

China Achieves “Soft Landing” Through Sustained Macro Stabilization

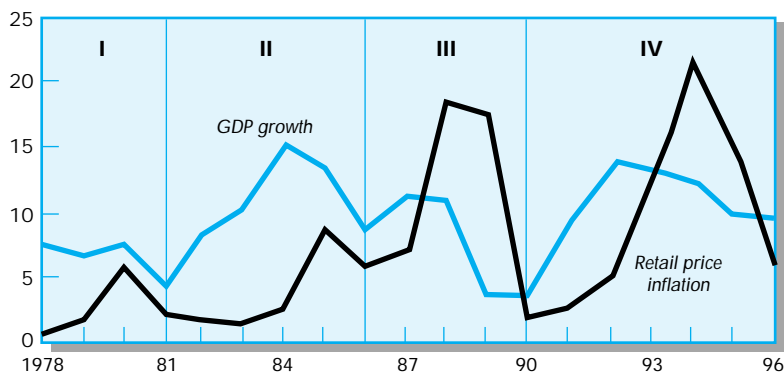
The following article is based on the recent Article IV discussions by the staff of the IMF’s Asia and Pacific Department with the People’s Republic of China.

China has achieved rapid economic growth and substantial structural transformation since initiating a comprehensive package of market-oriented reforms in 1978. Real GDP has grown at an average rate of 10 percent annually since 1978, and a dynamic nonstate sector—accounting for about two-thirds of industrial output—has emerged. Most transactions are now at market prices, and the roles of external trade and foreign investment have expanded.

The Chinese economy has, however, experienced recurrent cycles of overheating and pronounced, but short-lived, retrenchment. Economic upswings have been characterized by

(Please turn to the following page)

China: GDP Growth and Retail Price Inflation
(Percent)



Data: Chinese authorities and IMF staff estimates

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Countries with ESAF-Supported Programs Show Progress in Social Spending, Social Indicators

Fiscal adjustment lies at the core of the structural reforms undertaken by developing countries under adjustment programs supported by the IMF’s enhanced structural adjustment facility (ESAF). A key component of fiscal adjustment is improvement in the composition of public spending to strengthen long-term growth prospects and enhance the well-being of the poor by reallocating spending to the social sectors—health and education—and through greater efficiency of such spending.

A recent study by the IMF’s Fiscal Affairs Department of 23 countries with ESAF-supported programs for the period 1986–95 reveals that these countries have made progress in raising public social expenditures and improving social indicators. This overall progress, however, masks considerable variation in experience across countries.

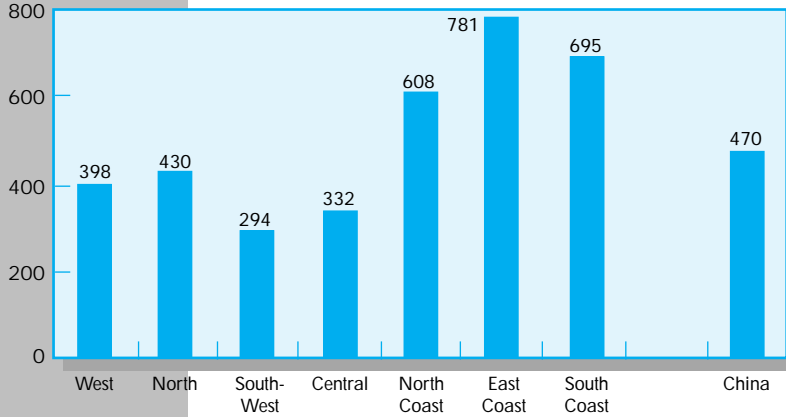
Education Spending

Results from the most recent year for which data are available, relative to the year preceding the introduction of an ESAF-supported program (a period averaging six years), show the increase in real education spending by the government averaged 46 percent. This implies an average annual growth of 6.4 percent a year, with average per capita growth of 3.8 percent a year (see chart, page 228). Of 23 countries, 20 increased real spending on education, and 17 increased real per capita spending. Average education spending also rose as a share of GDP by ½ of 1 percentage point, to 4.2 percent (Continued on page 228)

Overall progress in social areas masks considerable variation among countries.

sharp increases in inflation and a deteriorating external position, as domestic demand has tended to increase rapidly. The latest cycle, which began with a drive for faster growth and reform in 1991, resulted in a strong investment-led boom and a rapid acceleration of infla-

China: GDP Per Capita by Region, 1992
(U.S. dollars)



Data: World Bank, "China: Regional Disparities," Report No. 14496-CHA (June 1995)

tion. By 1996, however, with the help of sustained stabilization measures, the authorities achieved a "soft landing" for the first time in two decades. Annual retail price inflation dropped to 6 percent in 1996 from 22 percent in 1994, while real GDP moderated to a still strong 9.7 percent from 12.6 percent. Favorable macroeconomic conditions have continued into 1997; real GDP grew by 9.4 percent during the first quarter, and retail price inflation decelerated to an annual average of 3 percent.

**External Sector Reforms
Increase Openness**

A key element of China's economic reforms during the past two decades has been the gradual liberalization and opening of the external sector. Prior to 1978, China's exchange and trade system was based on foreign exchange and trade plans that were integral parts of the overall economic planning system and that regulated the allocation of foreign exchange as well as exports and imports. The role of imports was to fill domestic shortfalls in raw materials and capital goods; exports were planned to generate the foreign exchange necessary to pay for imports, with the trade balance generally in moderate surplus. With external borrowing strictly controlled through the foreign borrowing plan, external debt relative to GDP was very low, and the economy was practically closed to foreign direct investment.

Since the late 1970s, the authorities have introduced wide-ranging reforms to open the economy. Policies have focused on the exchange system, the trade system, and for-

Surging Investment Led to Overheating . . .

The years since the onset of market-oriented reforms divide into four cycles: 1979–81, 1982–86, 1987–90, and 1991 to the present (see chart, page 217). In the current cycle—to an even larger extent than in earlier ones—aggregate demand during the upswing was driven by fixed investment. Accelerating credit growth fueled an investment boom, with fixed investment by state-owned enterprises growing by close to 70 percent during the first quarter of 1993. The strong growth in investment brought the ratio of fixed investment to GDP to 37.5 percent in 1993. Demand pressures emerged, and in early 1993, overall retail price inflation started to accelerate rapidly. By mid-1993, the authorities implemented a "16-point" program to cool the economy. Measures included raising interest rates, tightening credit to banks, and cracking down on loans made outside the credit plan. The adjustment program failed to contain inflation immediately, with retail prices in October 1994 more than 25 percent higher than a year earlier. Starting in late 1994, however, the economy began to cool gradually in response to the adjustment program. Over the next two years, inflation came down significantly, to less than an annual rate of 5 percent in December 1996, as the growth rate of real GDP eased. Investment growth moderated, although the investment-to-GDP ratio declined only slightly and remained well above its level in previous cycles.

**. . . but the Added Capacity
May Have Helped the Soft Landing**

A number of factors are widely believed to have contributed to China's soft landing. These include:

eign direct investment. Much has been achieved. The exchange regime has been transformed into a market-based system with current account convertibility, and the trade system has been freed from central planning. China's open-door policy toward foreign investment within the framework of open economic zones has led to a steady rise and, since 1993, a surge in foreign direct investment inflows. The authorities have maintained controls on other capital flows, and although external debt has increased significantly, it has remained moderate in relation to the size of the economy.

The external sector reforms have increased openness significantly. Exports and imports outpaced GDP growth in 1996, and the share of exports in GDP grew to more than 15 percent in 1996 from about 5 percent in the early 1980s. With a surge in foreign direct investment—particularly in recent years—the contribution of foreign-funded enterprises expanded rapidly, accounting for more than 16 percent of industrial output and nearly 40 percent of exports.

- more gradual tightening of economic policies—notably investment approvals and monetary policy—and commitment to sustaining these measures;
- improved structure of the Chinese economy, with the more dynamic nonstate sector accounting for a larger share of GDP;
- greater attention to the composition and efficiency of investment;
- implementation of structural reforms to increase the market orientation and openness of the economy; and
- a record grain harvest in 1996, which allowed a rapid deceleration of food prices.

In addition, the impact on capacity of the sharp increase in fixed investment may have facilitated the soft landing. While investment spending initially increases aggregate demand more than supply—which tends to increase inflationary pressures—it eventually leads to an increase in capacity and potential output, which tends to dampen inflationary pressures. The likely result of the surge in fixed investment is an

State-Owned Enterprise Reform

China's economy includes more than 300,000 state-owned enterprises, which account for an estimated one-third of GDP and gross industrial output and as much as half of the value of national fixed assets (excluding land). These enterprises employ 13 percent of the economically active population and contribute an estimated 70 percent of total general government revenue.

