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In this issue

225 Köhler in Africa
225 Pre-summit meeting calls for IMF reforms
227 Aninat addresses ECOSOC meeting
228 IMF working group on selection process
229 Ukraine report
231 Political constraints in transition process
231 Data Quality Reference Site
232 Soft budget constraints
234 IMF releases Stand-By credit for Turkey
236 Turkey's disinflation program
238 Deposit insurance and financial stability

and . . .

230 New on the web
234 Use of IMF credit
234 Selected IMF rates
235 IMF Arrangements
239 Recent publications

Köhler travel

IMF Managing Director visits Africa, sees window for countries to move ahead with development

During July 2–8, in his first visit to sub-Saharan Africa since taking office, IMF Managing Director Horst Köhler met with government authorities and representatives of civil society in Nigeria, Senegal, Mozambique, Botswana, and South Africa. The purpose of his visit was, first, to hear from the authorities on the economic situations and challenges facing their countries and, second, to listen to the views of African leaders on the IMF's role and its involvement in restructuring African economies. In his meetings, he emphasized that there is today a single integrated world economy and the development of Africa is an essential component in ensuring its health. At the same time, he agreed with the African leaders he met that the IMF should stay fully engaged in Africa and should not succumb to any mood of "Afro-pessimism."

Following a meeting with Nigerian President Olusegun Obasanjo at the beginning of his African visit, Köhler said they had "good and constructive talks" on future IMF financial support for an economic program in Nigeria. He added that debt relief should be only one element of a comprehensive strategy to strengthen growth in the country. Nigeria has the potential for medium-term growth of 5–10 percent a year, he said, but what the country needs first and foremost is growth and investment in education, infrastructure, and institution building.

During his visit to Dakar on July 3, Köhler addressed Senegal's Economic and Social Council at a meeting that included representatives of the country's private business sector, labor movement, rural associations, and nongovernmental organizations. He also met with Charles Konan Banny, the Governor of the BCEAO (the Central Bank of West African States), and Abdoulaye Wade, the President of Senegal. In his remarks to the council, Köhler said that he is open to advice from both governments and civil society on how the IMF can best *(Please turn to the following page)*

Pre-economic summit meeting

Group of Seven finance ministers urge IMF to strengthen surveillance, reform lending facilities

Picture not available

Group of Seven and European Commission officials met in Fukuoka.

The IMF should seek to wean countries from their longer-term dependence on its funding and encourage them to turn more to capital markets, according to a statement issued by the Group of Seven finance ministers after their meeting in Fukuoka, Japan, on July 8. The meeting was part of the preparations for the economic summit of the Group of Eight to be held in Okinawa on July 21–23. Discussion also focused on the impact of the information technology revolution on the global economy and finance, and steps needed to strengthen the international financial architecture, to act against abuses of the global financial system, and to reduce poverty and spur economic development.

In discussing ways to strengthen the international financial architecture, the finance ministers said in their statement that "it is *(Please turn to the following page)*

Managing Director holds discussions in Africa

Horst Köhler

(Continued from front page) support development. He commented that reform of the IMF is being discussed within the IMF and that his talks in Senegal provided an opportunity to demonstrate the IMF's openness to the views of civil society and willingness to improve its efforts.

At the end of his visit to Mozambique on July 6, Köhler emphasized that the IMF does not recommend conditions and policies for African countries that are not in their interest and do not help countries solve their problems. He stressed that the IMF is interested in building a stronger dialogue on policies and in providing the best advice with the best expertise it has. He subsequently had discussions with finance ministers from the 14-member Southern African Development Community.

Köhler concluded his trip to Africa with a visit to South Africa on July 7–8. He had discussions in Johannesburg with President Thabo Mbeki and explained that the IMF is in favor of bolder debt reduction and restructuring the voting powers of developing countries within the institution. He emphasized that the developing countries will need to work harder to build credibility and demonstrate that they are building economies based on legitimate democratic structures that are free of corruption and maladministration.

Köhler's visit to Africa was the third in a series of visits he has made to developing countries of the IMF since taking office in May. He visited four Latin American countries on May 15–19 (see *IMF Survey*, May 22, page 161) and five Asian countries on June 1–6 (see *IMF Survey*, June 19, page 193). ■

Ministers propose reforms in IMF, multilaterals

(Continued from front page) essential to continue to examine the role and functioning of the international financial institutions, in view of the changing global financial landscape, including the increasing importance of private capital markets."

Reform of the IMF

As part of the effort to strengthen the international financial system, the Group of Seven finance ministers called for a reform of the IMF. Their recommendations seek to improve the IMF's effectiveness in tackling financial crises while extracting it from long-term lending that could equally well be provided by the private sector. Specific recommendations include

- strengthening IMF surveillance to prevent crises;
- promoting the implementation of internationally agreed codes and standards;
- reform of IMF facilities, "with a view to encouraging countries to develop stable access to private markets and discouraging prolonged use of, and deterring inappropriate large-scale access to, IMF resources";
- implementing the new framework for safeguards on the use of IMF resources and taking early action to strengthen post-program monitoring;
- making further progress in increasing the involvement of the private sector in program design; and
- strengthening the governance and accountability of the IMF.

The statement further calls on the IMF "to explore, in the context of the review of its facilities, appropriate uses of any resulting increase in IMF income within the existing framework of the Articles [of Agreement], with the objective of targeting support to the poorest countries."

The finance ministers also released for consideration at the Okinawa summit a report on strengthening the international financial architecture. The report recommended that for the IMF's nonconcessional facilities, interest rates should rise on a graduated basis according to the length of time countries have IMF resources outstanding; the ministers further suggested that there may be a case for imposing a premium cost on countries whose borrowings exceed a certain threshold.

The ministers called for a review of the Contingent Credit Lines, a relatively new IMF facility designed to shield countries that have good policies in place but are still affected by the financial crises that hit their neighbors. The Group of Seven report suggests that the effectiveness of the facility could be enhanced without compromising the initial eligibility criteria.

Reform of multilateral development banks

Also under the heading of strengthening the international financial system, The Group of Seven finance ministers called for broad reforms of the activities of the multilateral development banks. In their report, they said that "an increased focus on poverty reduction should underpin all aspects of the work of the multilateral development banks." Multilateral development banks, the report notes, need to "adapt their organization and operations in order to fulfill this mission more effectively and consistently" in a changing environment. There was a clear need, the ministers said, for additional progress in such crucial areas as information disclosures, public participation, and accountability to shareholders.

The reports of the Group of Seven finance ministers to the heads of state and government are available on the web at: http://www.g8kyushu-okinawa.go.jp/e/documents/index.html. ■

IMFSURVEY

Aninat outlines ways to integrate all countries into increasingly globalized economy

Following is an edited version of a speech delivered by IMF Deputy Managing Director Eduardo Aninat at the High-Level Meeting of the United Nations (UN) Economic and Social Council (ECOSOC) in New York on July 5.

The theme of this meeting—the role of information technology in a knowledge-based economy—raises the issue of "connectivity." I am referring not just to the fact that some people, or segments of society, are connected to the Internet and the latest in high-tech communications, while others are not. The problem is that some people are connected to the global economy, enjoying the immense opportunities of globalization—higher investment, job creation, and growth—while others are not.

Not surprisingly, the "disconnected" happen to be the world's poor, who lack access to basic social services, essential infrastructure, and income and employment opportunities, as well as to the web. Being disconnected bears an ever-growing cost of isolation and marginalization, at a time when there is already a growing gap between the rich and the poor within and among nations. What can the UN family—in particular, the IMF—do to help integrate all countries into our increasingly globalized economy? I would like to explore this question in my remarks today.

