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$4.5 billion arrangement

IMF approves Stand-By to support Russia's fiscal and monetary program

In a press release issued on July 28, the IMF announced it has approved a 17-month Stand-By credit for Russia equivalent to SDR 3.3 billion (about $4.5 billion) to support the government's 1999–2000 economic program. There will be seven equal disbursements of SDR 471.4 million (about $640 million), with the first installment to be released immediately. Subsequent installments will depend on quarterly reviews being completed and performance criteria and structural benchmarks being met. At the conclusion of the IMF Executive Board meeting, IMF First Deputy Managing Director Stanley Fischer made the following statement.

Russian Federation: macroeconomic indicators

	1996	1997	1998 Estimate	1999 Program
	(annual percent changes)			
Real GDP	–3.5	0.8	–4.6	–2.0
Change in consumer prices				
Annual average	47.6	14.6	27.8	92.5
12-month	21.8	11.0	84.4	50.0
	(percent of GDP)			
Federal government				
Overall balance	–8.4	–7.1	–5.9	–5.1
Primary balance	–2.5	–2.5	–1.3	2.0
	(months of imports of goods and services)			
Gross reserves coverage	2.0	2.2	2.0	2.6

Data: Russian authorities; and IMF staff estimates and projections

"Directors found that the economic crisis that erupted in 1998 had been due mainly to the failure of the authorities to come to grips with long-standing fiscal problems and to implement structural reform. The deterioration of the external environment as a result of Asia's economic crisis had been only the immediate cause of the crisis in Russia. In light of this, Directors endorsed the focus in the authorities' new economic program on fiscal consolidation and the acceleration of structural reforms. In view of Russia's extremely difficult economic and financial situation, Directors underscored the need for full and timely implementation of the envisaged reform measures. To facilitate effective implementation of the program, Directors urged the authorities to promote broader support for, and understanding of, the program in Russia.

"Stressing the crucial role of fiscal consolidation in the adjustment effort, Directors found that the fiscal targets were appropriately *(Please turn to the following page)*

Economic Forum

Financial sector liberalization promises benefits, but appropriate sequencing of reforms is crucial

Financial sector liberalization can spur economic growth and development. But liberalization can also entail risks if reforms are not appropriately designed and implemented. Participants in a recent IMF Economic Forum, "Getting It Right: Sequencing Financial Sector Reforms," examined this issue from several angles, including the optimal speed of liberalization, the appropriate timing and sequencing of reforms, and the lessons learned from past *(Continued on page 244)*

Participants in the Economic Forum, from left: Anders Åslund, V. Sundararajan (moderator), R. Barry Johnston, and Gerard Caprio. The panel also included Nicolas Eyzaguirre (not shown).

Contents

241 Stand-By credit for Russia

241 Sequencing financial sector reforms

243 Summers on debt relief and poverty reduction

246 Recent publications

247 IMF staff reports—pilot project

249 IIF report on emerging markets finance

249 New on the web

249 Selected IMF rates

251 Press releases
Mauritania
Madagascar

251 Condolences on death of King Hassan II

252 Brazil credit tranche approved

253 Galbraith on unfinished business of twentieth century

254 Dubrovnik conference on transition economies

255 Brau named IMF Treasurer

IMF support for Russian economic program

(Continued from front page) ambitious. A main objective was to reverse the prolonged decline in revenues, which had led to an unsustainable compression of expenditures, including in the area of social spending. However, Directors warned that these targets would not be achieved without strong political support to enforce large enterprises' compliance with statutory tax obligations. They also urged the authorities to refrain from allowing tax arrears to be offset against current expenditures and emphasized that further cuts in tax rates should be delayed until measures to increase tax compliance had yielded significant results. Directors also urged Russia and the World Bank to work together on a public expenditure review that focused on social and poverty alleviation needs.

"Directors emphasized that Russia was best served by a flexible exchange rate policy under current circumstances and welcomed the tightening of monetary policy since early 1999. They urged the government to resist pressures to curtail the independence of the central bank.

"Directors noted that there had been little progress in structural reform since last August, with some reversal in important areas. While there was a need to advance across the full range of structural reforms, Directors argued that tackling the pervasive problems of barter and nonpayments and the acceleration of bank restructuring would be key to the sustainability of macroeconomic stabilization and growth. Directors noted that political resolve to advance bank restructuring would require the authorities to resist what undoubtedly would be fierce opposition from vested interests and would be a key test of the commitment to structural reform in general.

"Directors noted that the de facto default on GKOs and OFZs was a regrettable setback, and that a normalization of relations with domestic and external creditors should be a main objective. They urged the authorities to seek orderly and cooperative rescheduling agreements with creditors.

"Directors expressed strong disapproval of the finding that the channeling by the central bank of domestic transactions through FIMACO and, in 1996, the transfer of assets in the books of the central bank to FIMACO meant that the balance sheet of the central bank had given a misleading impression of the true state of reserves and monetary and exchange rate policies. Without these indirect transactions and the inaccurate reporting of foreign reserves, it is possible that one or more of the disbursements of IMF funds to Russia in 1996 would have been delayed. Directors urged the Russian authorities to take immediate steps to prevent a recurrence of these problems. Directors took note of the findings that the July 1998 tranche from the IMF had not been misappropriated."

Program summary

Russia's exchange-rate-based stabilization strategy, which had produced notable gains since 1995, was abandoned in August 1998. The timing owed much to Asia's economic crisis and the rapid fall in investor confidence; however, the root cause was the failure to tackle underlying fiscal problems that had made the stabilization achieved under the fixed exchange rate policy inherently unstable. Political turmoil from mid-May 1998 had intensified financial market pressures. In mid-July, a new modified economic program supported by the IMF temporarily eased pressures, but confidence weakened anew following the Duma's refusal to accept key fiscal measures in the government's program. On August 17,1998, the authorities announced a default on ruble-denominated treasury bills and bonds maturing before end-1999 and widened the exchange rate band. In early September, the ruble was floated. A large depreciation of the ruble, loss of access to international capital markets, and a virtual collapse of the banking sector ensued. Moreover, large external arrears began to accumulate.