The economic performance of state-owned enterprises has deteriorated in recent years, lagging behind the nonstate sector, as evidenced by falling profitability, increasing losses, growing industrial inventories, and low rates of capacity utilization in some sectors. One of the main reasons for this decline is the dynamic growth of the nonstate sector since the start of China's reforms in 1978. This has generated greater competition in many industries and exposed the inefficient use of resources in parts of the state-owned economy.

In response to these developments, the authorities have begun to accelerate state-owned enterprise reforms during the past two years. The strategy includes:

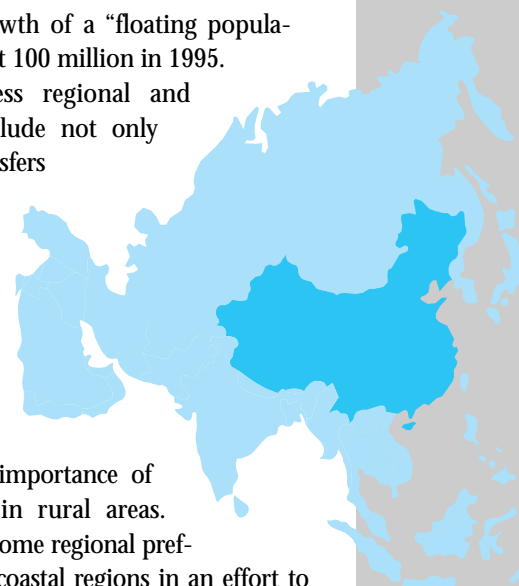
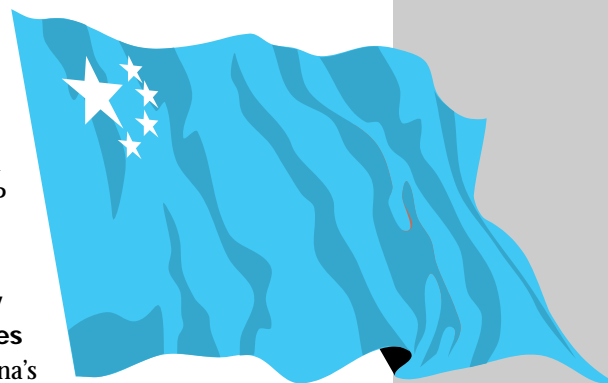
- introducing corporate governance, with clear separation of ownership and management;
- hardening enterprises' budget constraints through the reduction of fiscal subsidies and shifting of bank credit to commercial terms;
- removing social welfare functions and reducing excess labor;
- recapitalizing accumulated enterprise debts;
- providing new financing for technical updating, improvement, and expansion; and
- changing enterprise ownership through sales, mergers, leasing, joint stock participation or liquidation, and bankruptcy proceedings.

increase in the capital stock, and—taking into account China's large pool of excess labor in state-owned enterprises and in the agricultural sector—a temporary increase in the growth rate of potential GDP. Rapid growth in potential GDP may thus have allowed the economy to settle into a soft landing despite continued strong real GDP growth.

Strong Economy Masks Disparities

Although China's performance has been impressive, the strong macroeconomic picture masks considerable income disparities (see chart, page 218). During the past decade, income disparities in China have widened in a number of dimensions, as inequality between individuals, regions, and urban and rural areas has increased. This trend stands in contrast to the late 1970s and early 1980s, when major agricultural reform raised rural incomes to an average 60 percent of the urban level and lifted millions of people out of poverty. After 1984, the trend toward greater income equality reversed, however, as poverty reduction stagnated and the rural-urban income gap widened. Regional income disparities became more pronounced as well, as growth rates between regions diverged markedly in the second half of the 1980s. These disparities continue to fuel migration pressures from rural inland areas to the coastal cities and have contributed to the growth of a "floating population" estimated at about 100 million in 1995.

Strategies to address regional and income disparities include not only intergovernmental transfers in favor of disadvantaged regions but also the extension of market-oriented reforms and the promotion of foreign direct investment in inland China. The Chinese authorities have stressed the importance of increased investment in rural areas. They have scaled back some regional preferential policies in the coastal regions in an effort to redirect investment to the interior provinces. In addition, a major poverty alleviation effort initiated in 1993 has reduced the rural poverty rate substantially and aims to lift the remaining 50–60 million rural poor out of poverty by the year 2000.



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

| Member | Date of Arrangement | Expiration Date | Amount Approved | Undrawn Balance |
|------------------------------|---------------------|--------------------|------------------|------------------|
| | | | (million SDRs) | |
| Stand-by arrangements | | | 3,759.10 | 2,485.60 |
| Argentina | April 12, 1996 | January 11, 1998 | 720.00 | 214.00 |
| Bulgaria | April 11, 1997 | June 10, 1998 | 371.90 | 348.70 |
| Djibouti | April 15, 1996 | March 31, 1998 | 6.60 | 2.63 |
| Egypt | October 11, 1996 | September 30, 1998 | 271.40 | 271.40 |
| El Salvador | February 28, 1997 | April 27, 1998 | 37.68 | 37.68 |
| Estonia | July 29, 1996 | August 28, 1997 | 13.95 | 13.95 |
| Hungary | March 15, 1996 | February 14, 1998 | 264.18 | 264.18 |
| Latvia | May 24, 1996 | August 23, 1997 | 30.00 | 30.00 |
| Lesotho | September 23, 1996 | September 22, 1997 | 7.17 | 7.17 |
| Pakistan | December 13, 1995 | September 30, 1997 | 562.59 | 267.90 |
| Papua New Guinea | July 14, 1995 | December 15, 1997 | 71.48 | 36.14 |
| Romania | April 22, 1997 | May 21, 1998 | 301.50 | 241.20 |
| Uruguay | June 20, 1997 | March 19, 1999 | 125.00 | 125.00 |
| Venezuela | July 12, 1996 | July 11, 1997 | 975.65 | 625.65 |
| EFF arrangements | | | 10,183.93 | 6,047.66 |
| Algeria | May 22, 1995 | May 21, 1998 | 1,169.28 | 422.08 |
| Azerbaijan | December 20, 1996 | December 19, 1999 | 58.50 | 49.14 |
| Croatia | March 12, 1997 | March 11, 2000 | 353.16 | 324.38 |
| Gabon | November 8, 1995 | November 7, 1998 | 110.30 | 49.63 |
| Jordan | February 9, 1996 | February 8, 1999 | 238.04 | 127.74 |
| Kazakhstan | July 17, 1996 | July 16, 1999 | 309.40 | 309.40 |
| Lithuania | October 24, 1994 | October 23, 1997 | 134.55 | 10.35 |
| Moldova | May 20, 1996 | May 19, 1999 | 135.00 | 112.50 |
| Peru | July 1, 1996 | March 31, 1999 | 300.20 | 139.70 |
| Philippines | June 24, 1994 | July 23, 1997 | 474.50 | 438.00 |
| Russia | March 26, 1996 | March 25, 1999 | 6,901.00 | 4,064.74 |
| ESAF arrangements | | | 3,559.49 | 1,473.38 |
| Armenia | February 14, 1996 | February 13, 1999 | 101.25 | 50.63 |
| Azerbaijan | December 20, 1996 | December 19, 1999 | 93.60 | 73.12 |
| Benin | August 28, 1996 | August 27, 1999 | 27.18 | 22.65 |
| Bolivia | December 19, 1994 | December 18, 1997 | 100.96 | 33.65 |
| Burkina Faso | June 14, 1996 | June 13, 1999 | 39.78 | 26.52 |
| Cambodia | May 6, 1994 | August 31, 1997 | 84.00 | 42.00 |
| Chad | September 1, 1995 | August 31, 1998 | 49.56 | 16.52 |
| Congo, Republic of | June 28, 1996 | June 27, 1999 | 69.48 | 55.58 |
| Ethiopia | October 11, 1996 | October 10, 1999 | 88.47 | 73.73 |
| Georgia | February 28, 1996 | February 27, 1999 | 166.50 | 83.25 |
| Ghana | June 30, 1995 | June 29, 1998 | 164.40 | 109.60 |
| Guinea | January 13, 1997 | January 12, 2000 | 70.80 | 59.00 |
| Guinea-Bissau | January 18, 1995 | January 17, 1998 | 9.45 | 3.68 |
| Guyana | July 20, 1994 | April 17, 1998 | 53.76 | 8.96 |
| Haiti | October 18, 1996 | October 17, 1999 | 91.05 | 75.88 |
| Honduras | July 24, 1992 | July 24, 1997 | 47.46 | 13.56 |
| Kenya | April 26, 1996 | April 25, 1999 | 149.55 | 124.63 |
| Kyrgyz Republic | July 20, 1994 | March 31, 1998 | 88.15 | 16.13 |
| Macedonia, FYR | April 11, 1997 | April 10, 2000 | 54.56 | 45.47 |
| Madagascar | November 27, 1996 | November 26, 1999 | 81.36 | 67.80 |
| Malawi | October 18, 1995 | October 17, 1998 | 45.81 | 22.91 |
| Mali | April 10, 1996 | April 9, 1999 | 62.01 | 31.01 |
| Mauritania | January 25, 1995 | January 24, 1998 | 42.75 | 14.25 |
| Mozambique | June 21, 1996 | June 20, 1999 | 75.60 | 37.80 |
| Niger | June 12, 1996 | June 11, 1999 | 57.96 | 38.64 |
| Senegal | August 29, 1994 | January 12, 1998 | 130.79 | 17.84 |
| Sierra Leone | March 28, 1994 | December 31, 1997 | 101.90 | 5.06 |
| Tanzania | November 8, 1996 | November 7, 1999 | 161.59 | 110.18 |
| Togo | September 16, 1994 | June 15, 1998 | 65.16 | 32.58 |
| Uganda | September 6, 1994 | November 17, 1997 | 120.51 | — |
| Vietnam | November 11, 1994 | November 10, 1997 | 362.40 | 120.80 |
| Zambia | December 6, 1995 | December 5, 1998 | 701.68 | 40.00 |
| Total | | | 17,502.52 | 10,006.63 |

EFF = extended Fund facility.
 ESAF = enhanced structural adjustment facility.
 Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Drawings under arrangements are normally phased on a quarterly basis, with the release conditional on meeting performance criteria and periodic reviews by the IMF Executive Board.