A brighter world economic outlook

The encouraging news is that the global economy has recovered remarkably quickly from the financial crises of 1997–98. After two years of slowdown, world growth should be around 4½ percent this year—the highest since 1988—and continue at close to this pace next year. Most of the emerging market countries that experienced crises are enjoying impressive growth, reflecting in part resolute action by policymakers to stick to adjustment and reform efforts, although much remains to be done. Other developing countries, as well as a number of economies in transition, are also contributing to the pickup.

Even so, we cannot afford to be complacent. Three key concerns come to mind: (1) Are we doing enough to ensure a gradual rebalancing of global growth among the principal currency areas—the United States, where growth remains strong; Japan, where a fragile recovery from recession is under way; and Europe, where recovery from a period of weakness is on track? (2) Are the values of the key currencies in line with their medium-term fundamentals, notably the euro against the dollar? (3) Are we doing enough to ensure that any needed adjustments in financial markets occur in as orderly a manner as possible?

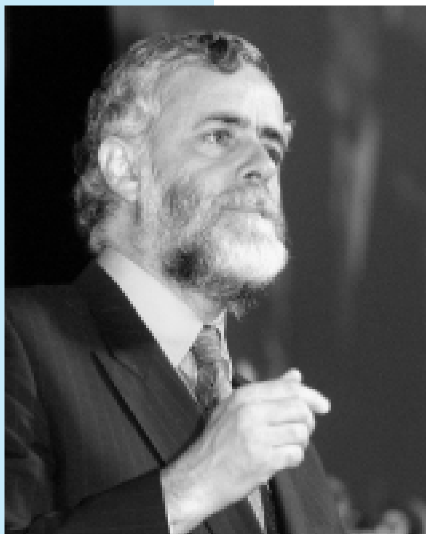
At the ECOSOC meeting (from left, front row): Mike Moore, Director-General, World Trade Organization; James Wolfensohn, President, World Bank; Lawrence H. Summers, U.S. Secretary of the Treasury; Louise Frechette, UN Deputy Secretary-General; Ambassador Makarim Wibisono of Indonesia, President of ECOSOC; Margaret Ann Kelley, Council Secretary; Ruben Ricupero, Secretary-General, UNCTAD; Eduardo Aninat, Deputy Managing Director, IMF; and Patrizio M. Civili, UN Assistant Secretary-General, Department of Economic and Social Affairs.

It is more urgent than ever that we secure a smooth transition to a more balanced pattern of global growth. In the United States, this means containing excess demand pressures, being careful not to loosen the fiscal stance unduly. In Japan and Europe, it means tackling structural rigidities, including intelligent deregulation of key sectors. In Latin America, it means continuing to reduce fiscal deficits to build investor confidence and contain the risks associated with high external financing requirements. In Asia, it means persevering with bank and corporate restructuring. In Africa, it means stepping up economic and institutional reforms to broaden the economic base and create a welcoming atmosphere for the private sector.

A safer global economic environment

The world economy is basically in good shape, giving us a much-needed opportunity to step up our efforts to spread the benefits of globalization to the disconnected. Globalization is not a recent phenomenon. But what is different is the enormous impact that new information technologies are having on market integration, efficiency, and industrial organization, as well as on human capital development. These new technologies help boost efficiency and growth by reducing information and transaction costs. Reducing these costs tends to lower barriers to entry, increase competition, and contribute to higher investment. Higher market efficiency, and the structural change in the ways businesses operate, represents a positive supply shock that could lead to a quantum shift in overall productivity. Advances in information processing, financial innovation, and financial liberalization have also unleashed a dramatic expansion in domestic and international financial flows, even after accounting for recent crises. Overall, capital flows have become more important than trade flows in determining the short-term evolution of exchange rates. However, a major drawback is that many of these flows have been highly

volatile. Until a few years ago, when crises erupted, they were mainly rooted in macroeconomic disequilibria and associated with current account imbalances. But now crises increasingly originate in the capital account and are associated with weaknesses in the domestic financial sectors. The absence of complete or timely information on the extent of foreign currency exposures—especially short-term debt—made it difficult to detect emerging vulnerabilities and design appropriate policy responses.



Aninat: New information technologies are having an enormous impact on market integration, efficiency, industrial organization, and human capital development.

So what can be done to create a safer global economic environment? Policymakers in developed and developing countries should tackle the critical structural adjustments that in too many cases have been delayed. The IMF should strengthen its focus on its core activities—macroeconomic stability; monetary, fiscal, and exchange rate policies; and financial sector issues—and step up its work with its development partners in other areas, mainly the social realm. In the past year, the IMF, working closely with the international community, has explored ways to better prevent crises and better manage those that inevitably do occur—what is often referred to as strengthening the international financial architecture. We have also continued to explore ways to make the institution more focused and more effective, seriously weighing the many reform recommendations being made by governments and task forces. We are listening and carefully assessing the possible avenues of reform.

In many areas, progress has been made in promoting transparency and accountability, developing internationally recognized standards and codes, strengthening domestic financial systems, increasing the capacity to assess countries' external vulnerability, and carrying forward the debate over the choice of exchange rate regimes. Let me elaborate. First, the IMF has been beefing up its surveillance of national economic developments and policies, especially *financial system stability issues.* One innovative initiative is the Financial Sector Assessment Program, begun last year as a pilot project with the World Bank. Drawing on a large and expanding number of cooperating institutions, it aims to identify strengths and vulnerabilities, assess the observance of financial sector standards, and help countries identify and sequence necessary financial sector reforms.

Second, countries and market participants need guideposts for health checks of financial systems and economies in general, and the international community has been working on establishing *international standards and codes of good practice.* The IMF now has standards for data dissemination and codes of good practice for the transparency of fiscal, monetary, and financial policies. Other agencies have developed, or are developing, standards for banking supervision and regulation, securities and insurance regulation, payment and settlement systems, accounting and auditing, corporate governance, and insolvency regimes.

IMF Executive Board establishes working group to review selection process of Managing Director

The IMF announced in a press release issued on July 7 that the IMF Executive Board has established a Working Group to Review the Process for Selection of the Managing Director. The full text of Press Release No. 00/40 is available on the IMF's website (www.imf.org).

The working group will review the IMF's experience with the nomination, selection, and appointment of the Managing Director and will make recommendations on possible improvements to the selection process. The working group intends to provide a report to Executive Directors in time for the Executive Board to report to the International Monetary and Financial Committee for its September 2000 meeting.

The working group will cooperate with the World Bank Executive Board's Working Group to Review the Process for Selection of the President, whose establishment is also being announced today.

The members of the working group (and their constituencies) are IMF Executive Directors:

- Thomas Bernes (Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines)
- Agustín Carstens (Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Spain, and Venezuela)
- Bernd Esdar (Germany)
- José Pedro de Morais, Jr. (Angola, Botswana, Burundi, Eritrea, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, South Africa, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe)
- Aleksei Mozhin (Russia)
- Shakour Shaalan (Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Maldives, Oman, Qatar, Syrian Arab Republic, United Arab Emirates, and Republic of Yemen)
- Gregory Taylor (Australia, Kiribati, Korea, Marshall Islands, Federated States of Micronesia, Mongolia, New Zealand, Palau, Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands, and Vanuatu)
- Yukio Yoshimura, Chairman (Japan)

Third, the IMF has been releasing more information than ever as part of its commitment to greater *transparency and accountability,* both for itself and for its member countries. We firmly believe that timely and detailed information can prevent the accumulation of problems by forcing governments to take appropriate measures at the right time. We also firmly believe that better information and standards should benefit the poor countries as well as the rich ones.