In the aftermath of the August crisis, little progress was made in bank restructuring, and there was a standstill in other areas of structural reform. Output contracted, government revenues fell, and inflation accelerated during the fourth quarter of 1998. The situation has, however, turned around recently. Policies have been tightened and inflation has come down to below 2 percent on a monthly basis in June. Industrial output has recovered. With regard to structural policies, some restrictive foreign exchange control measures introduced in the aftermath of the August crisis have been revoked and some progress has recently been made in bank restructuring.

1999–2000 economic program

The main focus is on fiscal adjustment and the acceleration of structural reforms, which are highly interrelated and must be tackled in tandem. The *fiscal program* targets a primary surplus at the level of the federal government of 2 percent of GDP in 1999. This represents an adjustment of about 3½ percentage points of GDP, compared to 1998. The program targets an inflation rate of 50 percent in 1999 (December to December), compared with 84.5 percent in 1998. Net international reserves are targeted to increase by $2.2 billion in 1999, with an increase in gross reserves of $1.7 billion during the last three quarters of the year. Real GDP is assumed to decline by 2 percent in 1999.

Monetary policy will be conducted in the framework of a flexible exchange rate policy. The authorities will intervene to smooth exchange rate fluctuations but will not resist fundamental changes in the balance of payments. The 1999 program assumes a rescheduling of nearly all obligations on Soviet-era debt falling due in

1999–2000, as well as the provision of additional exceptional balance of payments support from the IMF, the World Bank, and Japan. It assumes that all Russian-era debt will continue to be serviced as scheduled.

The authorities' strategy to raise revenues involves introducing new taxes and raising other tax rates to capture windfall gains from the large ruble depreciation and increase taxation of consumption. Also, a wide range of measures aim to improve tax compliance. In addition to avoiding recourse to tax offsets, the program calls for cutting the oil pipeline access of tax-delinquent oil companies and increasing compliance of enterprises with respect to their statutory tax obligations. On the expenditure side, the authorities aim to further prioritize spending and control commitments by line ministries, in particular in the context of a planned comprehensive expenditure review.

Structural reforms under the program fall into four broad categories: financial sector reform, including bank restructuring; private sector development, industrial restructuring, and liberalization of foreign direct investment and international trade; enhancement of fiscal management; and improvements in the competitiveness, transparency, and accountability of infrastructure monopolies. Measures within each of these categories will address the problems of nonpayments. Measures to improve transparency of the Central Bank of Russia's own operations and the relations between the authorities and commercial banks are also an important part of the program.

Russia joined the IMF on June 1, 1992, and its quota is SDR 5.9 billion (about $8 billion). Its outstanding use of IMF financing currently totals SDR 12 billion (about $16 billion). ■

The full text of Press Release No. 99/35 is available on the IMF's website (www.imf.org).

Summers outlines urgent agenda for debt relief, poverty reduction

In a day-long meeting on July 26 sponsored by the U.S. Executive Directors of the IMF and the World Bank—Karin Lissakers and Jan Piercy, respectively—senior IMF, World Bank, and U.S. officials, and representatives of leading nongovernmental organizations convened for a "nuts and bolts" discussion on debt relief. The conference's goal, noted Piercy, was to lay out a framework that would ensure that debt relief achieved its intended effect—namely, strong and durable growth and poverty reduction.

Opening the discussion, U.S. Treasury Secretary Lawrence Summers outlined an urgent agenda for changing the way the world approaches debt relief for the heavily indebted poor countries (HIPCs). The United States, he said, viewed three steps as critical imperatives: reassessing the proper scale of relief, finding appropriate financing, and revamping the way the international financial institutions approach poverty reduction and sustainable development and how their assistance is targeted. He underscored that debt relief was not an end in itself but a means to create successful development. The process could work, he said, only if national policies and institutions were right and if the right kind of support were available from the international community.

According to Summers, IMF and World Bank support for the poorest countries must feature a more integrated approach to adjustment that puts growth, poverty reduction, and good governance at the center of program design and strengthens the protection of core social priorities. A new mechanism must also be developed to ensure that the benefits of debt relief flow into increased national efforts to combat poverty, invest in people, and address AIDs and environmental degradation. In addition, a more explicit recognition was needed of the importance of transparent policymaking, good governance, and effective anticorruption efforts and of the need for a greater emphasis on building national ownership of policies and programs, with concrete steps to broaden participation and understanding. Finally, he stressed that the IMF's Enhanced Structural Adjustment Facility (ESAF) must be transformed, and the capacity of the IMF and the World Bank to support the poverty reduction and long-term growth must be strengthened.

Summers: A new, reformed approach to the IMF's and the World Bank's support for the poorest countries should be a goal of the September Annual Meetings.

These are ambitious goals, Summers acknowledged, but it is important to seize the momentum from the Cologne summit (see *IMF Survey*, July 5, page 209) and accelerate and integrate debt-relief efforts into a single package for consideration at the September Annual Meetings of the IMF and the World Bank. He also pointed to the crucial balance that must be struck between international and national interests as the debt-relief initiative moves forward. Three questions would be key—namely:

- how to target support for social objectives while enhancing national ownership and participation;
- how to accelerate the flow of debt relief within the HIPC Initiative while also strengthening the link between relief and lasting poverty reduction; and
- how to design effective economic adjustment policies while also protecting and advancing core social priorities.