Introduction of EMU and Euro Holds Important Implications for Capital Markets

In recent months, discussions of the European economic and monetary union (EMU) have been largely preoccupied with entry issues, with relatively little attention given to the enormous potential structural implications for international capital markets. A European monetary union of any size will present significant challenges, opportunities, and risks for the European and world capital markets, explain Alessandro Prati and Garry J. Schinasi of the IMF's Research Department in their IMF Working Paper entitled *European Monetary Union and International Capital Markets: Structural Implications and Risks*.

Some things will change unalterably in European markets: transaction costs will drop, currency risk will disappear, and direct financing in European capital markets should increase. Less volatile aspects of asset pricing will supplant currency risk in importance. The volume of investable funds should swell in the wake of necessary pension, social security, and health insurance reforms. Possible efficiency and other gains in the financial sector, however, will be reaped in proportion to EMU's ability to promote the completion of financial integration, create more uniform market practices, and achieve greater transparency in pricing. Also important will be the extent to which EMU members pursue related structural reforms and the quality and effectiveness of EMU policymaking. EMU's implications for banking and the international monetary system are equally profound, but here, too, full realization of its benefits will depend heavily upon complementary actions.

Implications for European and World Capital Markets

Financial deregulation, new investment opportunities, and bank disintermediation have in recent years made European capital markets more integrated and liquid. The creation of EMU and the introduction of the euro are expected to accelerate this process and spur greater securitization—that is, an even greater number of publicly tradable forms of credit, ownership, or derivatives whose price is determined, at frequent intervals, in an open market. A single currency should also, observe Prati and Schinasi, induce greater uniformity in market practices, more transparent pricing, and increased market integration. These changes will derive from:

- the elimination of national currencies—which will lower transaction costs—and of foreign exchange rate risk;
- the growing importance of other risk components, notably credit risk;
- fewer barriers to cross-border investment and the removal of some restrictions on currency exposures for pools of capital, such as pension funds; and
- possible alterations in portfolio diversification.

“Whether or not these incentives lead to the development of deep and liquid short-term securities markets will depend, in part,” note Prati and Schinasi, “on demand and supply factors and the extent of cross-border competition between financial intermediaries, both within and outside EMU.” Also important will be the financial policies that EMU member countries pursue and—even more vital—the institutional arrangements that EMU fashions to implement monetary and financial policy, including the role of the European cen-

European Union (EU) Countries, United States, and Japan: Equity Markets, 1996

| | Number of Listed Companies | | Domestic Market Capitalization | |
|--------------------------------|----------------------------|--------------|--------------------------------|----------------|
| | Domestic | Foreign | Million ECUs | Percent of GDP |
| Markets in EU Countries | | | | |
| Amsterdam | 217 | 216 | 302,452 | 96.10 |
| Athens | 217 | 0 | 18,988 | 19.64 |
| Brussels | 146 | 145 | 95,752 | 45.40 |
| Copenhagen | 237 | 12 | 57,281 | 41.46 |
| Dublin | 61 | 10 | 27,659 | 52.29 |
| Germany | 681 | 1290 | 531,553 | 28.34 |
| Helsinki | 71 | 0 | 49,444 | 50.41 |
| Lisbon | 158 | 0 | 19,706 | 23.40 |
| London | 557 | 833 | 1,368,000 | 153.61 |
| Luxembourg | 54 | 224 | 25,910 | 164.53 |
| Madrid | 357 | 4 | 194,681 | 42.25 |
| Milan | 244 | 4 | 206,997 | 21.79 |
| Paris | 686 | 187 | 472,426 | 38.48 |
| Stockholm | 217 | 12 | 194,045 | 97.42 |
| Vienna | 94 | 35 | 25,719 | 14.16 |
| EU total | 3,997 | 2,972 | 3,590,614 | 52.83 |
| Memorandum items | | | | |
| New York | 2,617 | 290 | 5,395,889 | 90.23 |
| Nasdaq | 5,138 | 418 | 1,192,290 | 19.94 |
| Tokyo | 1,766 | 67 | 2,374,733 | 64.88 |

Data: IMF Working Paper 97/62, *European Monetary Union and International Capital Markets: Structural Implications and Risks*

tral bank (ECB). In the United States, the Federal Reserve intervenes actively to smooth out fluctuations in liquidity and to provide stability to the pattern of interest rates on overnight funds. This has helped nurture efficient money and security markets there.

Repurchase Markets. The ECB will use repurchase agreements—arrangements whereby an asset is sold while the seller simultaneously obtains the rights and obligation to repurchase it at a specific price on a future

banking. How far market desegmentation advances and how liquid European sovereign debt becomes will depend on how credit risks are priced.

Corporate Bond Market. The euro is also expected to accelerate the development of corporate bond markets, particularly if the credit-risk culture that now typifies the United States and the United Kingdom takes hold in the EMU. Prati and Schinasi caution that a European-wide corporate debt market may not develop quickly. Excessive regulation and a narrow institutional investor base have thwarted development of these markets in the past and may continue to do so.

Equity and Derivative Markets. The advent of the euro is likely to accelerate the competition, consolidation, and technological innovation that has recently characterized equity markets. The single currency seems likely to promote the development of an EU-wide equity market for blue chip stocks.

Derivative markets will be affected in two ways by the creation of the euro: the number of contracts will decline—with nearly 200 contracts involving 13 currencies expected to disappear—and competition will increase among the European derivative exchanges for a

smaller number of contracts. The implications for bond market futures are less easy to predict, but stable spreads and low risk could lead to the development of a single liquid generic ten-year futures contract.

Systemic Risk. An efficient and effective wholesale payments system is essential to ensure liquidity for the securities market, handle rapidly changing dealer positions, and meet margin requirements for future and options markets. Two challenges Prati and Schinasi cite for the EMU's systemic risk management will be reaping the full benefits of its new "Target" payments system, which links nationally based real-time gross settlements systems, and ensuring that supervisory and lender-of-last-resort functions are clearly attributed so that crises can be effectively prevented and managed.

Implications for Banking Sector

The introduction of the euro and the creation of the EMU will provide incentives for broader, deeper, and more liquid private securities markets that, in turn, will stimulate competition for market shares long held by domestic universal banking institutions. Expanded capital markets and greater volumes of investable funds should intensify cross-border competition and spark incentives to acquire firms that have expertise in managing specialized assets. Deeper European capital mar-

Bank Profitability

| | Pre-Tax Profits ¹ | | | Return on Assets ² | |
|---------------------------------|------------------------------|---------|---------|-------------------------------|-------|
| | 1980-82 ³ | 1986-88 | 1992-94 | 1994 | 1995 |
| | (Percent of assets) | | | | |
| European Union countries | | | | | |
| Belgium | 0.40 | 0.40 | 0.30 | | |
| Denmark ⁴ | | | | 0.29 | 1.20 |
| Finland ⁵ | 0.50 | 0.50 | -1.60 | -0.69 | -0.16 |
| France | 0.40 | 0.40 | -0.10 | 0.17 | 0.27 |
| Germany | 0.50 | 0.70 | 0.50 | 0.52 | 0.56 |
| Italy | 0.70 | 1.00 | 0.80 | | |
| Netherlands | 0.30 | 0.70 | 0.60 | 0.69 | 0.72 |
| Spain | 0.70 | 1.10 | 0.60 | 0.70 | 0.79 |
| Sweden | 0.30 | 0.80 | 0.50 | 0.55 | 1.23 |
| United Kingdom | 1.10 | 1.00 | 0.70 | 1.22 | 1.27 |
| Memorandum items | | | | | |
| United States | 1.00 | 0.70 | 1.60 | 1.81 | 1.87 |
| Japan ^{6,7} | 0.50 | 0.60 | 0.20 | -0.21 | -0.75 |

¹All banks for Belgium and the Netherlands, and commercial banks only for other countries (OECD data).