Here, the theme of your conference ties in strongly, for the advances in information technology have revolutionized communications. Until about 15 years ago, the IMF was the major, if not the only, source of information on the economies of many countries. It was our job to develop and store information and make it compatible through time and across countries. Increasingly, our activities have shifted toward setting standards and codes for the information that countries themselves gather.

In other areas of reform, the bulk of our work is still ahead—in particular, the role of the private sector in preventing and resolving crises—but some principles are emerging. IMF Managing Director Horst Köhler favors "constructive engagement"—cooperation among the borrowing countries, the private sector, and the official international sector—in good times as well as in crises.

The IMF, working closely with the World Bank, the UN, and other partners, will continue to place a high priority on poverty reduction. We now better understand the complex links between growth and poverty. We have long known that sound macroeconomic policies favor growth and that sound macroeconomic policies and growth-enhancing structural reforms favor the poor, since growth is the single most important source of poverty reduction as well as a key source of sustained financing for social outlays. But there is now greater acceptance that causation also runs in the other direction. Poverty reduction and social equity can help policies, such as investing in primary education and basic health, that boost the potential of the poor to contribute to output, speeding up economic growth itself.

This does not happen overnight. But it can happen in a reasonable period of time. I offer an example from my own country. In about a decade, poverty in Chile has fallen drastically in an environment of strong economic growth and gains in price stability—which led to real wage growth and the rapid expansion of employment. Social outlays were increased and carefully targeted, and protected and inefficient sectors opened up to competition and mobility.

What can we hope to achieve globally? At the UN summit in Copenhagen in 1995, countries pledged to reduce by half the proportion of people living in extreme poverty by 2015. This is an ambitious goal, and important progress has been made. However, while some regions, such as East Asia and the Pacific, are likely to meet these targets, others—including Africa and large segments of Latin America and the Caribbean—are far behind. Our best hope lies with the approach to poverty reduction endorsed by the international community last September. The main innovation is deriving programs from comprehensive strategies for poverty reduction drawn up by individual governments, with the

National Bank of Ukraine releases PricewaterhouseCoopers report

In a news brief dated July 10, the IMF announced that the National Bank of Ukraine (NBU) has released the second of three reports from a special examination by PricewaterhouseCoopers (PwC) of the NBU's foreign reserves management.

The report covers the period November 30, 1996 to July 31, 1997; the first report covered August 1, 1997 to January 31, 1998; and the third report will cover February 1, 1998 to September 30, 1998. The NBU commissioned the report at the request of the IMF staff following various reports that the NBU carried out a number of transactions that gave the impression that Ukraine's foreign exchange reserves were higher than was actually the case. The IMF has posted the PwC report on its website at www.imf.org, where it will remain for one month, as did the first report (see News Brief No. 00/26, May 4). At the requirement of PwC, the report is available in a read-only version.

The second PwC report discloses no transactions adversely affecting reserve levels other than the transactions detailed in the first report and is consistent with the IMF staff's understanding of Ukraine's use of its foreign exchange reserves described in News Brief Nos. 00/15, March 14, and 00/26, May 4.

The IMF views very seriously any misreporting arising from overstating the level of reserves. The IMF's Executive Board in the next few weeks will decide whether Ukraine, by misreporting the level of its reserves in the periods covered by the first two PwC reports, breached its obligation to provide the IMF with accurate information under the IMF's Articles of Agreement or obtained disbursements under an IMF arrangement that it would not otherwise have received. Once a final determination on misreporting is made, the Executive Board will decide what remedial actions may be appropriate.

The third stage of the PwC special examination, which is not expected to raise additional issues, will be completed in August 2000, and it will also be published.

The full text of all the news briefs mentioned in this article, including News Brief No. 00/53, is available on the IMF's website (www.imf.org).

involvement of a broad range of stakeholders, including civil society and the donor community. The emphasis is on ownership, transparency, good governance, and accountability.

This is a *collaborative effort*, with the countries concerned in the driver's seat, and each partner playing a vital but specialized role. The World Bank, along with the regional development banks and UN agencies, takes the lead in discussions with authorities on the design of policies aimed at poverty reduction, including social safety nets to protect the poor and vulnerable. The IMF supports economic policies that provide an environment conducive to sustainable, inclusive growth.

Stepped-up debt relief

Another important component of this new approach is an enhanced debt initiative to give the world's heavily indebted poor countries deeper, faster, and broader debt relief. We are now talking about 36 countries, mostly in Africa, instead of the original 29. It should result in a reduction of their external debt burdens, in aggregate, by nearly two-thirds.

Why isn't the debt relief process going faster? Are the IMF and World Bank insisting on rigid or unreasonable conditions? In some of the early cases, we are prevented from going faster because of armed conflict, civil unrest, governance issues, and major slippages in economic, social, and structural programs. This initiative can contribute to poverty reduction and growth only if conditions are in place to use the additional resources effectively and to support the country's development agenda.

The IMF and the World Bank are committed to doing everything possible to speed up the process. We have recently established a Joint Implementation Committee to oversee the timely and effective delivery of these programs. However, more generous debt relief brings with it higher financing requirements—about $14 billion in 1999 net present value terms for multilateral creditors. There is still a financing gap—excluding the IMF and the World Bank—of around $5.5 billion. It is essential that the developed countries fulfill their stated commitments.

Let us seize the immense opportunities afforded to us by the more stable economic environment and current economic calm. We must tackle head-on the more intractable areas of reform that are so critical in an era of globalized markets. Ultimately, our goals are higher living standards, the elimination of poverty, and shared global prosperity. To accomplish these goals, we must ensure that all nations are fully connected to the global economy. ■

Available on the web (www.imf.org)

Press Releases

00/38: IMF Approves Third Annual Poverty Reduction and Growth Facility for Albania, June 30

00/39: IMF Approves Stand-By Credit for Panama, June 30

00/40: IMF Executive Board Establishes a Working Group to Review the Process for Selection of the Managing Director, July 7 (see page 228)

00:41: IMF and World Bank Support Debt Relief for Honduras, July 10

00/42: Burkina Faso Qualifies for HIPC Debt Relief Totaling $700 Million, July 11

News Briefs

00/50: IMF Completes Estonia Review, June 30

00/51: IMF Completes Latvia Review, June 30

00/52: IMF Completes Second Turkey Review and Approves $295 Million Credit, July 6 (see page 234)

00/53: Release of PricewaterhouseCoopers Report on the National Bank of Ukraine, July 10 (see page 229)

00/54: IMF Completes First Review of Burkina Faso Under PRGF-Supported Program and Approves $7.4 Million Disbursement, July 11

00/55: IMF's Aninat Welcomes Mexico's Financial Strengthening Program 2000–2001, July 11

Public Information Notices (PINs)

00/46: Singapore, June 30

00/47: India, June 30

00/48: Latvia, July 11

00/49: Estonia, July 11

Speeches

An address by Eduardo Aninat at the High-Level Meeting of the UN Economic and Social Council in New York on July 5 (see page 227)

Letters of Intent and Memorandums of Economic and Financial Policies (date posted)

Madagascar, July 7

Latvia, July 7

Turkey, July 10

Concluding Remarks for Article IV Consultations (date posted)

Germany, July 6

Report on the Observance of Standards

Canada, July 6

Other

IMF Financial Activities—Update, July 7

IMF Staff Statement at the Donors' Meeting on East Timor, July 5

IMF Financial Activities—Update, June 30

Schedule of Public Engagements of IMF Management, June 30

Political constraints need to be taken into account in design of transition strategy

The transition from socialism to capitalism, and the comprehensive transformation of the economic institutions of the countries concerned, is surely one of the most important economic events of the twentieth century. According to Gérard Roland of the Free University of Brussels, speaking at an IMF Institute seminar on July 6–7, future economic historians will probably remember the twentieth century for the contest that took place between the socialist and the capitalist economic systems.

