhance the credibility of their policies. Countries, we found, followed different recipes.

Some enhanced their credibility by creating an independent central bank—thus reducing the risk of monetary policy becoming a tool for the myopic interests of politicians. To avoid this risk, you assign monetary policy to an institution that has long-term price stability as its mandate. A constraint remains, but it is now placed on the final target, not on the instrument. The framework to achieve the target remains fairly flexible.

Other countries rely on a system of inflation targeting, which is not necessarily dependent on the central bank but does stress the objective of price stability as the key objective of monetary policy. And still others achieve credibility by borrowing it—for example, by entering into a program with an international institution like the IMF.

Borrowing credibility from an external source is consistent with another trend that we have seen over the period: more and more countries are using IMF programs, although the importance of IMF programs in terms of money has declined over time because of the growth in private market access. The volume of lending has decreased, while the number of programs has increased. What has become important is the fact of an IMF program and the credibility that the IMF imparts to the policies being implemented by the authorities.

IMF SURVEY: *Over the past 15 years or more, most of the countries coming to the IMF—with the exception of some of the larger transition economies—have been African or Latin American economies...*

COTTARELLI: We did not examine the composition of the countries coming to the IMF, but my impression is that there is an important breakdown between industrial and developing countries. Industrial countries often have a tradition of democratic institutions. Coups d'état are infrequent and credibility can be achieved through institutional means—for example, by setting up an independent central bank or establishing a system of inflation targets. If the authorities realize inflation is accelerating, they inform the public and explain why

they have to tighten monetary policy. To do this, though, you need an initial endowment of capital credibility, which I am not sure exists in many developing countries. In many developing—and transition—economies there is, in fact, a lack of trust in institutions, which often makes it more difficult to pursue credibility through means other than borrowing it externally.

The important and growing role of the IMF in helping countries pursue disinflation targets is heightened by the fact that other traditional anchors of inflation in developing countries are becoming more difficult to implement because of strong capital mobility. Greater capital mobility, for example, makes it more difficult to peg the exchange rate. We find evidence that as the financial system evolves, the money demand is more unstable in developing countries than in industrial countries. Centering a disinflation program on a monetary anchor or an exchange rate anchor is thus relatively more difficult in developing countries than in industrial countries, assuming that even industrial countries ever took monetary targets seriously.

IMF SURVEY: *Does the study project future trends?*

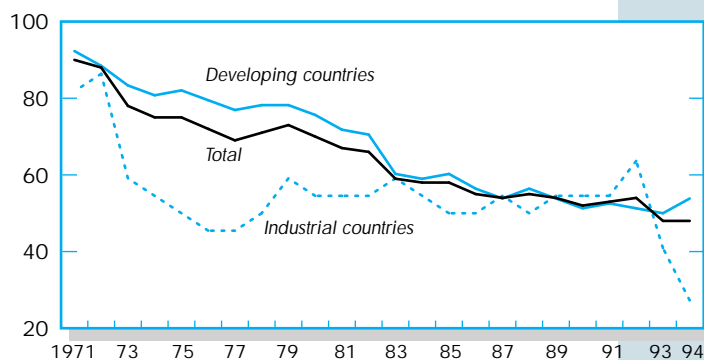
COTTARELLI: The move toward more flexible exchange rate regimes seems to be strictly related to increased capital mobility, and that trend is going to continue. To the extent that capital mobility increases, it will remain difficult to peg exchange rates unless the peg is bolstered by stronger institutional change, as is happening, for example, in the European exchange rate mechanism countries. They had to broaden their bands, but the project was supported by the understanding that reaching exchange rate stability was a first step toward economic integration—even political integration. For countries willing to enter into stricter forms of monetary coordination beyond purely bilateral or unilateral pegging, it will still be possible to peg the exchange rate, but capital mobility will make it more and more difficult. This trend has, in fact, been borne out by the events of the last 12 months.