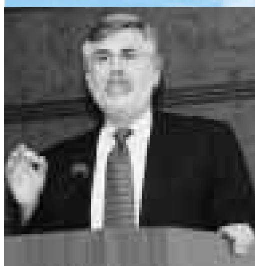
The right answer may differ from country to country, Summers observed, but it is critical to take advantage of this historic opportunity for positive change and reach broad international agreement between now and September on an enhanced framework for debt relief and poverty reduction.

Financial sector reform, capital account liberalization

(Continued from front page) attempts to defend the financial sector against external threats. V. Sundararajan, Deputy Director of the IMF's Monetary and Exchange Affairs Department, was the moderator. Participants included Gerard Caprio, Director of the World Bank's Financial Policy and Strategy Group and Head of Financial Sector Research; R. Barry Johnston, Division Chief in the IMF's Monetary and Exchange Affairs Department; Nicolas Eyzaguirre, IMF Executive Director; and Anders Åslund, Senior Associate at the Carnegie Endowment for International Peace.

Case for "right regulation"

Properly balanced and sequenced liberalization, Gerard Caprio said, is the only way to ensure maximum protection from financial crisis. The dangers and inherent risks of unbalanced liberalization are well known. Moving from rationing credit by quantity to rationing by price could impose substantial losses on those who have privileged access to funds, including governments. It is also likely that interest rates and asset prices, tightly controlled in repressive regimes, will become volatile once the restraints are removed, thereby increasing risk.



Gerard Caprio: Poor financial reform will surely generate backlash, so getting liberalization right is critical.

The dangers inherent in liberalization were magnified, Caprio said, by the way governments approached the process. In many cases, governments favored reforms that were cheap, easy, and quickly implemented—such as deregulation of interest rates, formal reductions in directed credit programs, and capital account liberalization. Wholly neglected in these efforts were more difficult, long-term, and expensive reforms—especially institution building.

Proper regulation—and, by extension, the government's role in the economy—can provide a framework for building a sound financial sector, Caprio said. The pervasiveness of the information problem in financial activities suggests that the larger the number of highly motivated monitors, the better the chance of guaranteeing the safety and soundness of the banking sector. The first line of defense in this "multiple eyes" approach should be the bank owners and managers. The greater the safety and soundness of their banks, the less likely owners will be to take excessive risks. Thus, governments need to find ways to increase that stake by assuring banks they can earn good profits from respectable banking rather than by gambling or by increasing the liability of bank owners and managers for imprudent actions.

R. Barry Johnston: In the absence of a broad program of financial sector reform, any liberalization effort is likely to founder.

The second line of defense should be the markets or bank creditors. Strong disclosure laws will provide information once accounting and auditing procedures have been developed to ensure that the information exists and is reliable. Forcing banks to issue uninsured subordinated debt is another attractive way to create a class of large bank creditors that will have an incentive to monitor the risk that the banks are taking, Caprio noted.

Supervisors would provide the last line of defense. They have an important role in ensuring safety and soundness in the banking sector, Caprio said. But effective supervision is not possible unless bankers oversee their own institutions and markets monitor developments, because supervisors might not find out about problems until too late.

Poor financial reform will surely generate backlash—possibly against all kinds of reform—so getting financial liberalization right is indeed critical, Caprio concluded. But establishing effectively working institutional structures in the financial sector is a long-term affair, and the effort needs to begin right away.

Sequencing and orderly liberalization

The recent currency crises in Asia, Russia, and Latin America have demonstrated the urgency of finding ways to achieve orderly liberalization, R. Barry Johnston said. Countries have turned to liberalization because of the benefits it provides—in particular, enabling them to achieve higher and more sustainable rates of growth. The trend toward more liberal capital accounts also reflects global developments—technical and financial market innovation, and the liberalization of current payments and transfers—that have generally lessened the effectiveness of capital controls. Countries may have to deal with large capital movements whether or not they have liberalized their own financial systems, Johnston said.

Capital account liberalization is an element of a broader program of financial sector reform that develops systems, institutions, and markets designed to operate in a world where financial resources are allocated by market processes. In the absence of these reforms, any liberalization attempt is likely to founder, Johnston noted. In particular, capital account liberalization will require broader financial sector reform, consistent monetary and exchange rate policy mix to avoid creating incentives for more volatile capital flows, and development of procedures and policies dealing with risk.

Turning to actual experiences, Johnston said there could be no unique approach to sequencing financial sector reform. What matters, rather, is the reform package, the supporting policies—that is, the "synergies within the reform mix." The speed with which the reform takes place, Johnston noted, has not proved to be a critical element in its success or failure, but the comprehensive policy package is crucial.

How does capital account liberalization fit into this process, particularly when a country has a weak financial market? Capital account liberalization is not an all

or nothing affair, Johnston noted. Elements within the capital account can be liberalized at different points as a country opens its financial system. The key issue is to identify those liberalizations with the objectives of building and establishing efficient financial markets and instruments so that the financial system is equipped to withstand shocks.

Discussing the liberalization of short-term capital flows, Johnston noted that such flows have often become problematic when there was a regulatory bias toward them, the country provided implicit or explicit exchange rate guarantees, and inadequate attention was paid to the risks of such flows.

Creating a "critical mass" of reforms

The choice between a big-bang liberalization or a gradual approach is really a "false problem," according to Nicolas Eyzaguirre. The transition from a closed economy with a repressed financial system to a market-based, financially open system is a difficult process. Because the amount of required institution building is enormous, big-bang attempts will almost unavoidably end in a crisis and a subsequent reversal. But the gradual approach is also unworkable; it is impossible to break down the liberalization process into finite building blocks, because of the strong interlinkages between the various components—for example, fiscal, monetary, domestic financial, and capital account issues. A more practicable approach, he said, is to aim for a "critical mass" of reforms that would include measures in all areas. These measures would be divided into core areas where reforms should be implemented early and into subsidiary areas where reforms can be postponed.