The large-scale institutional changes that transition requires are among the most complex economic and social processes one can imagine, Roland said, but because the collapse of central planning in many countries was sudden and unexpected, no theories or empirically tested models for dealing with transition existed to which policymakers and strategists could turn for guidance. Given these complexities and the important stakes for hundreds of millions of people, economists cannot claim to know the right answers. The experience in policy advice to transition countries, Roland acknowledged, has been "particularly humbling." It is important, he said, that research on transition issues be collated and systematized for the benefit of policymakers in transition countries as well as for the insights such research can provide to the study of economics at large.

Roland devoted the first part of the seminar to the political economy of reforms. The second part focused on the role of soft budget constraints (see box, pages 232–33).

Political constraints

Transition is an economy-wide process involving winners and losers. Thus, even if aggregate welfare is enhanced, political constraints are of crucial importance. These constraints, Roland said, have played an important role in the transition process in many countries, influencing both the design and the implementation of policy and affecting its outcome as well. Privatization strategies, for example, have differed markedly, depending on the political situation. In the Czech Republic, privatization was undertaken quickly, the object being to distribute assets and put ownership into the hands of outsiders as quickly as possible, leaving the new owners to undertake the necessary restructuring. In Russia, assets and ownership of privatized state enterprises were merely redistributed among the insiders, who were too strong a faction to oust.

Do political constraints matter? Some analysts have suggested that the efficiency gains from a reform program could be used to compensate the losers. If everyone is convinced that the outcome of a full-steam-ahead reform will be positive, then no one will attempt to derail or delay the reform. In this case, political constraints should not affect the speed and sequencing of reforms, only the level of compensation. The main flaw in the theory of compensation from efficiency gains, Roland noted, is that uncertainty about the outcome—either individual or aggregate—can lead to strong resistance from potential losers that may stall or subvert the reform process. In actual experience, political constraints appear to have played a major role in the transition process. In Russia, for example, the Duma has blocked stabilization plans, and continued stalemate over key issues of reform has been a characteristic of reform politics. In all transition countries, political constraints have also played an important part in blocking parts of the restructuring process—for example, drastic cuts in state-owned enterprises and heavy worker resistance

Gérard Roland addresses an IMF Institute seminar.

IMF launches Data Quality Reference Site

In recent years, the IMF has intensified its efforts to help countries improve the quality of their data. The establishment of a Data Quality Reference Site on the IMF's Dissemination Standards Bulletin Board (http://dsbb.imf.org) complements earlier work by the IMF's Statistics Department on statistical methodologies and technical assistance and training activities, and the IMF's data standards initiatives—-the Special Data Dissemination Standard and the General Data Dissemination System.

The main objective of the Data Quality Reference Site is to foster a common understanding of data quality. Drawing on contributions from the statistical community, the site introduces definitions of data quality, describes trade-offs among elements of data quality, and gives examples of evaluations of data quality. The reference site offers direct access to papers by experts within the statistical community and includes a basic bibliography on data quality issues. New articles and information are posted from time to time and are flagged to alert users to what's new. A comments box is provided on the site, and users are encouraged to use the box to e-mail their views to the IMF about the site.

to closing inefficient state enterprises. For this reason, Roland said, political constraints do matter.

Ex ante and ex post political constraints

Resistance to reform can block decision making before a reform is implemented (ex ante political constraint), Roland said, or act as backlash after decisions have been made and outcomes observed, leading to pressure for reversals (ex post political constraints). Reformists need to deal with each type of constraint differently. Ex ante constraints imply either that compromises must be made on reform plans, that credible compensation for losers must be devised, or that decisions on radical programs must be delayed. Ex post political constraints require that irreversibility be built into the reform process.

Roland: Depending on the level of uncertainty about the proposed reform or its outcome, the status quo bias can block reform.

A built-in "status quo bias" operates in the case of both ex ante and ex post constraints, Roland noted. Depending on the level of uncertainty about the proposed reform or its outcome, this bias can effectively block reform. Successful reforms must, therefore, satisfy both ex ante and ex post constraints.

Big bang or gradualism?

Because of the status quo bias, policymakers are likely to face resistance to reform, either from certain segments of the population (that is, the potential losers) or, more universally, as in the case of aggregate uncertainty. A gradualist approach—say, when one reform is proposed first and a second reform is proposed one period later—may simply give rise to what Roland termed an interim status quo bias. When this happens, vested interests (the losers) can block the reform process.

In this situation, Roland said, the "big bang" approach—when both reforms are proposed simultaneously—may be preferable. Under the big bang, the choice is narrowed down to maintaining the status quo (that is, not proceeding) or moving ahead with both reforms. In the face of individual uncertainty, the cost of reversal under a big bang strategy may be high enough to deter policy reversals, thus making this strategy preferable to gradualism.

Gradualism has one option that the big bang lacks, however, especially in the face of aggregate uncertainty. It can foster experimentation—that is, it allows for a period during which partial lessons about the viability of reform outcomes can be learned—and it holds out the possibility of early reversal of the first reform if the prospects for full reform look bad enough. This option of early reversal may make it easier for policymakers to start the reform process.

There is thus a trade-off between big bang and gradualist strategies. In general, it is the low reversal costs under gradualism that make this strategy more

Causes of soft budget constraints need further investigation

In the two decades since János Kornai first coined the phrase, soft budget constraints have entered the lexicon of mainstream economics. Soft budget constraints, as Gérard Roland noted, are frequently identified with moral hazard, confused with the absence of budget constraints, and thought to be synonymous with subsidies. They are not, however, a form of insurance or guarantee (the types of activities most associated with moral hazard). They are, Roland explained, an ex ante—but crucially not an ex post—budget constraint that may ultimately take the form of a subsidy but is not planned as a subsidy.

Countries may pledge never to bail out troubled firms or projects, but their resolve often falters in the face of serious problems. These ex post changes of heart are at the core of soft budget constraints, which Roland defined as a "dynamic commitment problem" triggered by specific institutional environments. Soft budget constraints may persist even when not desired, and steps, such as privatization, that should harden budget constraints may not do so in all circumstances. Generally, he found, conditions in socialist and transition economies tend to soften budget constraints, while characteristics of market economies, notably competition, tend to harden budget commitments. But, he added, as the Chrysler bailout or the resolution of the U.S. savings and loan crisis demonstrated, soft budget constraints can occur in market as well as socialist or transition economies.

Soft budget constraints in socialist economies

The key question in comparing hard and soft budget constraints in market and socialist economies, Roland said, is how poorly performing projects and firms are dealt with and whether institutional arrangements tend to encourage or discourage better-quality projects, increased effort, and innovation. An organization or government faced with poorly performing projects or firms has two options: refinance or liquidate. What distinguishes the socialist decision-making process from the private sector one is the degree to which it factors in social welfare (such as the benefits of keeping workers employed). Social benefits often tip the balance in favor of refinancing, leading to an ex post optimal decision in socialist economies that would, Roland said, be considered absolutely inefficient from an ex ante perspective.