²Pre-tax profits of major banks (IBCA data).

³For Belgium and France, 1981-82.

⁴The portfolio of securities is marked to market.

⁵The 1994 and 1995 reserves are not fully comparable due to a break in series.

⁶Fiscal years.

⁷The 1994 and 1995 data are a combination of half-year results at an annual rate and IBCA estimates.

Data: IMF Working Paper 97/62, *European Monetary Union and International Capital Markets: Structural Implications and Risks*

date—as its principal means of implementing monetary policy, which is expected to provide a decisive incentive for the development of an EMU-wide “repo” market. In the United States, where repo markets are an important alternative money market instrument, they provide ready access to secured borrowing, enhance liquidity in the securities market, facilitate portfolio financing, and provide the ability to short the market—namely, to sell securities that are not owned. The development of an EMU repo market could open opportunities for large global financial organizations to participate more fully in short-term EMU markets for liquidity management and could add depth, liquidity, and efficiency to European capital markets.

Bond Markets and Credit Risks. By eliminating currency risk and reducing transaction costs, the introduction of the euro will reduce the costs of issuing and investing in securities. More transparent costs and benefits are likely to influence supply and demand and encourage the harmonization of market practices, say Prati and Schinasi. And other forms of risk—notably credit (sovereign), liquidity, settlement, and legal—will become more important for issuers and investors alike. The competition to bring new issues to market, rate new credit, and allocate investment funds is likely to “go global” and contribute to a worldwide restructuring of investment and universal

kets and the possible creation of a single capital market will, according to Prati and Schinasi, encourage smaller firms to take advantage of direct access to securities markets. This will stimulate competition with banks and could hasten the ongoing disintermediation in European banking markets. In this environment, say the authors, credit evaluation and local market underwriting skills become extremely valuable.

At the wholesale banking level, the advent of a single currency will lift one of the few remaining barriers to global competition. Only financial institutions with ample capital, resources, and geographic reach are expected to be able to meet the needs of large multinational firms and good-sized companies with international operations. There will be much greater scope for restructuring and consolidation at the retail level, but traditionally more resistance as well. European banking is, the authors observe, “overbanked” at the retail and local levels. Banks are overstaffed, and services are provided at noncompetitive prices. The sector has weathered deregulation, the abolition of capital controls, and the single market initiative, but in the face of lowered net interest margins and declining bank profits (see table, page 222), it has largely remained impervious to pressures that have led to increased efficiencies elsewhere—notably in the United States.

The question, observe Prati and Schinasi, is whether the retail sector will remain sheltered from the competition that the euro and EMU can unleash. If retail banking does confront the stepped-up competition, it is reasonable to expect further mergers of small and medium-sized domestic institutions, more electronic banking, more efficient services, and customer access to regional, international, and global markets. But major progress, caution the authors, will depend upon structural changes to address labor market rigidities, public ownership structures, and other constraints.

Euro and International Capital Flows

With the euro and EMU, the size and pattern of capital flows to and from the euro zone will change, as will the allocation of international portfolios. Three elements are expected to drive these changes: the strength and stability of the euro, the role of euro in the international monetary system, and the future depth and liquidity of EU financial markets.

The role of the euro in the international monetary system will be determined largely by its strength and stability relative to the U.S. dollar and the yen and by its share in trade and payment flows. The independent status of the ECB and its mandate to pursue price stability bode well for the euro's future. Outside the euro zone, shifts in international official reserves into euros are likely to be influenced by the euro's future role in foreign exchange markets, the liquidity of the euro treasury bill market, and the stability and diversification

benefits of the euro. As EU financial markets become more integrated, the euro treasury bill market could offer an attractive alternative to central bank holdings of U.S. Treasury bills.

It is private—not official—entities, however, that are likely to be the major sources of flows. Private flows are expected to be influenced by the size, depth, and liquidity of euro capital markets and the relative diversification benefits of the new currency. The attractiveness of the European market will hinge on the extent and speed of integration of the European government bond markets and the emergence of a single euro government bond market.

In sum, the absence of currency risk and the reduced transactions costs that will characterize the euro and EMU should spur a greater reliance on direct financing. In this new culture, say Prati and Schinasi, borrowers will seek to improve their credit ratings and look for the lowest-cost locations. Lenders will try to assess and monitor relative asset values and credit risk more accurately. Simultaneously, fiscal reforms should make substantially more funds available for investment.

All of these changes will increase the depth, liquidity, and efficiency of money, financial, and capital markets under EMU. The degree to which needed structural reforms are pursued and the manner in which the ECB implements monetary policy will determine how far securitization goes in EMU.

Regardless of the depth and breadth of these changes, according to Prati and Schinasi, the greater resort to direct financing will affect the shape of European and international capital markets, cross-border competition, and the ongoing global processes of competition, restructuring, and consolidation of the banking sector at the wholesale and retail levels.

Finally, the euro has the potential to become the second most important reserve currency in the world. The future of the new currency will be determined, conclude Prati and Schinasi, by the strength of the fiscal consolidation and structural reforms in EMU's members, and the monetary and exchange rate policies of the ECB. ■

Copies of IMF Working Paper No. 97/62, *European Monetary Union and International Capital Markets: Structural Implications and Risks*, by Alessandro Prati and Garry J. Schinasi, are available for \$7.00 from Publications Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org. The full text is also available on the IMF's web site (<http://www.imf.org>).

Lack of currency risk and lower transaction costs should spur more reliance on direct financing.

Camdessus Urges Second Generation Reforms To Tap Globalization's Opportunities

On July 2, IMF Managing Director Michel Camdessus addressed the High-Level Meeting of the UN Economic and Social Council (ECOSOC) in Geneva. He addressed what needs to be done to foster an enabling environment for development and the IMF's role in this effort. Following is a summary of his remarks.

Globalization, stressed Managing Director Camdessus, raises new issues for all countries and for the international community. A particularly favorable world economy—one characterized by solid growth, low inflation, reduced fiscal deficits, and significant structural

reforms in many countries—offers a “window of opportunity” to pursue the bold initiatives and reforms needed to meet globalization's challenges. The IMF's strategy still begins with helping its members re-establish basic macroeconomic equilibria and complete the structural reforms needed to allocate resources efficiently and “jump-start” the engines of growth. The importance of a sound macroeconomic environment is rooted in both the increasing competition for capital and investment and the desire to accelerate social progress. This approach has provided the impetus for growth even in countries where the problems of underdevelopment have seemed intractable.

“But we have learned,” said Camdessus, “that this ‘first generation’ of reform is not, by itself, enough—either to accelerate social progress sufficiently, or to allow countries to compete more successfully in global markets.” He cited the IMF Interim Committee's “11 commandments” for broadening and strengthening the adjustment process and stressed four elements that constitute the “second generation” of reform and that are indispensable in boosting real per capita growth significantly and encouraging greater equity in income distribution:

- *Quality of fiscal adjustment.* Reducing budget deficits is key, but improving the composition of fiscal adjustment can have profound effects on economic welfare, saving, investment, and growth, according to Camdessus. The sustainability of growth depends on development of human resources, he said, again citing the Interim Committee.

- *Bolder structural reforms.* Too often, citizens are disappointed with initial stabilization and reform, because they do not see their own economic situation improving. Indeed, many obstacles to private sector initiative, job creation, and foreign investment remain

entrenched. The solution is bolder, deeper reforms—notably in the civil service, labor market, and trade and regulatory systems.

- *Better government.* Many countries have eliminated the negative aspects of state intervention but have not yet taken the complementary steps to make public institutions a positive force for growth and development. To do so, countries must increase the transparency of government operations and rededicate the state to the tasks so essential to the confidence of private savers and investors and to the smooth functioning of economies—notably reliable public services, transparent regulatory environments, independent judiciaries, and enforceable property rights.

- *Stronger banking systems.* Allowing banking problems to fester only encourages poor banking practices, impedes intermediation, and increases resolution costs. Also, in a weak financial system, policymakers tend to shy away from tightening macroeconomic policies when needed, for fear of precipitating banking crises.

Clearly, this second generation of reforms is more demanding, but absolutely indispensable, if countries wish to grasp globalization's opportunities and minimize its risks. The IMF is contributing to this second generation of reform in a number of ways:

- *Increased focus on education and health spending.* The IMF has increasingly focused on education and health spending in its surveillance, technical assistance, and use of resources, and the impact is being seen, for example, in countries using its concessional financing (see related story, page 217).

- *Concentration on good governance.* The IMF has focused on the aspects of good governance most closely

‘First generation’ reforms are not enough to raise competitiveness and accelerate social progress.