Among the core conditions, Eyzaguirre said, fiscal soundness is a prerequisite. Beginning the process of financial system reform with a weak and vulnerable fiscal position would invite domestic shocks that the newborn financial system might not be able to handle. More important, Eyzaguirre observed, a sound fiscal position is key for financing corrections to, and recovering early from, any financial crisis that may come down the pike.

Monetary stability is also of primary importance because, among other things, it imparts credibility to the central bank. A credible central bank, in turn, offers some defense against an attack on the domestic currency.

Because financial sector reform is extremely important for growth, Eyzaguirre advised careful in the pursuit of fiscal and monetary stability. A cautious liberalization of the interest rate would, he noted, avoid initial overshooting and excessive credit expansion. Also, direct monetary control instruments could be removed gradually to allow the development of mechanisms for open market operations and more sophisticated market-based instruments.

Macroeconomic balancing and domestic financial sector regulation should precede capital account deregulation, Eyzaguirre said. Without such regulation, foreign investors would take advantage of perceived soft budget constraints or willingly lend to distressed banks in the expectation of a government bailout.

As for sequencing capital account deregulation, Eyzaguirre said he favored initially liberalizing foreign direct investment, some long-term government borrowing, and portfolio flows, even if that involved retaining controls on other flows. He was aware that some observers had argued that considerable institutional capability was needed to differentiate and enforce controls, but, he contended, the institutional capability needed in a system without controls was also high.

Is "tough medicine" the only cure?

Departing from the tack taken by previous speakers, Anders Åslund said he would concentrate not on what *should* be done in financial sector reform but on what *can* be done, given the actual situation of a country—in this instance, Russia and Ukraine. Both countries have suffered recent financial crashes and are structurally weak. The choices open to them, Åslund said, are much more limited and much less attractive than some observers would like to admit.

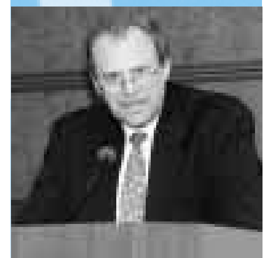
The causes of the severe financial crises that struck Russia and Ukraine last year were similar and straightforward: large budget deficits and the inability to finance them; overvalued pegged exchange rates; and problems servicing short-term debts because of limited international and domestic reserves rather than because of large overall government debt.

The preventive actions that should have been taken were as obvious as the symptoms, Åslund said: reduce budget deficits, devalue the exchange rate earlier and faster; and restrict the government's own borrowing, at least of short-term international capital. The relevant question, Åslund said, is why these actions were not taken.

Initially, the effect of the crash on the Russian economy was much more severe than that on the Ukrainian economy, Åslund said: industrial output in Russia fell by 15 percent in September 1998, and GDP fell by 4.6 percent, whereas in Ukraine, GDP fell by barely 2 percent. Both countries devalued, but the Russian devaluation was fourfold, the Ukrainian, twofold. Similarly, inflation in Russia soared to 200 percent from June 1998 to June 1999, while in Ukraine, it doubled to 20 percent in the same period. In addition, Russia defaulted on its treasury bills, and half of its banks collapsed. The financial crisis in Russia was, in social terms, more costly than the entire transition period up to that point.

Åslund said a year later the situation looks quite different. Both countries have been forced to make radical cuts in public expenditures, so the budget deficits are now very small; both have lingered on the verge of external default

Nicolas Eyzaguirre: Direct monetary control instruments should be removed gradually to allow the development of more sophisticated market-based instruments.



Anders Åslund: In Russia and Ukraine, what the precrisis reforms never managed, the financial crisis made possible.

but have essentially avoided it through restructuring; and both are getting IMF funding—although with some delay.

In short, both countries are managing to do a lot of things they could not do before, because the financial crash in Russia and its repercussions in Ukraine made the hard budget constraint credible for the first time. What the precrisis reformers never managed, Åslund said, the financial crash—an exogenous force—made possible.

In Russia, the salutary effects of the crash are even more apparent than in Ukraine. The country has been forced to undertake a substantial restructuring of the banking sector, with the result that a lot of bad banks have been closed. As a result of the hard budget constraints, arrears are falling and monetization is rising dramatically. Income differentials have fallen sharply, largely because of the hit the upper middle class took from the financial crash.

Unlike Ukraine, Russia is already experiencing a resurgence of portfolio investment; the Russian stock index has risen almost fourfold since October 1998, and Eurobonds have risen almost threefold. Most important, Åslund observed, industrial growth in the first half of 1999 has risen to 3 percent and is clearly headed for double that amount for the year. Ukrainian output, however, remains stagnant.

The fundamental problem in both Ukraine and Russia, Åslund said, is that they were dominated by rent seekers from the old communist elite who hoped to make money on government subsidies and regulations. In Russia, at the heart of this rent seeking were the banks, which were in reality not banks at all, but powerful general companies that were wholly resistant to regulation or reform.

Nothing could dislodge these nonbanks or break their power, Åslund noted, short of attrition or exogenous shock. Similarly, the budget deficit could not be brought under control as long as the elite thought they could get more subsidies from the government. And, structurally, since the Russian banks were not really banks, they blocked the development of a banking sector. The crash, Åslund said, took out the nonbanks and left the real banks standing.

Several conclusions may be drawn from the Russian and Ukrainian experiences, Åslund noted:

- The main task of the initial transformation is to impose hard budget constraints. To do so, the old power structure needs to be disarmed. A financial crash may be the only way to break up the power of these structures.
- An early and radical liberalization can weaken the oligarchy—either immediately if the liberalization is successful, or later because the effort facilitates a crash.
- In Russia, the political strength of the banks was solidly entrenched even before the transition process began; there was no chance that they would submit to regulation.