Cumulative resource constraints make it infeasible to bail out all firms, but, Roland explained, the stage is set for a transfer from strong performers to weaker ones. This penalization of good performers may partially explain the relative lack of innovation in socialist economies. Previous research, he observed, demonstrated that soft budget constraints led socialist economies to downplay lessons learned from experi-

initially attractive or acceptable than the status quo. The high reversal costs under the big bang approach, however, may make this strategy more advantageous from the point of view of ex ante political constraints, because it reduces the reversibility of enacted reforms. Thus, Roland suggested, reformist politicians will use any window of opportunity to get big bang packages through to create irreversibility.

However, irreversibility under these windows of opportunity can sometimes be more of a curse than a blessing, Roland noted. With high reversal costs of reform, policymakers may get stuck in an economically inefficient situation, whereas lower reversal costs would allow them to undo a reform that has proved unsuccessful and then try something else in its place.

Sequencing and complementarities

Complementarities between reforms are particularly important in the sequencing of reforms in the gradualist approach, Roland said. For example, a first reform might be to develop a small private sector, while a complementary reform might be to reform the state sector. Together, both reforms will create entry and competition and increase output supply as well as allocative efficiency. However, the development of the small private sector without a reform in the state sector may lead to an inefficient diversion of inputs from the state sector if the private sector can bid up prices for inputs and the state-owned enterprises are not allowed to do so. This inefficient diversion may include collapses of production chains in the state sector and create a situation that is worse for social welfare than the status quo.

Thus, Roland suggested, correct sequencing can exploit the complementarities between reforms to create momentum effects and build constituencies for further reforms. While experimentation under gradualism can make proposed reforms more acceptable, without complementarities, partial reforms are unsustainable in the long run, forcing politicians either to go ahead with further reforms or to go backward.

Conclusion

In transition strategy, Roland said, uncertainty needs to be taken into any consideration of a reform program, because, as experience has shown, the efficiency gains from reform are not virtually certain in the medium run. One should always be cautious, he warned, when drawing policy recommendations from theoretical models. It is especially damaging for the reputation of the economics profession as a whole—and even more for the populations of the countries concerned—when economists present reform blueprints promising sure efficiency gains, and then the opposite materializes, he said. Unilaterally emphasizing the irreversibility created by reforms may be misleading and damaging in social welfare terms when uncertainty is important, as it virtually always is in the transition context. The theory of reform under uncertainty thus emphasizes the importance of experimentation, trial and error, and pragmatism. ■

ence (little energy was expended, in fact, on screening results) and to overemphasize the prescreening process. This reliance on prescreening tended to discourage the type of risk taking, accidental discovery, and learning from experience that fueled innovation.

Research has also suggested that shortages in an economy tended to curb soft budget constraints by lowering the perceived benefits of refinancing poorly performing operations, according to Roland. More curiously, price liberalization increased soft budget constraints—at least in the short run—because state-owned firms competed with consumers for scarce resources—driving up prices and crowding out consumers—while performing worse and worse.

Increased enterprise autonomy in a socialist economy could also exacerbate moral hazard issues. In enterprises where there was little hope of boosting profits, reduced state monitoring simply encouraged a drop in effort and an increase in soft budget constraints.

Private ownership and banking

For the private sector, returns on investment are the sole concern. Roland found that when social welfare ceased to be a primary objective in an economy, budget constraints hardened.

Increased competition and demonopolization provided a key impetus toward harder budget constraints. In this regard, Roland was critical of early transition policies that favored privatization schemes but neglected competition.

Greater competition helps to harden budget constraints by reducing returns to investments (which stimulates greater attention to the bottom line) and by improving the quality of projects (fewer poor-quality projects are submitted and few poor performers are bailed out), Roland said. Increased entry of new firms, greater competition, and larger excess capacity all contribute to harder budget constraints.

Decentralized banking and credit were also essential if budget constraints were to harden. Roland contrasted the sharply divergent experiences of Korea and Taiwan Province of China during the Asian crisis. Korea, with its centralized financial system and soft budget constraints, fared far worse than did Taiwan Province of China, whose decentralized financial system and hard budget constraints seemed to shield it from the worst of the regional tumult. Decentralized financial systems also seem better able to mobilize resources to underwrite innovative sectors.

Ultimately, Roland concluded, soft budget constraints represent a specific incentive problem in socialist and transition economies. A great deal more empirical analysis needs to be done to develop a fuller understanding of how institutional factors affect the hardness or softness of budget constraints.

Program on track

IMF completes second review under Stand-By credit for Turkey, releases $295 million

The IMF Executive Board announced in a news brief issued on July 6 that it has completed the second review under the Stand-By credit for Turkey. The full text of News Brief 00/52 is available on the IMF's website (www.imf.org).

Istanbul's Blue Mosque

The review was completed in light of the observance of end-March performance criteria, among other things, and the judgment of the IMF that the program remains on track. As a result of the review, Turkey will be able to draw up to the equivalent of SDR 221.7 million (about $295 million) from the IMF (see page 236).

The three-year Stand-By Arrangement was approved on December 22, 1999, in a total amount equivalent to SDR 2.9 billion (about $3.9 billion). Turkey has so far drawn the equivalent of SDR 443.4 million (about $590 million) under the Stand-By Arrangement.

Commenting on the Board discussion, IMF First Deputy Managing Director Stanley Fischer said, "The Executive Board of the IMF commended the Turkish authorities on their steadfast implementation of the disinflation and fiscal adjustment program launched in late 1999, which led to a rapid deceleration of inflation and a resumption of economic growth.

"Strong fiscal performance in the first half of 2000 has underpinned the improvement in macroeconomic conditions. Despite stronger-than-expected revenues and a faster-than-anticipated drop in interest rates, expenditure policies were not relaxed. The authorities' commitment to keep nominal primary expenditures in line with the program for the rest of 2000 will likely result in a primary fiscal surplus higher than that envisaged by the original program target for 2000.

"Inflation, while still high, has declined to its lowest level since 1986. Also, partly reflecting the increase in oil prices and the accelerated restocking of raw materials and intermediate goods, imports picked up significantly in the first four months of 2000. To ensure the attainment of the end-year inflation target, as well as to minimize risks to the external accounts, the authorities have appropriately committed themselves to strengthening the macroeconomic framework through firm fiscal policy implementation, particularly in the area of primary expenditure, as indicated above. They also stand ready to introduce additional fiscal measures if warranted by macroeconomic developments. The continued strict implementation of the program should help minimize any latent risks to both inflation and the external balance.

"A key contribution to the further fall in inflation will continue to come from rigorous implementation of the monetary and exchange rate framework introduced in early 2000. Specifically, the execution of the no-sterilization rule has provided additional credibility to the program. However, an early decision on the monetary framework that will, over the medium term, replace the existing one, as envisaged in the program, would help sustain credibility and further reduce long-term interest rates.

"Progress in the area of structural reform has continued, albeit with some delays. The recent approval of the law on agricultural state cooperatives and the decision to increase wheat prices in line with program

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
July 3	4.39	4.39	5.09
July 10	4.49	4.49	5.20

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 (as of May 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (115.9 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 or check the IMF website (www.imf.org/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

Members' use of IMF credit

(million SDRs)

	June 2000	January–June 2000	January–June 1999
General Resources Account	**420.55**	**1,967.09**	**6,105.39**
Stand-By Arrangements	86.76	1,320.99	4,309.07
SRF	0.00	0.00	3,636.09
EFF	333.80	646.10	1,129.70
CFF	0.00	0.00	666.62
PRGF[1]	**40.70**	**148.47**	**413.20**
Total	**461.25**	**2,115.56**	**6,518.59**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.
[1]Formerly ESAF—the Enhanced Structural Adjustment Facility.