IMF SURVEY: *Are there specific lessons for countries re-examining their exchange rate policies?*

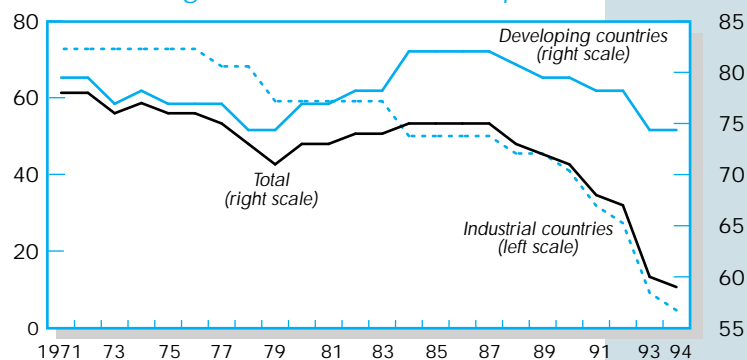
COTTARELLI: The European transition countries are moving from an initial phase in which the external equilibrium was key to a new phase in which disinflation will be the focus. For those countries, the exchange rate peg has become even more difficult to maintain and, in some instances, has already been abandoned. This trend is likely to continue, precisely because it becomes more difficult to keep the exchange rate pegged and because for countries in which there is always an external problem, the very aggressive use of the exchange rate may be highly risky. If you have an inflation problem—and want, say, to reduce the rate of growth and the inflation rate—using the exchange rate as the main lever to lower inflation implies some risks on the external side. To avoid

these risks, we will likely see further shifts to flexible rate regimes supported by institutional means—for example, independent central banks and possibly programs with the IMF. Bulgaria, for example, would probably not have been able to introduce a credible currency board without the support of the IMF. The IMF said, in effect, the country has an inflation problem, is addressing the problem, and it is going to work. And it is working. In

Percentage of Countries with Pegged Exchange Rates



Percentage of Countries with Capital Controls



Data: IMF, Occasional Paper No. 154, *Credibility Without Rules? Monetary Frameworks in the Post-Bretton Woods Era*

Bulgaria, pegging the exchange rate was part of the deal. For the transition countries that still have an inflation problem, there are lessons to be learned from this paper.

IMF SURVEY: *Will there be a follow-up to this study?*

COTTARELLI: We are writing a shorter paper that will be taking a closer look at the role of the IMF in disinflation. What is the role of the organization when its supporting programs are aimed not at external adjustment but at lowering inflation? To date, the IMF has been committed to providing monetary support only where there was a balance of payments need. Now we have a number of countries in which there is a disinflation problem but no immediate, or prospective, balance of payments need. ■

Copies of IMF Occasional Paper No. 154, *Credibility Without Rules? Monetary Frameworks in the Post-Bretton Woods Era*, by Carlo Cottarelli and Curzio Giannini, are available for \$15.00 (academic rate: \$12.00) from IMF Publication Services. See ordering information on page 42.

Continued Trade Growth Is Crucial Element in Global Recovery



The continued dynamism of world trade, which has been important in the more open global economic strategies countries have been pursuing, will be crucial to their successful recovery from current setbacks, the UN Department of Economic and Social Affairs states in its report, *The World Economy at the Beginning of 1998*. The report notes that the volume of world trade recovered strongly in 1997 from its slowdown in 1996, with growth estimated at 9.4 percent. Growth of 7 percent is forecast for 1998.

Other highlights of the report follow:

- While noting that “the unknown duration and ramifications of the huge swing in financial market sentiments in 1997 makes the overall economic outlook particularly cloudy at this time,” the report observes that the world economy in the 1990s moved toward a “cruising speed” of 3 percent growth a year. In 1997, it grew by slightly more than 3 percent; 3 percent growth is forecast for 1998.

- In the developing world, GDP growth in 1997 was almost 6 percent. In 1998, while growth is forecast to

pick up in Africa (to 4 percent), slower growth is envisaged in other major regions, yielding an overall average growth rate for developing countries of 5 percent. An encouraging feature of 1997, the report notes, was the indications of renewed growth in the economies in transition, including in Russia.

- The Asian crisis raises systemic questions concerning the operation of the international economy, the report notes. The immediate aim of a response strategy must be to assist countries to overcome domestic financial crises and safeguard the system of large-scale international financial flows. However, the study adds, “deeper systemic questions about the varieties of international finance and how countries insert themselves into the global financial system warrant revisiting in the light of recent events.” ■

The World Economy at the Beginning of 1998 is prepared by the Development Policy Analysis Division of the UN Department of Economic and Social Affairs. Copies may be obtained free of charge from the Development and Human Rights Section, Department of Public Information, Room S-1040, United Nations, New York, NY 10017, U.S.A. Fax: (212) 963-1186.