These observations, Åslund said, suggest that in countries like Russia and Ukraine, where the governments could do little to resist vested interests, there was scant choice about sequencing of reform, and orderly liberalization was out of the question from the outset. For countries in similar circumstances, he said, the only choice may lie between petrification and stagnation and doing as much as they can whenever they can. ■

The full transcript of this Economic Forum, "Getting It Right: Sequencing Financial Sector Reforms," is available on the IMF's website (www.imf.org).

Recent publications

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Pilot project

Member country authorities agree to release IMF staff reports on consultation discussions

As part of a broad effort by the international financial community to strengthen the international financial system, the IMF's Executive Board has agreed to a pilot project under which member countries would voluntarily release the reports prepared by IMF staff at the conclusion of Article IV consultation discussions. This project is intended to increase the transparency of the operations of the IMF and its members. A lack of transparency is considered to be one of the causes of the emerging market crisis that first erupted in 1997, because the different players involved in the crisis did not have the information they needed to make sound financial decisions.

Among the countries that have agreed to participate in the project are Estonia, Albania, and Malta in Europe and Aruba and Trinidad and Tobago in the Caribbean. This article describes some of the issues raised in discussions between the countries' authorities and IMF staff during their recent Article IV consultations.

Estonia

Estonia is a leading reformer among transition economies, according to the IMF staff, and has benefited from its currency board arrangement and the stability of its exchange rate against the deutsche mark and, more recently, the euro. It enjoyed 10 percent growth in 1997 before the economy and aggregate demand cooled in 1998 and early 1999 because of the October 1997 stock market crash, tighter macroeconomic policies (implemented as part of the 1997 program supported by the IMF; see *IMF Survey,* January 12, 1998, page 11) and spillover effects from the Russian crisis. Reflecting in large part the weakened economy, the budget balance turned in a substantial deficit in the second half of 1998 and widened markedly in the first quarter of 1999. Nonetheless, inflation continued to decline in 1998 and early 1999.

Discussions between the Estonian authorities and IMF staff in the Article IV consultation, conducted in May 1999, centered on the 1999 budget, which, in the opinion of the IMF staff, was formulated on the basis of unrealistic growth and revenue projections. The previous government was reluctant to alter the budget—particularly in light of the elections held in March—maintaining that GDP growth and revenues would exceed IMF staff projections. The new government agreed with the IMF staff's assessment and implemented expenditure cuts equivalent to 1.2 percent of GDP in a June supplementary budget. Although it recognized that additional cuts would be desirable, the government felt that room for further correction was very limited. It would, however, aim for a balanced budget in 2000. The IMF staff supported the authorities' intention to reduce the role of the government sector in GDP and their desire to balance the budget in 2000.

Privatization is an important part of the transition to a market economy. The Estonian authorities have been very successful in their privatization efforts thus far and intend to complete the process in the near future, including facilitating the privatization of land. The IMF staff supports the government's intention to resist using privatization revenues to finance current expenditures and instead to set them aside for later use, possibly to fund a major pension reform. Other structural reforms will be driven by the need to meet the requirement for membership in the European Union (EU) and include pension and health reforms. In its report, the IMF staff encourages these efforts and supports the authorities' intention to address the future of the oil shale sector.

Albania

Having emerged in 1991 from 45 years of isolationist communist rule, Albania has encountered more bumps in its path than has Estonia. Recently, it has begun to recover from the disturbance caused by the collapse of fraudulent pyramid finance schemes in 1997 and to restore macroeconomic stability. The authorities have achieved success in fiscal consolidation and have pursued a prudent monetary policy, thereby meeting all performance criteria under the country's Enhanced Structural Adjustment Facility (ESAF) Arrangement (see *IMF Survey,* June 21, page 201) to date.

While Albania has not yet completed the transformation to a market-oriented economy and has a long way to go to catch up with middle-income European countries, the authorities have made progress in structural reforms and the country is currently enjoying price stability, a comfortable level of reserve cover, and positive output growth. The Kosovo crisis has presented new challenges to macroeconomic stability and structural reform. However, the IMF staff is optimistic that the country's recent successes will help it deal with these challenges, which include ensuring that governance is not relaxed and addressing a worsening balance of payments position. The staff expects that, if Albania continues along the same path, its balance of payments should recover next year.

Fiscal discipline remains key to Albania's macroeconomic strategy. The IMF staff indicates that the authorities must redouble their tax collection efforts to free up resources for investment and other development and social priorities and, at the same time, broaden the tax base, in particular by taxing the agricultural sector.

Overall, the staff believes that Albania is following a strong and appropriate program of macroeconomic sta-

bilization and structural reform whose objectives, despite the refugee crisis, are within reach. Given Albania's satisfactory performance under the first annual ESAF Arrangement, the staff supports the authorities' request for its second annual arrangement under the ESAF and for an augmentation of the arrangement.

Malta

After a period of commendable growth earlier in the decade, Malta's economy has slowed in recent years, with a high external current account deficit and growth of less than the 4–5 percent that the IMF staff considers feasible. The deterioration can be attributed to persistent weaknesses in structural policies and a loss of fiscal discipline. The challenge facing the authorities is to jump-start the growth process, which the staff believes can be achieved through labor-saving structural reforms in the public sector. These, combined with further trade liberalization, EU membership, and promotion of Malta as a destination for foreign direct investment, would enable the country to realize its growth potential. Despite progress toward this end, the IMF staff believes that Malta requires technical assistance to guide its efforts and notes that a number of recent measures—including decisions to reverse utility price increases and raise civil service salaries—have compounded fiscal pressures.

Against this background, the Maltese authorities and the IMF staff focused their discussions on ways to advance the fiscal and structural agenda. The staff welcomed the steps that the authorities had taken to correct the fiscal deficit in 1999 and to formulate a medium-term fiscal framework, which would form the core of the administration's economic program. Other key elements include privatization and labor retraining. Malta has initiated a vigorous privatization program, which the staff welcomes while urging the authorities to take the next steps as soon as possible. Extensive facilities for retraining labor in both the public and the private sector are available, although it was agreed that the beneficiaries should contribute more to the costs.