Selected IMF Rates

| Week Beginning | SDR Interest Rate | Rate of Remuneration | Rate of Charge |
|----------------|-------------------|----------------------|----------------|
| July 7 | 4.02 | 4.02 | 4.41 |
| July 14 | 4.02 | 4.02 | 4.41 |

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

From the Executive Board

Togo: ESAF

related to its surveillance over macroeconomic policies, namely, the transparency of government accounts, the effectiveness of public resource management, and the stability and transparency of the economic and regulatory environments for the private sector. It promotes these objectives through institutional reforms of the treasury, budget preparation and approval procedures, improvements in tax administration and accounting practices, increased transparency in central bank operations, and more effective audit procedures.

- *Greater emphasis on banking and financial sector problems in IMF surveillance.* In addition, the IMF has pointed to the need for an internationally recognized and applicable set of “best practices.” It stands ready to disseminate these best practices through its policy discussions with members.

The IMF has taken three additional steps to help countries take fuller advantage of globalization. First, it has increased surveillance, especially as regards banking soundness, sustainability of financial flows, and countries whose financial market movements might have spillover effects. Second, the IMF has actively encouraged all countries—particularly those having or seeking market access—to improve the economic and financial data they provide to the public, and has set up a Special Data Dissemination Standard to facilitate this. Third, it is working out provisions for an amendment to its charter that will call upon the IMF to promote capital account liberalization and give the IMF appropriate oversight over restrictions on capital movements.

Fostering an effective environment for development also calls for international cooperation and strong international financial institutions. Advanced economies can contribute by ensuring their domestic policies encourage lower inflation, lower real interest rates, and steady growth; opening their markets to developing country products; reversing the negative trends in bilateral development assistance; and providing the IMF, the World Bank, and other international organizations with the resources needed to fulfill their mandates.

The IMF, said Camdessus, has taken steps to put its concessional lending—its enhanced structural adjustment facility (ESAF)—on a permanent footing and, using ESAF resources, is working with the World Bank to implement a strategy to relieve the external debt burdens of highly indebted countries. If the world wants “the market to see Africa as a land of opportunity, ESAF programs must be implemented steadfastly and credibly financed,” Camdessus emphasized.

The IMF’s ability to help its members and to act decisively in a crisis, he stressed, depends upon adequate “regular” or quota resources.

Finally, said Camdessus, the challenges of globalization and efforts to realize its benefits will also depend more than ever upon the close cooperation of members of the United Nations family. ■

The IMF today approved the third annual loan under the enhanced structural adjustment facility (ESAF) for Togo in an amount equivalent to SDR 21.7 million (about \$30 million) to support the government’s 1997 economic program. The loan is available in two semiannual installments, the first of which is available immediately.

Togo’s performance in 1996 under the program supported by the second annual ESAF loan was mixed, and the midterm review of the program could not be completed. Performance was satisfactory in terms of a robust 6 percent annual GDP growth and the slowing of inflation to 4.6 percent from 15.9 percent in 1995. However, both the primary fiscal balance and the external current account were well short of the program’s original targets, and new domestic and external arrears were accumulated. The implementation of the structural reform program was also uneven. There was mixed progress in liberalizing the agricultural sector, restructuring telecommunications, and implementing price reforms, but significant delays occurred in the privatization program.

Camdessus Welcomes Philippine Exchange Rate Announcement

On July 10, IMF Managing Director Michel Camdessus made the following statement, in response to the announcement by the Philippine authorities that, effective July 11, the government would allow greater flexibility of the exchange rate.

This policy, which has been taken in response to recent turmoil in regional financial markets and speculative pressures, is consistent with the rapid development of the Philippines’ foreign exchange market and its integration into global markets.

IMF management strongly commends the Philippine authorities for their timely and decisive action. Within the next few days, I will be asking the IMF Executive Board to approve the authorities’ request for the extension of the current extended Fund facility [EFF], which was to expire on July 23, 1997. I have also indicated to the authorities that, at that time, I will recommend to the IMF Executive Board that it make available additional financial resources on which the Philippines could draw to support their comprehensive strategy to safeguard macroeconomic stability.

I am confident that this set of measures—in conjunction with the authorities’ resolve to maintain fiscal and monetary discipline—will help protect the Philippine economy from the consequences of instability in regional financial markets and contribute to the restoration of more orderly conditions in these markets. These measures should also ensure that the Philippines will continue its impressive economic progress of the recent years.

The 1997 Program

The objectives of the 1997 program are to correct the weaknesses that occurred in 1996, particularly in the fiscal consolidation effort, and to accelerate the implementation of the agreed structural reforms. The government's revised medium-term macroeconomic projections for the period 1997–99 are to achieve an average annual real GDP growth of more than 5.5 per-

Togo: Selected Economic Indicators

| | 1995 | 1996 ¹ | 1997 ² | 1998 ² | 1999 ² | 2000 ² |
|--|------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| | (percent change) | | | | | |
| GDP growth | 7.2 | 6.0 | 5.8 | 5.7 | 5.6 | 5.5 |
| Consumer price index (annual average) | 15.9 | 4.6 | 3.9 | 3.5 | 3.0 | 3.0 |
| | (percent of GDP) | | | | | |
| Overall government deficit (excluding grants) | -7.9 | -6.5 | -4.3 | -3.5 | -2.9 | -2.4 |
| Current account balance (excluding grants) | -8.3 | -8.5 | -6.6 | -6.1 | -4.7 | -4.0 |

¹Estimates.
²Projections.

Data: Togolese authorities and IMF staff estimates and projections

cent, reduce annual average inflation to 3 percent by the end of the period, and lower the external current account deficit (excluding grants) to an annual average of less than 5 percent of GDP. Overall investment is projected to increase to 17.1 percent of GDP in 1999 from 13.7 percent in 1996, while domestic saving is expected to rise to 13.2 percent in 1999 from 6.4 percent in 1996. For 1997, real GDP is expected to grow at a rate of 5.8 percent, the rate of inflation is to be reduced to 3.9 percent on average for the year, and the current account deficit is to be narrowed to 6.6 percent of GDP, from 8.5 percent in 1996.

To achieve these objectives, the fiscal program for 1997 aims at reducing the overall deficit to 4.3 percent of GDP from 6.5 percent in 1996, while improving the primary balance (excluding interest payments, foreign-financed investment, and privatization receipts) to a surplus of 0.8 percent of GDP from a deficit of 1.4 percent in 1996. To attain these targets, the reforms of the tax system and of tax administration will be continued, with technical support from the IMF. On the expenditure side, the authorities intend to increase outlays in real terms for the health and education sectors and for the rehabilitation and maintenance of infrastructure while curtailing nonpriority spending. Budgetary and treasury procedures will enhance the control of expenditures, and a comprehensive civil service employment strategy is being prepared.

The government will also undertake in 1997 a comprehensive restructuring of its domestic debt, including the settlement of outstanding domestic payment

arrears, funded in part by resources from the privatization program.

Togo's monetary program, coordinated with that of its partners in the West African Economic and Monetary Union (WAEMU), calls for the continuation of a prudent policy stance that aims to strengthen Togo's contribution to the net external position of the regional central bank, while lowering the rate of inflation. Key policy elements are market-determined interest rates through the use of indirect instruments of monetary policy and the deepening of financial intermediation. A financial sector restructuring program aimed at strengthening the banking system and other financial institutions is under preparation.

Structural Reforms

The 1997 program entails a further strengthening of the structural reform effort and the completion of reforms delayed in 1996. A key aspect is the conclusion of the first phase of the privatization program and the rehabilitation of enterprises remaining under government control. A new regulatory framework for telecommunications has been introduced in preparation for the partial privatization of the sector during 1998. These reforms, together with the rehabilitation of the electricity company and measures taken in the area of road and maritime transportation, should improve Togo's economic infrastructure significantly over time. Finally, the authorities have begun the process of reforming the legal and regulatory framework in order to improve the climate for private economic activity.

Addressing Social Needs

Togo continues to have a high poverty rate, with 75 percent of the population having difficulty meeting basic health, education, nutritional, and housing needs, particularly in the rural areas. The government intends to pursue the fight against poverty through an appropriate investment policy in the areas of health, basic education, and vocational training. The government will seek to improve coordination with donors and nongovernment organizations active in these areas in order to optimize the use of available financial resources. To protect the most vulnerable segments of society, the government will also continue its labor-intensive public works projects.

The Challenge Ahead

The resumption of fiscal consolidation and successful implementation of the various structural reforms in 1997 will be the determining factors of the government's commitment to accelerating the reform process and creating the conditions for sustained growth. The various regional initiatives under way in the WAEMU will reinforce the reform effort. Togo has already made substantial progress in liberalizing its trade system, and the planned West African customs union should

expand, thereby reducing Togo's dependence on receipts from commodity exports, which remain vulnerable to world market price fluctuations.

Togo joined the IMF on August 1, 1962, and its quota is SDR 54.3 million (about \$76 million). Togo's outstanding use of IMF financing currently totals SDR 59 million (about \$82 million).