Recent IMF Publications

World Economic and Financial Surveys Series

Toward a Framework for Financial Stability (\$25.00; academic rate \$20.00). Outlines the broad principles of sound financial systems, to facilitate IMF surveillance over banking sector issues of macroeconomic significance.

Occasional Papers (\$15.00; academic rate: \$12.00)

No.157: *Central Bank Reforms in the Baltics, Russia, and the Other Countries of the Former Soviet Union*, Malcolm Knight and others (see page 44).

Working Papers (\$7.00)

97/182: *Winner-Loser Reversals in National Stock Market Indices: Can They Be Explained?*, Anthony Richards. Examines possible explanations for “winner-loser reversals” in the national stock market indices of 16 countries.

98/1: *The Impact of Fiscal Policy Variables on Output Growth*, Philip Gerson. Surveys the theoretical and empirical literature on the relationship between taxation and public expenditure and economic growth.

98/2: *Developing Countries and the Feldstein-Horioka Puzzle*, Athanasios Vamvakidis and Romain Wacziarg. Shows that limited financial integration in the industrialized world holds only for OECD countries.

98/3: *Exchange Rate Uncertainty in Money-Based Stabilization Programs*, R. Armando Morales. Explains that exchange rate uncertainty introduced with imperfect competition in the banking system leads to a bias toward appreciation.

98/4: *Economic Security, Private Investment, and Growth in Developing Countries*, Hélène Poirson. Provides empirical support for the view that enhanced economic security fosters private investment and growth in developing countries.

98/5: *Estimating Egypt's Equilibrium Real Exchange Rate*, Joannes Mongardini. Estimates empirically Egypt's equilibrium real exchange rate—that is, the rate that is consistent with fundamentals.

Publications are available from Publication Services, Box XS800, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full text of the English edition of the *IMF Survey*, the *IMF Survey's* annual *Supplement on the IMF*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's web site (<http://www.imf.org>). The full texts of all Working Papers, Papers on Policy Analysis and Assessment, and Press Information Notices (PINs) are also available on the IMF's web site.



Following are excerpts from a recent IMF press release. The full text is available on the IMF's web site (<http://www.imf.org/external/news.htm>) or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Argentina: EFF

The IMF approved a three-year credit for Argentina equivalent to SDR 2.08 billion (about \$2.8 billion) under the Extended Fund Facility (EFF) to support the government's medium-term economic reform program for 1998–2000. The government attaches importance to the IMF's approval of its policy framework. It intends to treat the EFF credit as precautionary and will only draw under it if adverse external circumstances make it necessary.

Medium-Term Strategy and 1998 Program

The program for 1998–2000 assumes that the expected slowdown in the growth of world trade caused by the crisis in emerging economies in Asia will result in a deceleration of Argentina's real GDP growth in 1998, but that real GDP growth should recover to potential output by 2000. The rate of unemployment should continue to decline gradually, inflation should remain in the neighborhood of 1 percent in 1998, and the current account deficit, as a result of an expected upturn in exports, should decline to about 3.5 percent of GDP by 2000.

The program envisages the continuation of fiscal adjustment, with near balance being reached in the public sector accounts by 2000. A reduction of the overall federal government deficit from the equivalent of 1.4 percent of GDP in 1997 to 1 percent in 1998 and further to 0.3 percent of GDP by 2000 is envisaged, despite the transitional costs of the switchover to privately administered pension funds, equivalent to about 1 percent of GDP annually.

The rules-based monetary framework under the currency board arrangement aims to strengthen confidence by maintaining a sound financial system and providing for an adequate cushion of liquidity that could compensate for the limited

role of the central bank as a lender of last resort in the event of a crisis.

Structural Reforms

The structural reform agenda for 1998–2000 includes reforms in the labor market, in the tax system, and in budgetary procedures, the conclusion of the privatization process, and reforms in the health and judicial systems.