Official projections for 1999 show increases in the rate of growth, trade imbalances, and inflation; staff projections were broadly similar although more optimistic on the outlook for inflation and the balance of trade in goods and services.

Aruba

Aruba's strong economic growth for much of the past decade has been underpinned by generally sound and stability-oriented monetary and fiscal policies. The IMF staff notes in its report, however, that fiscal policy was relaxed unduly in 1996, leading to growing budgetary imbalances. In mid-1998, the Aruban authorities recognized the crucial need to restore fiscal discipline and took steps to curb spending, clear overdue taxes, and reverse the buildup of arrears. They also made an effort to reduce public sector employment, contain wage costs, and develop a phased program for public investment. As a result, expenditure declined by 1½ percentage points of GDP, and the budget deficit was reduced to less than 1 percent of GDP.

The staff supports these measures and emphasizes that they should not be open to reversal. Both the staff and the Aruban authorities agree, however, that initiatives to bring tax assessments up to date and speed up the collection of tax arrears are not a substitute for far-reaching reform that would permanently increase the elasticity of the tax system and strengthen tax administration.

The challenge the authorities face is to maintain a prudent fiscal stance to avoid jeopardizing the economy's satisfactory growth and low inflation. In the authorities' discussions with the IMF staff, it was agreed that this policy stance should encompass reforms in social entitlements to safeguard public finances over the longer term. The problems that must be addressed include imbalances in the pension and health care systems.

The authorities outlined the steps, taken or planned, to restore lasting budgetary discipline. Their official projection for 1999 called for a small surplus of about ½ of 1 percent of GDP. The staff agreed with the substance of the 1999 budget but considered the authorities' revenue projections overly optimistic.

Trinidad and Tobago

In Trinidad and Tobago, the economic expansion over the past five years can be partly attributed, according to the IMF staff report, to sound macroeconomic management and continued progress in liberalization and structural reform. The country's external debt has declined, inflation has slowed, and unemployment has dropped. The staff expects economic performance to continue to be favorable, with growth accelerating to about 4½ percent in 1999 and inflation slowing to 4½ percent.

The staff's main concern for 1999 is that lower oil and petrochemical prices will make it difficult for the country to achieve its budgetary objectives. The authorities hope to keep the budget in balance by curbing spending to compensate for the lower oil prices, but prices have only recently begun recovering, putting the fiscal target at risk.

As for revenues, the staff expects them to fall short of the budget by 1½ percent of GDP, primarily because of shortfalls in collections on oil and nontax revenues. The staff encourages the authorities to focus on raising revenues by increasing some excises, broadening the base of the value-added tax, limiting provisions in the income tax to carry losses forward, and strengthening tax and customs administration. The staff also encourages the authorities to raise the existing ceiling on domestic debt to broaden the options for financing the deficit, reducing reliance on central bank financing. In light of the long-term trend in commodity prices and

Trinidad and Tobago's gradually declining oil output, the staff emphasizes that the government should strengthen revenues from sources other than oil.

Exchange rate stability is one of Trinidad and Tobago's principal policy goals. The authorities are committed to a market-determined exchange rate and are pursuing prudent monetary and fiscal policies to keep inflation low. Over the past two years, there has been a moderate real appreciation of the currency and, in 1998, a significant deterioration in the terms of trade. The staff considers that, although the exchange rate appears to be broadly competitive, the authorities should use market mechanisms—including interest rates and, if necessary, central bank intervention—to smooth supply and demand. The authorities said the lumpy nature of foreign exchange inflows necessitated some smoothing of the exchange rate.

In the opinion of the IMF staff, the medium-term outlook for Trinidad and Tobago remains favorable because of the large volume of energy sector investment now under way and the soundness of fiscal and monetary policies. The staff expects that even a small improvement in the terms of trade will lead to a considerable narrowing in 1999 of the current account deficit and that the fiscal balance will improve over the next several years. ■

The full texts of these Article IV staff reports may be found on the IMF's website (www.imf.org). The IMF invites reader comments on the reports before October 5, 2000. They may be sent by e-mail to pilotproject@imf.org.

Available on the web

News Briefs

99/41, July 22. IMF Completes Review and Approves $213 Million Credit Tranche for the Philippines

99/43, July 27. IMF Approves ESAF Disbursement to Tanzania

Public Information Notices (PINs)

99/61: Mozambique, July 14

99/62: Oman, July 16

99/63: Côte d'Ivoire, July 16

99/64: Czech Republic, July 29

Letters of Intent and Memorandums of Economic and Financial Policies

Bolivia, Letter of Intent, April 8

Senegal, Letter of Intent, June 4

Madagascar, Letter of Intent, June 28

Russia, Statement on Economic Policy, July 13

Notes: **PINs** are IMF Executive Board assessments of members' economic prospects and policies issued following Article IV consultations—with the consent of the member—with background on the members' economies; and following policy discussions in the Executive Board at the decision of the Board.

Letters of Intent and **Memorandums of Economic and Financial Policies** are prepared by a member country and describe the policies that the country intends to implement in the context of its request for financial sup port from the IMF.

Institute of International Finance report

IMF transparency will help resolve future financial crises

According to a high-level steering committee of senior financiers formed by the Institute of International Finance (IIF), the IMF has greatly improved its transparency during the past year, both in its operations and in its discussions of systemic issues. This increased transparency can significantly contribute to cooperation between the public and private sectors in addressing future financial crisis. The Steering Committee on Emerging Markets was established in the summer of 1998 to recommend ways to strengthen the architecture of the international financial system. The committee held meetings with top Group of Seven and other officials and issued reports on their findings. (See *IMF Survey*, April 5, page 110, for a summary of two of the reports: *Report of the Working Group on Transparency in Emerging Markets Finance* and *Report of the Task Force on Risk Assessment*.) The IIF's *Summary Report on the Work of the IIF Steering Committee on Emerging Markets Finance* is now available and highlights the issues likely to feature in discussions leading up to this year's Annual Meetings of the IMF and the World Bank.