Data: IMF Treasurer's Department

commitments are key steps in reforming agricultural policies. The privatization program has remained on track and, with some delay, the privatization of Turk Telecom has now been launched. Efforts to accelerate the privatization process are needed. Progress in making the Bank Supervision and Regulation Agency operational ahead of the end-August program deadline is welcome. The Turkish authorities are encouraged to proceed speedily to the restructuring and eventual privatization of the banks taken over by the Saving Deposit Insurance Fund. In addition, the structural component of the program has been reinforced by the authorities' commitments under the Economic Reform Loan recently approved by the World Bank.

"The authorities have completed a fiscal transparency Report on the Observance of Standards and Codes, and the Board welcomed their intention to publish it," Fischer said. ■

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By			**42,920.43**	**16,914.99**
Argentina	March 10, 2000	March 9, 2003	5,398.61	5,398.61
Bosnia and Herzegovina	May 29, 1998	March 31, 2001	94.42	30.15
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	141.73
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,087.50
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Mexico	July 7, 1999	November 30, 2000	3,103.00	1,163.50
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	75.54
Philippines	April 1, 1998	July 31, 2000	1,020.79	475.13
Romania	August 5, 1999	February 28, 20001	400.00	260.25
Russia	July 28, 1999	December 27, 2000	3,300.00	2,828.57
Turkey	December 22, 1999	December 21, 2002	2,892.00	2,448.56
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Zimbabwe	August 2, 1999	October 1, 2000	141.36	116.62
EFF			**9,543.37**	**7,696.26**
Bulgaria	September 25, 1998	September 24, 2001	627.62	209.22
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2002	3,638.00	3,096.50
Jordan	April 15, 1999	April 14, 2002	127.88	106.56
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Pakistan	October 20, 1997	October 19, 2000	454.92	341.18
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	September 3, 2001	1,919.95	1,207.80
Yemen	October 29, 1997	March 1, 2001	105.90	65.90
PRGF			**3,516.41**	**1,976.28**
Albania	May 13, 1998	May 12, 2001	45.04	11.76
Benin	August 28, 1996	August 26, 2000	27.18	10.87
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	33.53
Cambodia	October 22, 1999	October 21, 2002	58.50	50.14
Cameroon	August 20, 1997	August 19, 2000	162.12	18.02
Central African Republic	July 20, 1998	July 19, 2001	49.44	32.96
Chad	January 7, 2000	January 7, 2003	36.40	31.20
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	16.36
The Gambia	June 29, 1998	June 28, 2001	20.61	13.74
Ghana	May 3, 1999	May 2, 2002	155.00	110.70
Guinea	January 13, 1997	December 20, 2000	70.80	15.73
Guyana	July 15, 1998	July 14, 2001	53.76	35.84
Honduras	March 26, 1999	March 25, 2002	156.75	80.75
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	38.23
Madagascar	November 27, 1996	July 27, 2000	81.36	40.68
Mali	August 6, 1999	August 5, 2002	46.65	39.90
Mauritania	July 21, 1999	July 20, 2002	42.49	30.35
Mongolia	July 30, 1997	July 29, 2000	33.39	15.95
Mozambique	June 28, 1999	June 27, 2002	87.20	42.00
Nicaragua	March 18, 1998	March 17, 2001	148.96	53.82
Pakistan	October 20, 1997	October 19, 2000	682.38	417.01
Rwanda	June 24, 1998	June 23, 2001	71.40	38.08
São Tomé & Príncipe	April 28, 2000	April 28, 2003	6.66	5.71
Senegal	April 20, 1998	April 19, 2001	107.01	42.80
Tajikistan	June 24, 1998	June 23, 2001	100.30	40.02
Tanzania	March 31, 2000	March 30, 2003	135.00	115.00
Uganda	November 10, 1997	November 9, 2000	100.43	17.85
Yemen	October 29, 1997	October 28, 2000	264.75	114.75
Zambia	March 25, 1999	March 24, 2002	254.45	244.45
Total			**55,980.21**	**26,587.53**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Treasurer's Department

Extended Fund Facility Arrangements are designed to rectify balance of payments problems that stem from structural problems.

IMF support

Turkey's disinflation program has positive impact, including fall in interest rates, gains in equities

Turkey introduced a disinflation program in December 1999, supported by an IMF Stand-By Arrangement of about $3.9 billion. The following description of Turkey's program is based on a report included in the May 2000 World Economic Outlook *and updated to reflect more recent developments.*

Macroeconomic instability—characterized by chronic inflation, wide swings in output, volatile interest rates, and persistent fiscal imbalances—has been the norm for the Turkish economy during the past two decades. The country launched five disinflation programs during the 1990s, but these were ineffective in lowering the inflation rate, which averaged over 80 percent over the period. As a result, Turkey has been a striking exception to the disinflation trends observed worldwide since the 1970s.

The ultimate cause of chronic high inflation in Turkey has been the existence of deep structural weaknesses in public sector finances. Opaque indirect agricultural support policies, other nontransparent fiscal and nonfiscal activities by budgetary and nonbudgetary funds and state enterprises, and credit subsidies through state banks have contributed to substantial primary deficits. These deficits have persisted since the 1970s and have been consistently monetized to alleviate the government's budget constraint. As the inflation tax base eroded, however, the same level of money creation extracted lower amounts of seigniorage and provided further upward pressure on prices. Inflation was also sustained by a strong expectational component, which impeded the success of the disinflation programs of the 1990s. In particular, in the programs implemented in 1994–95 and 1998, the fiscal primary position strengthened significantly, and inflation performance also improved, but nominal interest rates failed to come down as envisaged. This was partly because financial markets remained worried about the sustainability of the situation, especially in the light of the crises in Asia and many other emerging market countries in 1997–98. The end result was sizable increases in real interest rates from already very high levels, thus undermining the authorities' resolve to continue disinflation.

Design of program

The new disinflation program supported by the Stand-By Arrangement approved by the IMF Board on December 22, 1999 (see *IMF Survey*, January 10, page 14) was designed to address up front the credibility of the disinflation effort. To this end, the program rests on three pillars: a large front-loaded fiscal adjustment; a strong exchange rate commitment underwritten by a no-sterilization monetary policy rule and income policies; and a wide range of upfront structural reform measures. This is expected both to stabilize the fiscal situation and to bring inflation down from 65 percent at the end of 1999 to 25 percent by the end of 2000, and to single digits by the end of 2002.

The front-loaded fiscal adjustment is necessary because fiscal weakness is at the root of the inflationary process. A shift in the primary position of the fiscal sector to long-term fiscal sustainability is to be undertaken in the first year of the program. In particular, the primary balance of the public sector is expected to improve from a deficit of 2.7 percent of GNP in 1999 to a surplus of 2.2 percent of GNP in 2000. The achievement of these fiscal goals will be facilitated by the tax package approved by parliament in late November 1999 (the package includes important adjustments in a wide range of both indirect and direct taxes), as well as by additional revenue-boosting and expenditure-cutting measures included in the 2000 budget prior to its approval in late 1999.