Argentina: Selected Economic Indicators

	1996	1997 ¹
	(percent change)	
Real GDP growth	4.2	8.1
Consumer prices (end of period)	0.0	0.3
	(percent of GDP)	
Overall fiscal balance	-2.2	-1.4
External current account balance	-1.9	-3.8

¹Projection.

Data: Argentine authorities and IMF staff estimates

The program envisages putting in place a reform of the labor market by mid-1998. A comprehensive tax reform will seek to improve efficiency and equity of the tax system and promote the competitiveness of the economy. Reforms in budgetary procedures aim at promoting transparency and efficiency in public spending and include widening the coverage of the budget, moving to a pluri-annual process, preparing annual assessments of the cost of fiscal benefits and incentives, and introducing the use of expenditure efficiency indicators.

Addressing Social Needs

Building on the significant progress made in 1997 in the area of poverty reduction, the government intends to continue its efforts to restructure social programs to better target budgetary resources toward vulnerable groups.

Argentina joined the IMF on September 20, 1956. Its quota is SDR 1.5 billion (about \$2.1 billion). Its outstanding use of IMF credit currently totals SDR 4.2 billion (about \$5.7 billion).

Press Release No. 98/1, February 4

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
January 26	4.21	4.21	4.61
February 2	4.25	4.25	4.66

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 U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 109.6 percent) 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.

Data: IMF Treasurer's Department

Press Information Notices

Press Information Notices (PINs) are IMF Executive Board assessments of members' economic prospects and policies issued—with the consent of the member—following Article IV consultations, with background on the members' economies. Recently issued PINs include:

Slovenia, No. 98/3, January 26

Kuwait, No. 98/4, February 3

Full texts of PINs are available on the IMF's web site (<http://www.imf.org/pins>).



Central Banks in Transition Economies Pursue Market-Based Reforms

Since 1991, the IMF has coordinated an intensive multilateral program to provide technical assistance to the central banks of 15 transition economies (the Baltic states, Russia, and the other countries of the former Soviet Union). A recently published IMF Occasional Paper, *Central Bank Reforms in the Baltics, Russia, and Other Countries of the Former Soviet Union*, by a staff team led by Malcolm Knight of the Monetary and Exchange Affairs Department, analyzes the progress of central bank reform undertaken by these countries.

The 15 countries have, to varying degrees, been pursuing reforms designed to achieve market-based interest and exchange rates, manage banking system liquidity through market operations, and provide the institutional underpinnings for the design and implementation of macroeconomic stabilization and structural reform programs supported by the IMF. Implementation of these measures has required close coordination of associated reforms to foster interbank money markets, government securities and foreign exchange markets, and to strengthen other functions of central banking. These functions include the payments system, central bank accounting and internal audit, and bank supervision and restructuring.

The study ranks the progress the countries have achieved in each of the main central banking areas surveyed based on information up to the first half of 1997. From these rankings, the authors distill an overall ranking for each country's progress compared with its peer group. The results need to be treated with caution, since they involve some qualitative assessments, the study warns. But country authorities should find the rankings useful in helping them to reform their central banking functions, as should the international community in drawing broad conclusions about the effectiveness of past efforts and the extent of further reforms needed.

Institutional Background

Central banks in all but two of the 15 countries (Belarus and Turkmenistan) have broad de facto autonomy to pursue price stability and to formulate and implement monetary policy. Exchange rates are flexibly managed and intervention has generally been active (except in Estonia and Lithuania, which have currency board arrangements, and Latvia, which informally pegs its currency to the SDR). For all practical purposes, only Belarus, Turkmenistan, and Uzbekistan have restrictions on external current account transactions. Most countries have only limited restrictions on capital movements.

Most of the 15 countries have liberalized interest rates on bank deposits and lending and rely mainly on indirect instruments to control bank liquidity. The prospects for deepening money, securities, and foreign exchange markets are still limited by uncertainties about the enforceability of contracts, shortcomings in the payments infrastructure for financial market transactions, and concerns over the soundness of many bank counterparties in the market. Although the regulatory frameworks are reasonably strong, their effectiveness is limited by weak and uneven accounting and disclosure standards, limited on-site inspection, and problems in enforcing the supervisory and intervention powers of central banks. Market discipline, accordingly, remains weak, leaving the central banks with much of the burden of ensuring orderly conditions in the banking system.