Challenges

The report enumerates major challenges facing participants in the global system of emerging market finance:

• *For market participants, including commercial banks, securities firms, asset management and insurance firms, and hedge funds:* improve risk monitoring and management, support increased transparency, and work cooperatively to resolve crises voluntarily.

• *For governments, central banks, and regulators of emerging market economies*: maintain sound domestic

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
July 19	3.34	3.34	3.80
July 26	3.32	3.32	3.77

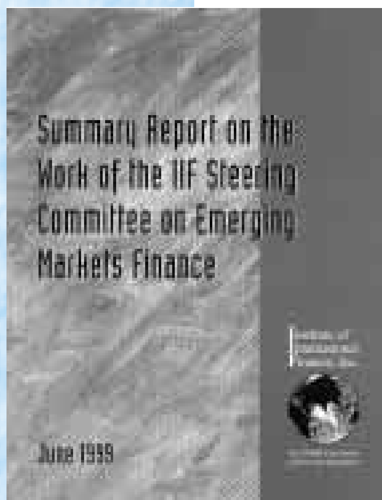
The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (as of January 1, 1999, the U.S. dollar was weighted 41.3 percent; 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 (currently 113.7 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

policies, accelerate financial sector reform, meet international standards on issues from data disclosure to governance, and manage relations with private investors and lenders.

• *For the IMF, the World Bank, and other international organizations:* build on improvements in transparency and lending facilities, catalyze sustainable private financing on a voluntary basis as needed, and cooperate with emerging market governments and market participants to support strong adjustment programs.

• *For the Group of Seven and other industrial countries:* pursue noninflationary growth without creating unsustainable external imbalances, provide leadership in lowering barriers to trade and finance, and support cooperative approaches to preventing and resolving crises.



IMF role

The report forcefully argues for a stronger and earlier two-way relationship between the official community and the private financial community to reinforce the global framework for sustainable and productive private capital flows to emerging markets. One vehicle for achieving this, the report notes, is the IMF's new Contingent Credit Lines, viewed as a "potentially important vehicle" for ensuring finance in advance of need for countries meeting global standards for access to capital markets. Questions regarding the vehicle's use will need to be addressed, the report states, and some authorities may wish to explore market-based contingent financing arrangements with private lenders.

Unsustainable short-term debt has been an important factor in the recent crises, and policies that create a bias in favor of short-term financing need to be corrected, the report states. Transparency in this area needs to be enhanced, and the report recommends closer surveillance by the IMF, the World Bank, the Organization for Economic Cooperation and Development, and other official bodies.

A lack of information was a factor in the crises of the 1990s, and the steering committee recommends further work in the areas of data standards and IMF transparency. The committee welcomes recent revisions in the IMF's Special Data Dissemination Standard while recommending that more needs to be done to strengthen it further. Along with the IMF's increased transparency, surveillance results in IMF Article IV staff reports provide important guides for private investors and lenders, particularly in situations where spreads may not fully reflect underlying risks. Therefore, the report recommends that market participants closely follow the IMF's 18-month pilot program for voluntary release of staff reports. (See page 247.)

Despite efforts to prevent crises, the report notes, they are likely to occur from time to time. Official support is one of the crucial elements for the constructive involvement of the private sector in future crises. While countries can recover from a crisis without support from the IMF and other official sources, deeper and longer recessions may well be the result. Official support can speed up the adjustment process in several ways, according to the report. IMF conditionality can lend credibility to reforms adopted in crisis countries. Balance of payments financing can lessen pressure on countries to impose capital controls or accumulate payments arrears that could postpone access to markets. These steps can help catalyze new flows of private capital to support a country's recovery. As a complement to these efforts, the IMF has created two facilities—the Supplementary Reserve Facility and the Contingent Credit Lines—to provide short-term financing to deal with or forestall liquidity crises.

Next steps

Efforts by the public and private sectors to find ways to prevent and resolve financial crises in emerging markets have provided a better understanding of the linkages in the international financial system. The report urges the private financial community to focus on several measures to implement improvements independently and in conjunction with other participants in the international financial arena.

• In their internal risk-management activities, financial firms should give high priority to using better risk-measurement techniques and improving internal controls.

• In their relations with emerging market authorities, financial firms should encourage investors to be proactive, promote high standards of transparency, and pursue other means to enhance differentiation among economies with varying prospects.

• In their relations with the IMF and other international organizations, financial firms should take advantage of opportunities to explain their concerns about the policies and performance of countries, as well as monitor the surveillance activities of these agencies more closely and help identify programs that could be effective in catalyzing sustainable private financing. ■

The full text of the *Summary Report on the Work of the IIF Steering Committee on Emerging Markets Finance* is available on the IIF's website: www.IIF.com.

Photo Credits: Denio Zara, Padraic Hughes, and Michael Spilarto for the IMF, pages 241, 243–45, and 256; Gero Breloer for AFP, page 251; and the American College, page 253.

Following are excerpts of recent IMF press releases. Full texts are available on the IMF's website (www.imf.org) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Mauritania: ESAF

The IMF approved a three-year loan for Mauritania under the Enhanced Structural Adjustment Facility (ESAF), equivalent to SDR 42.5 million (about $56.5 million) to support the government's 1999–2002 economic program. The first annual loan will be disbursed in two equal installments; the first, equivalent to SDR 6.1 million (about $8.1 million), will be available immediately.