The nominal anchor—absent in earlier programs—will be provided by a forward-looking commitment on the exchange rate. The authorities chose a nominal exchange rate anchor because of the high visibility and strong effect on prices that the exchange rate has in Turkey, the difficulty of finding suitable alternatives (money demand appears unstable), and the need to facilitate a rapid decline in interest rates. The exchange rate commitment (12-month-forward devaluation rate; 20 percent for 2000 and updated after every quarter) is supported by strong fiscal adjustment and consistent income policies in the government sector (civil servant and minimum wages will rise only in line with targeted inflation). In addition, the conduct of monetary policy will be guided by a rule whereby base money will be created only through changes in the net foreign assets of the central bank (apart from short-term fluctuations). Finally, to avoid being locked in this rigid monetary framework beyond the disinflation stage, the authorities have incorporated a preannounced exit strategy. A gradual shift into a more flexible exchange rate regime (with a widening symmetric band around the preannounced exchange path) will be introduced in mid-2001.

Structural reform

A comprehensive and front-loaded structural reform agenda, which is being supported by the World Bank,

will underpin the program. The agenda includes privatization, a restructuring and strengthening of the banking sector, an overhaul of financial support to agriculture, and pension reform. In addition, fiscal management and transparency will be strengthened, and tax policy and administration improved. The structural reform effort is also expected to generate efficiency gains; limit contingent claims on the government; and, through increased privatization receipts, stabilize the level of public debt.

A breakthrough pension reform was implemented in mid-summer 1999, which allows for a gradual but significant strengthening of the pension system. Additional changes in administration, coverage, compliance, and the legal framework (including legislative changes allowing for the creation of private pension funds) are expected to deepen these reforms in the coming years. In the agricultural area, the long-term goal is to replace existing indirect support policies with a direct income support system. In the interim, the government has taken several steps to contain the cost of the existing system, most notably by phasing out credit subsidies and reducing agricultural price support. As regards fiscal management and transparency, changes will be implemented to strengthen budget preparation, execution, and control, most notably through the implementation of an integrated financial system based on a single account and a general ledger. Fiscal transparency will be enhanced by broadening the effective coverage of the budget and by limiting the operations of quasi-fiscal entities. The tax system will be improved to provide for a broad revenue base with low and predictable tax rates.

Far-reaching reforms are also envisaged to address long-standing weaknesses of the banking sector. Legislation increasing the independence of supervisors and streamlining bank resolution procedures has already been passed, and a fully independent Banking Regulation and Supervision Agency has been created. Further changes in the regulatory framework—including the implementation of internationally accepted prudential regulations—are also an important part of the program. The program includes, in addition, measures to deal with the problems of the operations of state banks by increasing transparency and hardening the budget constraints facing their management. Finally, some commercial banks were taken over for restructuring by the deposit insurance fund at the inception of the program.

Privatization is another key area of reform. The government intends to sell large stakes in the telecommunications operator Turk Telecom and major state enterprises. This privatization program is expected to lead to significant efficiency gains in key sectors of the economy and to also generate sizable budgetary proceeds, which will help achieve the program's fiscal goals. Total receipts from these operations are expected to reach about $7½ billion (about 3½ percent of GNP) during the course of 2000. Attainment of this target has been facilitated by major revisions in the legislation regarding privatization, including a constitutional amendment to allow for international arbitration, a law changing the role of the State Council, a new energy law, and a new telecommunications law.

Results

Six months after its inception, the program has generated very positive results. The disinflation program has borne fruit early in the form of sharp declines in interest rates, with yields on government paper dropping from over 90 percent in November 1999, to about 33 percent in early July 2000. Economic activity is now picking up, after a strong decline in 1999, partially related to the effects of the Marmara earthquake. Inflation in January and February 2000 was higher than programmed but has decelerated considerably since then, and the target for the year remains within reach. Fiscal performance in the first quarter was strong, as government revenues were buoyant, exceeding program expectations by some 0.9 percent of GNP, thus allowing for meeting the primary surplus target under the program by a wide margin.

In parallel with the recovery of economic activity, and reflecting a sharp pickup in imports (because of the rise in international oil prices, among other reasons), the external current account deficit has widened significantly. To minimize the risks to the external accounts, the authorities have strengthened the macroeconomic framework during the second review of the program by committing to save any revenues in excess of the budget projections that will materialize in 2000 (fiscal overperformance is likely to be sizable) and by taking early commitments affecting the 2001 budget. They also stand ready to introduce additional fiscal measures, if warranted by macroeconomic developments. On the structural side, considerable progress has been made in the area of privatization, with deals amounting to $5 billion being concluded in the first half of 2000; also, the bidding process for Turk Telecom has now been launched. Furthermore, key changes have been introduced in the areas of agricultural policy (the removal of credit subsidies and the passage of the agricultural cooperatives law) and banking (appointment of the members of the new supervision agency and the introduction of new key prudential regulations). ■

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Interview

With the right incentives, deposit insurance can strengthen stability of financial system

A survey of the world's deposit insurance schemes, which relied heavily on the IMF's Monetary and Exchange Affairs Department (MAE) staff and country desk economists and resident representatives throughout the organization, provided the basis for Gillian Garcia's IMF Working Paper, Deposit Insurance and Crisis Management. *Garcia, a Technical Assistance Advisor in MAE, spoke with the* IMF Survey *about how a sound deposit insurance scheme can encourage responsible behavior among banks and their customers and help ensure the stability of the financial system.*

Garcia: "The public must believe the [deposit insurance] system is well funded; it must have confidence that the money will be there when needed. "

IMF Survey: What is deposit insurance? And why is it important?

Garcia: A deposit insurance system guarantees that small depositors will receive their funds if their banks fail. In a broader sense, however, a deposit insurance scheme also provides a crucial set of incentives for the financial system. If those incentives are right, wealthy depositors will discipline their banks, bankers will not gamble with others' money, borrowers will repay their loans, and politicians will resist interfering with sound regulation. If all this happens, you have better banks, faster economic growth, and greater financial stability. Of course, a deposit insurance system can also provide the wrong incentives and actually make things worse.

IMF Survey: What, broadly, are the objectives of deposit insurance?

Garcia: Different countries have different objectives, but the two most popular aims are to help stabilize the financial system and to protect the small, unsophisticated depositor. It's important to protect small depositors because you don't want them to get scared, line up outside banks, and be seen on television. That generates a panic among other depositors and politicians, who in turn do some bad and unnecessary things.

Small depositors really don't have the resources to monitor banks; monitoring is a complex and time-consuming task in a modern economy with derivatives and international transactions. Monitoring should be left to the large depositors—the people with the resources.

IMF Survey: What key elements should a country be mindful of in setting up a deposit insurance scheme?

Garcia: First of all, be realistic. Deposit insurance is no panacea. If you have a weak banking system, improve it before you put your deposit system in place. When you put the scheme in place is also important. Then, you want your system to be compulsory, explicit, and transparent. Once all of that is done, there will be room to fit the design to country circumstances.

The system should be compulsory because if weak banks fail and lose money, deposit insurance premiums will rise, and stronger banks will drop out. Gradually, the system will deteriorate. One country had exactly this experience. It started off with 140 members in its deposit insurance scheme and is now down to 6.

The deposit insurance scheme should also be written into the law. You want the public to know, clearly, what is covered and what is not. Otherwise, they can't protect their interests. And you want to publicize all of this. Your deposit insurance agency should have a logo and should do some advertising. It may, perhaps, publish a pamphlet that explains to the public just what the rules are.