Monetary Operations and Government Securities Markets

All 15 countries have made reasonably good progress in establishing market-based monetary policy instruments and procedures, according to the study. Kazakhstan, the Kyrgyz Republic, Latvia, and Russia have advanced the furthest, while the other countries have generally established basic instruments and procedures. For all countries, however, the development and effectiveness of short-term operating frameworks have been hampered by insufficient coordination within the central banks and between central banks and treasuries in terms of short-term forecasts of government cash flows.

Priorities for reform include:

- Central banks need to improve their lending facilities and the operating framework for monetary policy and to facilitate the development of financial markets suitable for monetary operations.
- In the context of increased credit risks associated with systemic banking weaknesses, access to central bank credit should be collateralized, and credit auctions should be transformed into repurchase auctions.
- The coordination of indirect instruments of monetary policy through a short-term programming framework as a condition for more active liquidity management needs to be strengthened, or, in some cases, put in place. At the institutional level, coordination within central banks and between them and government bodies responsible for financial policies needs to be strengthened.
- An efficiently functioning interbank money market is critical to the development of indirect monetary

control. However, in an environment of poor information on the financial condition of individual banks, widespread bank unsoundness, and a lack of collateral, development of this market will be difficult. The central bank can play an active role by making the interbank money market the focus of its liquidity operations and by providing banks with timely information on clearing positions at the central bank.

- Most countries must still develop the institutional framework to conduct repurchase agreements.

Foreign Exchange Markets

All but a few countries have moved toward unified exchange rates through introducing market-determined exchange rates supported by monetary and fiscal discipline, and most have adopted external current account convertibility. Liberalizing exchange controls has had a major impact on the structure and efficiency of foreign exchange markets.

With a few exceptions (Tajikistan, Turkmenistan, and Uzbekistan), the central banks' internal organization, procedures, and staffing for conducting market operations and managing official international reserves are largely in place.

Depending on each country's capacity to implement reform, further action will be needed in four broad areas, according to the study:

- supporting the move toward external convertibility;
- strengthening the basic conditions for developing an interbank foreign exchange market;
- designing and implementing prudent guidelines for reserve management and improving the organization of foreign exchange operations; and
- improving coordination between money and foreign exchange operations, as well as devising strategies for a smooth transition between alternative monetary and exchange arrangements.

Banking Supervision

The structural transformation taking place in these 15 transition economies since the early 1990s has profoundly affected their banking systems. The monobank system has been replaced by a two-tier system, and many of the state banks have been partially or fully privatized. At the same time, new private commercial banks have entered the market in all countries and proliferated in some. Market forces, rather than government or central bank direction, have increasingly determined credit allocation, and banks and authorities alike have become exposed to financial risk.

All 15 countries have sought to develop a framework for managing and controlling banking risks. And all of them, except Tajikistan, have developed adequate prudential regulation, although implementation is lagging, especially in exit policies—the timely and effective application of corrective measures to delinquent, weak, or insolvent banks.

A remaining weakness is the absence of clear accounting rules, rules on consolidation of the balance sheets of related entities, and rules for loan classification, loan-loss provisioning, and income recognition.

The immediate challenge for banking supervision will be to move forward in two areas:



Central bank building in Moscow. The structural transformation taking place in transition economies since the early 1990s has profoundly affected their banking systems.

- improving accounting techniques and procedures for assessing loan quality and other areas related to the quality of the data; and
- developing and refining on-site inspection skills, including sampling techniques for loan quality analysis.

Bank Restructuring

The rapid growth in the number of commercial banks in the 15 countries under review has exposed significant structural weaknesses, such as poor managerial skills and the initial lack of a suitable regulatory and supervisory framework. In the early 1990s, the true financial condition of banks was obscured by weak accounting practices and the effects of high inflation, which helped them appear solvent, and by generous central bank credit facilities, which helped them to remain liquid. As macroeconomic stabilization policies have taken hold, however, and inflation has been brought under control, many of the new banks have only limited scope for sustainable profitability because of difficulties in the traditional enterprise sector and the earlier sharp contractions in real economic activity.

Photo Credits: Denio Zara and Padraic Hughes for the IMF, pages 36 and 40; Ria-Novosti for Publishers Depot, page 45.