Press Release No. 97/31, July 1

Mauritania: ESAF

The IMF approved the third annual loan under the enhanced structural adjustment facility (ESAF), in an amount equivalent to SDR 14.3 million (about \$20 million), to support Mauritania's economic program in 1997. The loan is available in two equal semi-annual installments, the first of which can be drawn on July 31, 1997. The three-year ESAF credit, for the equivalent of SDR 42.8 million (about \$59 million) was approved on January 25, 1995 (see Press Release No. 95/5, *IMF Survey*, February 6, 1995).

Since late 1992, the Mauritanian government has been implementing a comprehensive medium-term adjustment program, which has achieved significant results: savings and economic growth have rebounded, inflation has been lowered, fiscal stability has been regained, and the external current account has been strengthened. Progress has also been made in the areas of price liberalization, restructuring of the banking system and key public enterprises, tax and trade reforms, liberalization of the banking system, and reform of the fisheries sector. Economic adjustment has also been accompanied by a reduction in poverty and an improvement in social indicators. In 1996, economic growth continued at over 4.5 percent, the annual rate of inflation declined to 4.7 percent from 6.5 percent in 1995, and the external current account deficit (excluding official grants) narrowed to 9.7 percent of GDP, from 13.1 percent in 1995. While progress was made during 1996 in the reduction of macroeconomic imbalances, Mauritania's economy remains vulnerable to external shocks mainly because of its high external debt burden and export concentration.

The 1997 Program

The key macroeconomic objectives of the 1997 program that the ESAF supports are to achieve a real GDP growth rate of 4.9 percent; hold the inflation rate at 5 percent; and limit the external current account deficit, excluding official transfers, to 5.5 percent of GDP. To achieve these objectives, fiscal policy envisages an overall government surplus of 4.1 percent of GDP in 1997, reflecting the further rationalization and control of expenditure and the containment in the decline of total revenues in relation to GDP mainly on account of lower fishing royalties. Monetary policy under the program will be consistent with the

achievement of the program's inflation and balance of payments objectives.

Structural Reforms

In 1997, the government has undertaken a number of actions to reform the legal, judicial, and regulatory framework, including, notably, accelerating procedures for establishing new enterprises and adopting measures to encourage private sector investment in the mining sector. Legislation is also being prepared to encourage private sector participation, particularly in the transport and energy sectors.

Addressing Social Needs

The authorities are committed to observing minimum levels of expenditure on health and education and are adopting measures to further improve the quality and coverage of services in these areas. While the 1996 Poverty Profile shows a decline of 7 percentage points in poverty between 1990 and 1996 to 50 percent of the population, the uneven distribution of this progress points to the need for improved targeting and monitoring of social programs, which will be undertaken with the assistance of the World Bank.

Mauritania: Selected Economic Indicators

| | 1995 | 1996 | 1997 ¹ | 1998 ² | 1999 ² |
|---|---------------------|------|-------------------|-------------------|-------------------|
| | (percent change) | | | | |
| Real GDP | 4.6 | 4.7 | 4.9 | 5.1 | 5.3 |
| Consumer prices (end of period) | 6.5 | 4.7 | 5.0 | 4.6 | 4.0 |
| | (percent of GDP) | | | | |
| Overall fiscal balance | -0.8 | 5.3 | 4.1 | 4.0 | 4.0 |
| External current account balance (excluding official transfers) | -13.1 | -9.7 | -5.5 | -6.0 | -4.5 |
| | (months of imports) | | | | |
| Gross official reserves | 1.7 | 2.6 | 4.4 | 5.1 | 6.2 |
| ¹ Program. ² Projections. | | | | | |
| Data: Mauritanian authorities and IMF staff estimates and projections | | | | | |

The Challenge Ahead

Achievement of high and sustainable growth will require the maintenance of sound macroeconomic policies and the deepening of structural reforms already in place. Despite the improved medium-term prospects resulting from the debt rescheduling under Naples terms granted by Paris Club creditors in 1995 and the commercial debt buy-back operation completed in 1996, Mauritania's external debt-service burden remains heavy. Sustained progress in economic policy implementation will also need to be supported by continued external financial assistance in concessional terms.

Mauritania joined the IMF on September 10, 1963, and its quota is SDR 47.5 million (about \$66 million). Its outstanding use of IMF financing currently totals SDR 72 million (about \$100 million).

Press Release No. 97/32, July 14

Overall Spending on Health and Education Rises In Countries with ESAF Arrangements

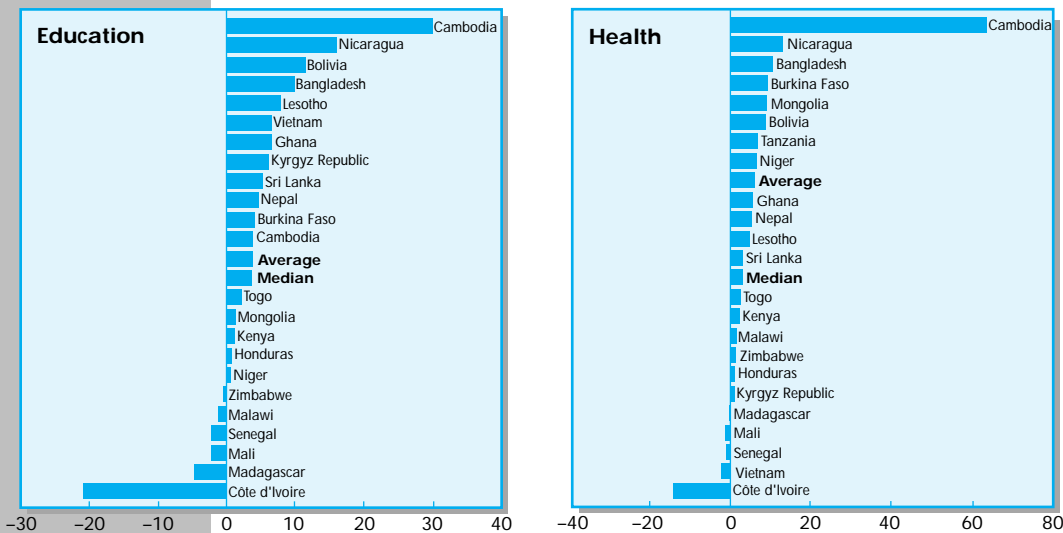
(Continued from front page) of GDP (see lower chart, page 229). Education outlays rose as a share of total spending in 16 countries, suggesting that education became a higher priority for countries with ESAF-supported programs.

The extent to which education outlays increased, however, varied markedly across regions and countries. Per capita real spending on education declined by an average of 0.4 percent a year in Africa, compared with a rise of more than 9 percent annually for other countries

outlays. This translates into an average annual real increase of 8.4 percent a year and average real per capita annual growth of 5.8 percent. Reflecting the large increment in health spending in two countries—Cambodia and Nicaragua (see chart below)—the median increase in real spending by all countries (6.2 percent a year) was lower than the average increase. Health spending also rose as a share of GDP—by 0.4 percentage point. The share of government expenditure absorbed by health increased in 18 of the 23 countries.

Real Per Capita Education and Health Spending In Countries with ESAF-Supported Programs¹

(Annual average change in percent)



¹Between the year preceding the ESAF arrangement and the latest available year.

Data: Country authorities and IMF staff estimates

with ESAF-backed programs—this despite relatively rapid increases in real per capita spending in Burkina Faso, Ghana, and Lesotho. The drop in per capita education spending in Africa reflects declines in some CFA franc zone countries in the wake of the January 1994 devaluation of the CFA franc, in particular in Côte d'Ivoire. Education spending in Africa as a percent of GDP rose by just 0.4 percent, about half the increase recorded outside the region.

Health Spending

Public spending on health care also rose as well in countries with ESAF-supported programs in the latest year for which data are available, compared with the year preceding the introduction of an ESAF-backed program. Health spending rose by nearly 56 percent on average in real terms, with only 3 of the 23 countries reducing real

Increases in real per capita health spending were smaller for African countries; such increases averaged just 1.7 percent a year, compared with more than 11 percent a year elsewhere. Some African countries (Burkina Faso, Niger, and Tanzania), however, did raise real per capita annual spending by amounts larger than the average for all countries. In Côte d'Ivoire, on the other hand, real per capita spending fell markedly.

Changes in Social Indicators

Have these spending increases had a favorable impact on social indicators? Although social indicators are influenced by many variables beyond government expenditures—such as general economic

conditions and the activities of private sector providers, including nongovernmental organizations—the increase in the share of spending allocated to health and education in countries with ESAF-supported programs appears to have coincided with some tangible improvements in social indicators.

Illiteracy, for example, fell by an average of 3 percent a year in countries with ESAF-backed programs, and gross enrollment rates for primary education increased by 1 percent a year (see top chart, page 229). This represents a faster pace of improvement in enrollment than in 24 low-income countries without ESAF-supported programs. Some countries registered relatively large annual gains in primary education enrollment, including some African countries (such as Burundi, Malawi, and Mauritania). For Africa as a whole, however, gains in literacy were somewhat below

average. Despite the increases in primary and secondary enrollment, illiteracy rates remain high on average in countries with ESAF-supported programs. Furthermore, the frequency with which pupils repeat a class year—a proxy for the quality of education—actually worsened on average.