IMF Survey: What role does public confidence play?

Garcia: It's crucial. If the public doesn't know about the deposit insurance scheme, or doesn't trust it, it's pretty useless. Part of that confidence, of course, depends upon the system's funding. The public must believe the system is well funded; it must have confidence that the money will be there when needed.

IMF Survey: How do country circumstances differ?

Garcia: Some countries, such as the United States, build a fund. That fund, collected from banks and thrifts, totals about $40 billion right now. Canada has a fund, but a small one. If one of its banks failed, Canada would borrow funds if more money were needed. Other countries, such as the United Kingdom, essentially don't have a fund. If a bank fails, the authorities say, "OK, surviving banks, chip in some money to pay the depositors."

The differences partly reflect the relative power of banks in these countries. A concentrated banking system with powerful bankers may want to be in charge of its deposit insurance scheme. Privately run schemes historically have had ex post funding. Very often, government-run schemes accumulate a lot of money, in part to protect the government. Without a pot of money on hand, depositors might well expect taxpayers to reimburse them.

IMF Survey: What pitfalls should a deposit insurance scheme be aware of?

Garcia: An overindulgent system creates moral hazard. If virtually everyone's entire deposits are covered, then no one keeps an eye on the condition of banks. You want to protect small depositors, but you want those in the private sector who are able to be vigilant to remain so. If large depositors see a bank taking on too risky a portfolio, they will move their money. That's a powerful means of disciplining the bank. You don't want to rely entirely on government regulation to make sure the banking system is sound. The private markets have a role—they have different sources of information and know different things from the regulators.

We touched earlier on the problem of stronger banks opting out of voluntary systems. Another concern is that in a system without adequate funding, regulators or supervisors may be tempted to keep a bank open longer than it should be. That gives the people in charge of the bank an opportunity to gamble for recovery. And as the U.S. saving and loan crisis showed, these gambles usually lose. The system simply becomes more insolvent—something we've seen in a number of countries around the world.

There is also the potential for tension between regulatory agencies that have somewhat different objectives. In a government-run system, the government deposit insurance system is an agent for both the depositors and the taxpayers. A proper balance has to be struck. There may be interagency conflicts—the lender of last resort may have a different agenda from that of the deposit insurance agency, and the minister of finance may have yet a third one. These different agencies must talk and not regard each other as enemies but as complementary parts of an overall safety net. But that's surprisingly difficult to do.

IMF Survey: How does the IMF counsel its member countries on deposit insurance systems?

Garcia: The IMF never goes into a country and says, "You don't have a system of deposit insurance. You need one." Rather, if a country comes to the IMF and says, "We've decided to create a deposit insurance system; how do we do it best?" the IMF staff will advise that the system should be compulsory, explicit, well funded, and transparent, which means the public and the supervisors must have good information.

And then the staff will consider country conditions—whether a deposit insurance system would be better funded ex post, whether it should be a private or a public system, and so on. The nature of the banking system also plays a part in this advice.

IMF Survey: How does a deposit insurance system treat foreign banks?

Garcia: Branches of foreign banks that take retail deposits are required to join the deposit insurance system. If they don't take retail deposits, they probably won't be allowed to join. Branches of domestic banks operating abroad are typically not part of a deposit insurance system. They would have to join the system in the host country. Virtually the only exceptions to this general rule are the countries of the European Union, which allow branches of foreign banks to be covered.

IMF Survey: How does a deposit insurance system deal with systemic problems?

Garcia: During the Asian crisis, a number of countries put on comprehensive guarantees. They believed the situation could escalate into the equivalent of the Great

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Depression, and they wanted to avoid that. A full guarantee is a last resort.

Indonesia, Japan, Korea, Malaysia, and Thailand all put on full guarantees; Hong Kong SAR, India, the Philippines, and Singapore did not. Elsewhere, Mexico put on full guarantees during its crisis; Argentina did not. Finland and Sweden did so in the early 1990s; Norway did not. Which crisis was worse than the other? It's a judgment call. Countries have to weigh the pluses and the minuses and figure out whether they can withstand both local and international pressures. If a country has good resources and is particularly worried about the severity of a crisis, it will probably opt for guarantees.

Garcia: "Countries should impose full guarantees only when they absolutely have to."

If a country decides to issue a full guarantee of deposits, it should be explicit, credibly funded—which means the government has to do so; bankers can not—and temporary to avoid the long-term moral hazard problem that arises if everyone is covered. In terms of timing, if you extend full guarantees before the public perceives there really is a crisis, you likely lose the opportunity to do it well and you exacerbate moral hazard. Countries should impose full guarantees only when they absolutely have to. Even so, the question of when you put on a full guarantee is less thorny than the question of when you take it off.

A number of Asian countries are now in the process of removing full guarantees. Mexico has said its full guarantee will be gone by 2004—it is phasing it out. Korea took one small step and plans to remove the remainder of the full guarantee by the end of the year. Japan announced when it put on the full guarantee that it would remove it in April 2001, but it has since postponed that to 2002. Premature removal risks a resurgence of payments problems, borrowers being unable to borrow, depositors running, foreign creditors pulling out their money, and panic. But the greater danger is leaving the full guarantee on too long.

There are no easy answers in terms of the right time to remove full guarantees. Basically, as an academic advised, "You take it off when it's not an issue anymore." You have to give the public plenty of notice—a couple of years. It's useful to set a deadline, even if you then have to move it back, as Japan has done. Everyone is on notice that the full guarantee is an emergency measure and will disappear. As to whether it is better to remove a full guarantee in one step or in phases, we don't know enough to say. Finland and Sweden took it off in one go. The two countries that are now phasing it out are the exceptions.

IMF SURVEY: What are the major outstanding issues now for deposit insurance?

GARCIA: Whether to have a fund or not, and if you have a fund, whether to have a large or a small one. One area that clearly needs substantial improvement is the speed with which the system pays depositors. Small depositors need their money pretty fast to pay for groceries and so on, but countries typically take months to pay. The U.S. Federal Deposit Insurance Corporation deals with the problem over the weekend, but that is very, very unusual. Most countries take much longer. They are looking for ways to accelerate payment, but a lot of legal systems make it very difficult to do that. They require the depositor to lodge a claim and show proof. ATMs may offer one means of providing quick payment, but you still have the problem of verifying the claim. Some countries rely on the bank's records and just feed this information into their deposit insurance program. But multiple accounts must be aggregated under the one depositor identity number. The bank's own recording information has to be very good—something that is costly for the banking industry. One of the challenges is for banks to modernize their systems sufficiently to make fast payments.

IMF Survey: What is deposit insurance's contribution to financial stability?

GARCIA: Bank supervision and regulation are very important for the health of the financial system, as are a judicious lender of last resort, the integrity of the government, the quality of the legal system, and the role of the press in monitoring bank performance. Deposit insurance is just one piece of the network that keeps a financial system prosperous and stable. But there is a degree of excitement among deposit insurance aficionados right now. Last fall, the Financial Stability Forum created a Working Group on Deposit Insurance. Deposit insurers are finally able to get together, as central bankers and bank supervisors have long been able to do. Now there seems to be more interest in, and a greater appreciation of, the role deposit insurance can play in the financial system safety net. If domestic safety nets are done well, international financial stability is strengthened. ■

Copies of IMF Working Paper No. 00/57, *Deposit Insurance and Crisis Management*, by Gillian Garcia, are available for $10.00 each from IMF Publication Services. See page 239 for ordering information.