Improved accounting and inspection procedures, increases in minimum capital requirements, and stricter loan classification and provisioning rules have brought the underlying problems in the banking system into sharper relief.

The financial problems of the banking systems have led to a markedly diminished role for financial intermediation relative to even the depressed levels of economic activity recorded in recent years. These problems have also hampered the banks' role in financing sustainable economic growth.

The soundness of the banking system remains a cause for concern in all 15 countries. Current restructuring efforts will need to be supported by the ongoing

Central banks should encourage commercial banks to play an increasing role in the payments system.

development of supervisory capacity, as well as by better accounting and legal frameworks. Priorities for reform should be in two main areas:

- The degree of undercapitalization of individual banks and of the system as a

whole needs to be determined on the basis of consistent and realistic asset values to permit estimates of the full cost of recapitalization or liquidation.

- A comprehensive restructuring strategy that would attract adequate political support needs to be formulated. The strategy would include classifying banks on the basis of their viability and importance to the economy creating the legal and institutional framework for implementing restructuring and managing problem assets and the assets of liquidated banks.

Payments System Policies

The banking system in the countries under review has not developed sufficiently as the core provider of payments services to allow access to the full range of diversified payments features characteristic of mature market economies. The central bank, therefore, remains the sole provider of clearing and settlement services. In most of the 15 countries, central banks have formulated explicit strategies to reform their payments systems. Most central banks have improved their own accounting and information management systems and settlement procedures, so that banks cannot rely on receiving overnight credit without prior approval from the central bank under a standing facility.

Considerable restraints remain on the commercial banks' ability to manage their liquidity. Areas where progress is needed include the centralization of commercial banks' accounts with the central bank; better design of reserve averaging and standing facilities to support the liquidity needs of the banks; the development of specialized systems for large-value and low-priority or high-volume payments, with clear arrangements for minimizing risks; and more flexible

delivery-versus-payment arrangements for securities markets.

The momentum of reform in payments systems has clearly been established in most of the countries under review, the study notes. The remaining challenges are to develop policies that encourage competition and innovation in private sector provision of payments services. Central banks should encourage commercial banks to play an increasing role in the payments system; also, the legal and regulatory framework should reinforce confidence in payments instruments and clearing and settlement arrangements.

Central Bank Accounting

In the past few years, many of the 15 countries have been implementing central bank accounting reforms that reflect internationally accepted accounting principles and standards. All countries, except Russia, Tajikistan, and Turkmenistan, have reached or passed the core implementation stage associated with developing a new chart of accounts for their central banks; and at least four (the three Baltics and Armenia) can now be regarded as having attained internationally accepted standards and procedures.

The direction of future reforms falls into two broad categories, according to the study: countries that require a broad program of reform, and those that have already made progress but still need to pursue integration of accounting systems to meet the information needs of policymakers and prepare financial statements that can withstand an external audit based on international accounting standards. For this second group, relevant actions include:

- formalizing and documenting international accounting standards principles and practices;
- installing new accounting software and integrating subsidiary systems;
- developing accounting practices and controls in foreign exchange and market operations;
- refining financial statement formats for use in both internal and external reporting; and
- developing staff training programs covering international accounting standards practices and principles.

Nearly all countries, the study concludes, must still address internal audit reforms, including developing modern internal audit capability that focuses on assessing the adequacy of internal controls and managing risks facing a central bank. ■

Copies of IMF Occasional Paper No.157, *Central Bank Reforms in the Baltics, Russia, and the Other Countries of the Former Soviet Union*, by a staff team led by Malcolm Knight, are available for \$15.00 (academic rate: \$12.00) from IMF Publication Services. See ordering information on page 42.

Egypt's Successful Stabilization Program Lays Foundation for Renewed Growth

Egypt's recent economic stabilization efforts represent a remarkable success story. The determined application of appropriate macroeconomic policies, in the context of IMF-supported programs during the 1990s, led to reduced inflation, improved public finances, a more stable currency, and a strengthened banking system, as well as a stronger balance of payments position (see chart, page 48). Financial markets have for some time recognized the improved strength and stability of the Egyptian economy, as evidenced by significant inflows of portfolio and direct investment. This article examines the key elements of the country's economic reform program that have contributed to Egypt's renewed growth and stability.