With respect to indicators of progress in health, access to health care increased substantially among countries with ESAF-backed programs—rising to 64 percent from 46 percent, or 10 percent a year. In addition, countries with ESAF arrangements raised the shares of children immunized against DPT and measles by 14 percent and 12 percent a year, respectively; these countries also significantly in-creased the percentage of their population with access to safe water and sanitation. In some cases, these gains exceeded those for other low-income countries without ESAF-supported programs.

Improvements in health status, however, were less dramatic. Life expectancy in-creased by 0.3 percent a year—about 60 percent of the rate of 24 low-income countries without ESAF-backed programs—and infant mortality rates fell by 2.1 percent a year (see top chart), about two-thirds as fast as in the non-ESAF countries.

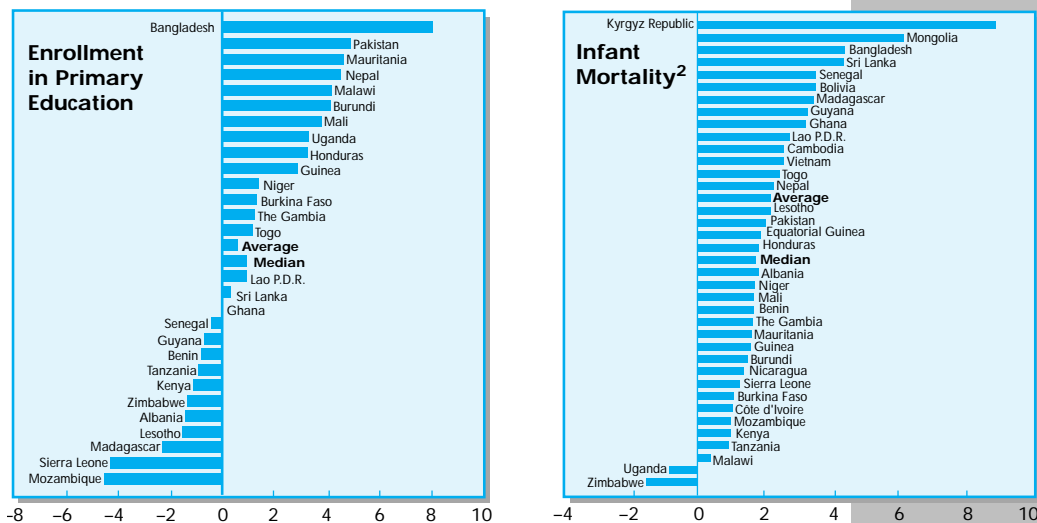
Access to health care rose more sharply for African countries with ESAF arrangements than for other ESAF countries. But gains in health status in Africa were smaller than in other ESAF countries, which may reflect the adverse effect of the spread of AIDS in some countries.

Conclusion

Social spending on education and health care appear to have become higher priorities in countries with ESAF-supported programs—with an increase in their share in total public spending. Nonetheless, spending has varied greatly among countries and regions. Moreover, an increase in levels of spending on education and health in and of itself is not a sufficient indicator of improved

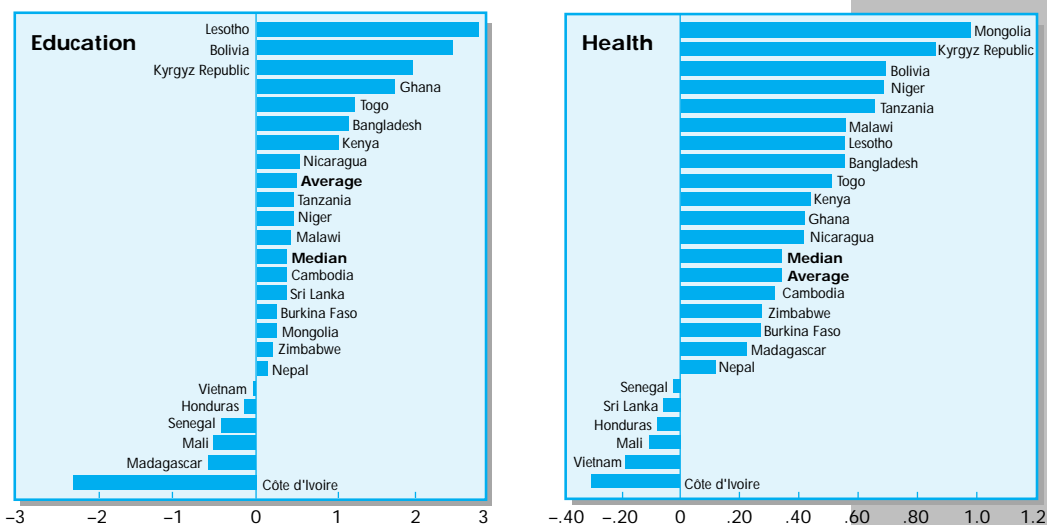
social conditions. Emphasis also needs to be placed on improving the efficiency of public social spending by targeting it to those categories that benefit the poor most, such as primary health and basic education in rural areas.

**Enrollment and Infant Mortality Rates
In Countries with ESAF-Supported Programs¹**
(Annual average change in percent)



¹Between the year preceding the ESAF arrangement and the latest available year.
²A fall in infant mortality rates is indicated by an increase.

**Education and Health Spending Relative to GDP
In Countries with ESAF-Supported Programs¹**



¹Percentage change between the year preceding the ESAF arrangement and the latest available year.
Data: Country authorities and IMF staff estimates

Finally, individual country data and cross-country comparisons should be interpreted with some caution. The coverage of data varies from country to country; also it may not include spending at local levels and does not include private sector spending. Increased decentralization of social spending would thus bias results in favor of spending declines over time.

Hungary's Stabilization and Reform Yield Solid Results

The following article is based on the recent Article IV discussions by the staff of the IMF's European I Department with the Hungarian authorities, and the Executive Board's first and second reviews under Hungary's stand-by arrangement with the IMF.

Macroeconomic conditions in Hungary have improved markedly since the beginning of 1995, when Hungary was faced with large fiscal and external current

Hungary's strategy is aimed at promoting export-led growth and nondebt capital inflows.

account deficits. The twin deficits, coupled with high levels of external debt, posed a threat to financial stability and sustainable growth. In addition, the

government's commitment to structural reforms had dwindled, undermining the sustainability of competitive private sector activity.

During 1995, in response to adjustment efforts initiated by the government in March 1995—and supported by an IMF “precautionary” stand-by arrangement (an arrangement under which the authorities do not intend to make any drawings) since March 1996—the economy started turning around. The twin deficits began to narrow sharply; structural reform regained momentum; and the stronger external performance—together with large privatization receipts from abroad—facilitated a sizable decline in external debt. Price developments have also been favorable; after showing considerable inertia over the previous few years, consumer price inflation began falling during the second half of 1996.

IMF Publishes Guide for Macro Policymakers in Transition Economies

In an effort to provide a clear and comprehensive exposition of basic applied macroeconomics for policymakers and analysts in transition economies without formal training in western economics, the IMF has published a book entitled *Macroeconomic Accounting and Analysis in Transition Economies*, by Abdessatar Ouanes and Subhash Thakur of the IMF Institute. The manual provides practitioners with a guidebook to the core macroeconomic concepts underlying policymaking and offers directions for further exploration of the key issues. It presents the macroeconomic framework and illustrates the accounting and analysis for a transition economy with a case study of Poland, owing to Poland's pioneering role among east European economies in instituting comprehensive reforms. The manual is aimed mainly at audiences in transition economies, but its content is general enough to guide policymakers in any country. (See Recent IMF Publications box, page 231, for ordering information.)

Inadequate Reforms Led to Major Imbalances

Compared to other formerly centrally planned economies in central and eastern Europe, Hungary entered the postcommunist era in a favorable position. While it retained central planning, its economic system had allowed for significant enterprise autonomy, resulting in few shortages. Aside from a history of progress toward economic liberalization in the structural area, Hungary's economy featured a less distortionary price system; a more stable international macroeconomic position; a smaller, though still dominant, share of external trade conducted within the Council for Mutual Economic Assistance trading bloc; a skilled labor force; and proximity to Western markets. In the early 1990s, however, Hungary's economy faced a number of external shocks that it could not address quickly.

The drop in output and revenues resulted in a sharp deterioration of the fiscal accounts in 1992. Initially, the effect of this deterioration on the external accounts was cushioned by a reduction of enterprise investments and an increase in household saving. However, as private demand resumed strength, the external current account deficit deteriorated markedly. It widened to 9–10 percent of GDP in 1993–94, against a background of relatively subdued economic activity and already high external debt and debt-service ratios. Moreover, progress toward lower inflation stalled, employment fell sharply, and structural reform slowed to a halt.