Stabilization Strategy

Egypt's stabilization strategy has four main pillars:

- *Rapid reduction of the fiscal deficit.* Egypt achieved an up-front fiscal adjustment in 1991/92 through a substantive revenue effort coupled with significant expenditure restructuring and reduction. The country recorded further progress in deficit reduction each year from 1991/92 through 1996/97. On the revenue side, the main increases drew from an adjustment of the exchange rate—which

boosted Suez Canal revenues and oil company profits—and the introduction of a general sales tax. On the expenditure side, the authorities made deep cuts in the extensive capital investment budget, reduced debt servicing following Paris Club agreements, and significantly reduced untargeted subsidies. Other expenditures, including wages, were relatively protected.

- *Currency and financial system reform.* Early in the stabilization program, the authorities implemented major reforms in the financial sector to strengthen the banking system and initiated steps to improve monetary instruments to control liquidity. In early 1991, Egypt effectively unified its foreign exchange markets and concurrently lifted official limits on interest rates and introduced auctions for the sale of treasury bills. During 1992 and 1993, it also lifted direct credit controls to private and public sectors.

- *Use of exchange rate as a nominal anchor with active management of liquidity.* Starting in 1991, Egypt maintained its exchange rate at a stable rate to the U.S. dollar. It followed an active sterilization policy to dampen the expan-



IMF Support Aims to Raise Growth, Create Employment Opportunities

On October 11, 1996, the IMF's Executive Board approved a 24-month stand-by credit for Egypt of SDR 271.4 million (about \$390 million at the time). In view of the country's strong reserve position, the government has not drawn and does not intend to draw on the credit. The arrangement has helped to intensify efforts to meet the chief medium-term challenge facing the country—namely, the need to increase economic growth to create employment opportunities and to raise living standards for Egypt's rapidly growing population.

The two-year economic program has consolidated the macroeconomic stabilization gains achieved under previous IMF-supported programs, and is broadening and intensifying structural reforms through greater privatization, deregulation, trade liberalization, and fiscal and financial sector reform. For the period 1996–98, the program aims to achieve annual real GDP growth of about 5 percent, a further decrease in inflation to about 5 percent, and maintenance of a viable exchange position. The increased growth rate is expected to create 400,000 new jobs annually. An expected 2.5 percentage point rise in investment and saving relative to GDP and a budget

deficit of under 1 percent of GDP are expected to underpin this stronger macroeconomic performance.

A fundamental goal of the program is to transform the ownership structure of the Egyptian economy, where the public sector still figures prominently in manufacturing and investment and represents about one-third of total employment. Other key structural reforms include further trade liberalization, deeper fiscal revenue reforms (including the transformation of a general sales tax into a value-added tax) and rationalization of the income tax, civil service reform, accelerated financial sector reform, further strengthening of banking supervision, and administrative reforms to simplify and rationalize investment regulation.

Under the program, Egypt is pursuing measures to ensure that critical social needs are also addressed. The program provides for an increased number of qualified nurses and teachers to strengthen publically provided health and education services, a stronger social safety net, and greater targeting of assistance so that the most vulnerable segments of the populations are protected. The country's Social Fund for Development is drawing increased support from foreign donors, with a focus on providing retraining and related assistance for displaced workers.



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sionary impact of capital inflows using treasury bill sales with the proceeds deposited at the Central Bank of Egypt. The rapid accumulation of foreign exchange reserves early in the stabilization period enhanced credibility of the exchange rate peg and in turn led to a reduction of inflation expectations.

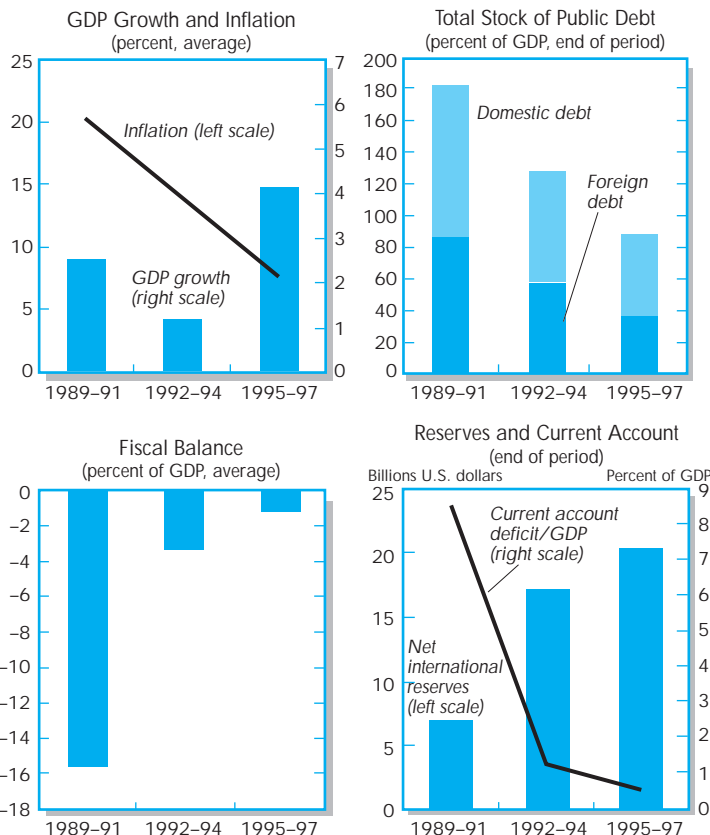
• *Improved poverty alleviation policies.* To counteract the short-run effects of lower consumer subsidies during the adjustment program, Egypt created the Social Fund for Development in 1991 to protect and improve the status of key vulnerable groups. The Social Fund for Development helped alleviate poverty through labor-intensive public works, support for micro enterprises, basic community services, retraining, and improved monitoring of living standards.

During the early 1990s, the pace of structural reforms lagged behind the stabilization program and, by 1994, the privatization program had stalled and other planned reforms had been postponed. More recently, however, there has been a reinvigoration of structural reforms—most evident in the economic program that Egypt has had in place since early 1996 with support of an IMF Stand-By Arrangement. The authorities have made considerable progress in privatization, deregulating protected sectors, reducing distortions from pricing and subsidy policies, and removing other obstacles to trade and investment. Private investment has responded positively to liberalization and is increasingly serving as the engine of growth for the economy.

The privatization program has been a notable achievement, particularly since early 1996: more than one-third of the state industrial portfolio has been divested and divestiture proceeds have ranked high in comparison with other transforming economies. Privatization has focused on the divestiture of majority stakes of nonfinancial public enterprises (excluding state utilities and infrastructure operations) and the reduction of state involvement in banking and insurance. To sustain the strong pace of privatization, a broader range of state assets will need to be added to the sale portfolio. The Egyptian authorities have indicated that in the future, the privatization program will include sale of a minority stake in the state telecommunications authority as well as stakes in ports and hotels.

Egypt has traditionally had a strong “banking habit,” with high levels of financial intermediation, notwithstanding extensive state controls in the sector. Financial sector reform initially focused on developing indirect instruments of liquidity management and enhancing the attractiveness of domestic currency banking assets through interest and credit liberalization, while also recapitalizing the main public sector banks. The second phase of finan-

Egypt: Selected Economic Indicators



Note: All data refer to financial years; for example, 1996 covers July 1, 1995–June 30, 1996.

Data: IMF staff estimates

cial sector reform aimed to increase the competitiveness of financial markets by divesting state ownership of joint venture banks, while also strengthening bank supervision and adherence to international banking standards. In large part, these reforms have underpinned an expansion of financial asset intermediation, particularly in the equity markets, and have contributed to a strengthening of banking profitability and bank soundness.

Next Steps

Nonetheless, the task of delivering sustained growth of output and employment in Egypt is incomplete. Investment and domestic saving rates remain below levels needed to accelerate growth further over the medium term. And despite relatively competitive labor costs, labor-intensive production remains well below potential, while merchandise exports are limited and narrowly focused.

The key to unlocking Egypt's growth potential is continued reforms to improve investment and saving, notably through completing the process of privatization, modernizing the financial sector—especially through the divestiture of commercial banks and insurance companies—and removing bureaucratic hurdles to private sector development. In addition, further efforts to liberalize the external trade regime will enhance competitiveness. ■