Adjustment Achieves Turnaround

Hungary's latest economic turnaround stems from adjustment efforts made in the context of a macroeconomic strategy aimed at establishing conditions conducive to export-led growth and nondebt capital inflows. This strategy, instituted in March 1995 and supported by an IMF stand-by credit of SDR 264.2 million since March 1996, has four main components:

- an up-front devaluation of the forint to restore competitiveness;
- the introduction of a preannounced exchange rate crawling peg and tight incomes policy to anchor wage and price dynamics, maintain external competitiveness, and lower inflation;
- fiscal retrenchment to sustain the adjustment in relative prices and in nominal variables; and
- acceleration of the structural reform process—including a new wave of privatization to improve productivity and boost foreign direct investment—and an overhaul of the social security system to ensure its long-term viability.

Reforms Improve External Balance

The combination of policies under the austerity program brought about a marked improvement in the balance of payments—one that reflected gains in export market shares and a containment of imports. Exports surged in 1995, narrowing the current account deficit to 5.6 percent of GDP from 9.5 percent in 1994. This improvement somewhat exaggerated the underlying strengthening in the external accounts, however, as the government's introduction of an 8 percent import surcharge in March 1995 dampened import demand. Nevertheless, cuts in some tariffs, import duties, and fees and a relaxation of import quotas partially offset the import surcharge. Indeed, both import and export flows increased considerably after 1994, signaling a further opening up of the Hungarian economy. The improvement in the balance of payments continued into 1996: the current account deficit dropped to below 3 ¾ percent of GDP, less than half its level in 1994. This sharp narrowing was the result of a boom in travel receipts and a fall in interest payments abroad, reflecting large foreign exchange privatization receipts at the end of 1995.

A privatization-led surge in direct investment and in other private capital inflows accompanied the strengthening of Hungary's current account. These inflows boosted gross official reserves to a level equivalent to 9.5 months of imports at the end of 1995. During the first half of 1996, private capital inflows remained high, and foreign direct investment exceeded \$2 billion for the entire year. The strength of the current account, along with the buoyancy of foreign direct investment, facilitated a drop in the net external debt-to-GDP ratio to 32.3 percent in 1996 from 45.8 percent in 1994. At the end of 1996, foreign exchange reserves stood at approximately \$10 billion (about seven months of imports)—this despite early repayment of external debt and relocation abroad of some of the foreign exchange deposits held by commercial banks at the National Bank of Hungary.

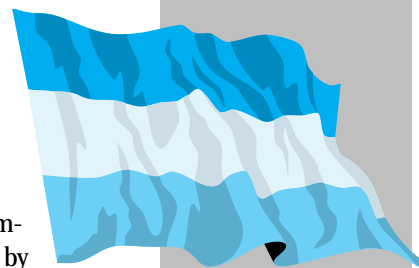
Fiscal consolidation and a sharp drop in real wages have played an important role in enhancing Hungary's external balance. Beginning in March 1995, the government strictly limited wage growth in the public and public enterprise sectors. As inflation picked up, owing to the devaluation of the forint and increases in administered prices, real wages dropped. This wage compression benefited the external accounts in two ways: through a direct effect on competitiveness, which was also spurred by productivity gains; and through an increase in the saving rate of the nongovernment sector, as enterprise profit margins and savings recovered.

Hungary's adjustment has also required containment of government expenditures. Spending curbs have been particularly marked in subsidies and social transfers and in the wage bill, which in addition to shrinking in

response to lower real wages, has fallen owing to a retrenchment of public employment. These actions have helped reduce primary expenditures of the consolidated government to 39 percent of GDP in 1996 from about 53 percent in 1994.

Domestic Indicators Improve

Hungary's adjustment has not been accompanied by a major output loss. Output rose by



Recent IMF Publications

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Proceedings of a May 1996 seminar exploring how Africa could accelerate reforms, drawing lessons from East Asia.

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An update of optimum currency area theory that extends and clarifies the analytical framework for assessing European monetary union.

Macroeconomic Accounting and Analysis in Transition Economies, by Abdessatar Ouanes and Subhash Thakur (\$19.00):

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97/51: Belize



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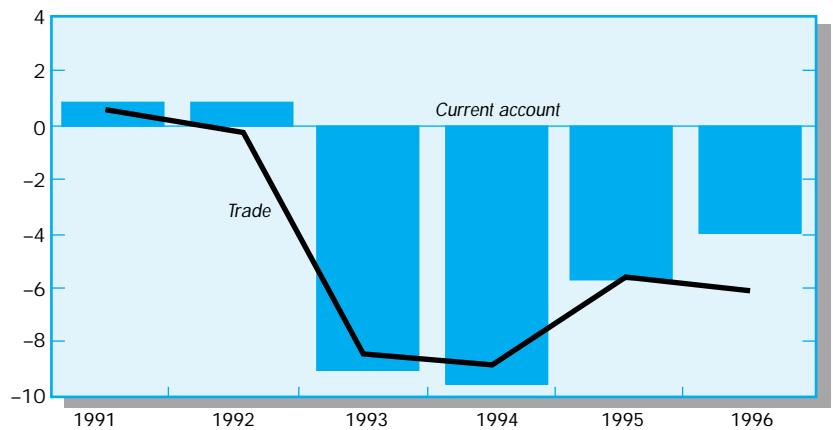
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1½ percent in 1995, reflecting the contribution of the external sector. After declining in the first part of 1996, investment recovered and, together with the continued strength of exports, led to a 3 percent increase in GDP in the last quarter of 1996 relative to a year earlier. Estimated GDP growth for all of 1996 was 1 percent, and several indicators point to continuing economic recovery. During the first five months of 1997, industrial production and construction activity were some 6–7 percent higher than a year earlier, and the procurement managers' index of economic activity has increased continuously during the first quarter of 1997. While output growth has been modest in comparison with the fastest growing transition economies, it is nevertheless an achievement in light of the severe demand constraints imposed by the stabilization program.

Unlike most other countries undergoing transition to a market-based system, Hungary did not experience a surge in inflation during the initial phases of reform. Hungary instituted price liberalization in a gradual way, in contrast to other countries in the region that adopted abrupt and comprehensive "big-bang" reforms. As a result, rather than rising and then falling sharply, Hungary's inflation rate over the past decade rarely climbed above 30 percent, or fell below 20 percent, on an annual basis.

The authorities' disinflation strategy under the most recent stabilization program has centered on the discipline of the exchange rate crawling peg and containment of domestic demand. Consumer price inflation, while abating after an upsurge in 1995, lingered at 24–25 percent through June 1996. These reflected

Hungary: Balance of Payments
(Percent of GDP)



Data: Hungarian authorities and IMF staff estimates

higher-than-anticipated increases in administered prices and excessive wage increases in the nontradables sector, which are less directly influenced by the discipline of the exchange rate system. In order to offset excess inflation at least partially, the government accelerated the gradual phasing out of the import surcharge, starting in July 1996; this is also expected to improve economic efficiency and growth. The import surcharge was eliminated at the end of June 1997. By January 1997, the disinflation strategy yielded important results, with the 12-month inflation rate slipping below 19 percent.

An Unfinished Agenda

International confidence in the Hungarian economy has improved substantially. Both Standard & Poor's and Moody's raised their ratings of Hungary's external debt to an investment grade, and Hungary's bonds are now trading at about 75 basis points over U.S. Treasury bonds—down sharply from about 300 basis points at the start of the stabilization. Hungary's success is also evidenced by its issuance, since the end of 1996, of five-year domestic government bonds—the first with such a maturity to be issued by a transition country.

Notwithstanding the remarkable progress made so far, stabilization and structural adjustment are incomplete. Both the external and public debts remain sizable, the tax burden is still high, and structural reforms—especially of the social security system—remain unfinished. The authorities have already undertaken important steps, most notably in privatization; indeed, a surge in sales at the end of 1995 brought in about two-thirds of the total cash revenues expected from the entire 1995–97 privatization program. Nevertheless, a further strengthening of reforms, along with continued reduction in the inflation rate, is needed for strong macroeconomic performance over the medium term.

Members' Use of IMF Credit
(Million SDRs)

| | June 1997 | Jan.–June 1997 | Jan.–June 1996 |
|---------------------------|--------------|----------------|----------------|
| General Resources Account | 131.7 | 2,008.2 | 2,965.1 |
| Stand-by arrangements | 121.4 | 494.9 | 1,288.3 |
| EFF arrangements | 10.4 | 1,405.7 | 1,502.2 |
| CCFF | 0.0 | 107.6 | 174.6 |
| SAF and ESAF arrangements | 37.7 | 248.6 | 335.7 |
| Total | 169.4 | 2,256.8 | 3,300.8 |

Note: EFF = extended Fund facility.
CCFF = compensatory and contingency financing facility.
SAF = structural adjustment facility.
ESAF = enhanced structural adjustment facility.
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department