Excerpts from the IMF Deputy Managing Director Shigemitsu Sugisaki's statement on the Executive Board discussion follow:

"Directors commended the authorities for the significant progress made over the past few years in improving macroeconomic conditions and social indicators. While recognizing external vulnerabilities and the need to preserve macroeconomic stability, they considered that there was room for some gradual reduction of the overall fiscal surplus and of interest rates. Directors also underscored the need to take advantage of the favorable fiscal position to implement a program of fiscal reform and to pursue a more active role of the private sector in the economy in order to stimulate economic growth and help in further reducing poverty.

"Directors stressed the importance of preserving government revenue by strengthening tax administration and reducing exemptions particularly in view of the expected decline in trade taxes. They welcomed efforts under way to strengthen targeting and monitoring of government spending in social sectors.

"Directors commended the authorities for embarking on an ambitious and comprehensive structural reform program and encouraged a sustained effort. They noted that the proposed policies to foster private sector development, liberalize markets, and promote competition are essential for accelerating the rate of growth and creating employment.

"Directors reaffirmed their support for Mauritania's request for assistance under the HIPC Initiative and considered that the approval of the ESAF should mark the beginning of the track record period leading to the completion point."

Program summary

The Mauritanian authorities are embarking on an ambitious economic program aimed at raising growth rates and improving social conditions, with particular focus on poverty reduction.

The medium-term strategy will focus on consolidating macroeconomic stability, deepening structural reforms, redefining the role of the government while improving governance and increasing transparency, liberalizing markets and promoting greater competition, creating a supportive environment for private sector investment, and implementing a far-reaching social development agenda. The 1999 program aims at raising GDP growth to 4.1 percent, reducing inflation to 4 percent, containing the current account deficit to 11.2 percent of GDP, and increasing official reserves to the equivalent of 5.1 months of imports of goods and nonfactor services.

Given the volatility of the external environment on the export sector, the government is targeting a budget surplus of 2.2 percent of GDP in 1999 to achieve its macroeconomic objectives.

Several key structural reforms will be implemented in the first year of the program, encompassing the exchange market system, the restructuring of the public sector, and the development of the rural sector.

Although social indicators have improved in the past decade, poverty is still widespread, affecting over 50 percent of the population, and health and education needs remain high. The program aims at significant further poverty reduction and the development of the country's human capital through an extensive range of actions.

Mauritania joined the IMF on September 10, 1963, and its quota is SDR 64.4 million (about $85.7 million). Its outstanding use of IMF financing currently totals SDR 75.0 million (about $99.7 million).

Press Release No. 99/32, July 21

Mauritania: selected economic and financial indicators

	1996	1997	1998	1999 (Projection)	2000 (Projection)	2001 (Projection)	2002 (Projection)	2003 (Projection)
				(annual percent changes)				
GDP at constant prices	4.7	4.5	3.5	4.1	4.4	4.6	5.0	5.2
Consumer price index (period average)	4.7	4.5	8.0	4.0	3.5	3.0	2.5	2.5
				(percent of GDP)				
Overall government balance (excluding grants)	5.3	4.2	2.1	2.2	1.3	0.5	0.4	0.3
Current account balance (excluding official transfers)	–13.2	–9.0	–11.4	–11.2	–10.8	–10.5	–10.1	–9.6
				(months of imports of goods and nonfactor services)				
Gross official reserves	2.8	4.6	4.6	5.1	5.3	5.4	5.5	5.6

Data: Mauritanian authorities and IMF staff estimates and projections

Madagascar: ESAF

The IMF approved the second annual loan under the Enhanced Structural Adjustment Facility (ESAF) to support Madagascar's economic and financial program and extended the commitment period of the three-year loan under ESAF until July 27, 2000. The three-year ESAF program was approved on November 27, 1996, in an original amount of SDR 81.4 million (about $108.1 million), of which SDR 27.1 million has been disbursed. This decision provides

Camdessus offers condolences on death of King Hassan II

In a news brief dated July 26, IMF Managing Director Michel Camdessus expressed his condolences on the death of the King of Morocco. The text is also available on the IMF's website (www.imf.org).

"We were all deeply saddened to learn of the death of His Majesty Hassan II, King of Morocco, who worked tirelessly for the modernization and development of his country, for regional cooperation, and for peace. It was my privilege to meet with King Hassan II on a number of occasions and to benefit from the wisdom of his counsel and the breadth of his understanding. He attached great importance to the opinion and recommendations of the IMF and was appreciative of the support we were able to extend to Morocco under difficult circumstances. On behalf of the Executive Board and the entire institution, I propose to convey our respectful condolences to His Majesty Mohammed VI, together with assurances of our support and our desire to develop fruitful and trusting cooperation with his government."

Madagascar with SDR 27.1 million ($36.0 million) during the second annual economic and financial program supported by the ESAF, with SDR 13.6 million available as of July 30.

Excerpts from IMF Deputy Managing Director Shigemitsu Sugisaki's statement on the Executive Board discussion follow:

"Directors welcomed the government's recent efforts to strengthen the implementation of its reform strategy. Directors considered the program to be appropriately aimed at increasing growth and supporting an ambitious poverty reduction plan. They concurred that continued fiscal reform, a reduced role for government in the production of marketable goods and services, and a transparent regulatory framework were crucial to ensuring macroeconomic stability and creating an environment for much-needed foreign investment.

"Directors noted that reform of public finances was central to the success of the program. They supported the authorities' intention to shift the emphasis of public expenditure further toward key priorities in health and education and to take steps to improve the efficiency of public spending.

"Pointing to the heavy debt burden faced by Madagascar, Directors supported the authorities' desire to secure early debt relief. To this end, Directors underscored the importance of establishing a strong policy track record, through full implementation of the envisaged macroeconomic and structural measures."

Madagascar: selected economic and financial indicators

	1995	1996		1997		1998		1999	2000	2001
		Program	Actual	Revised program[1]	Actual	Target scenario	Actual		Program	
	(annual percent change)									
Real GDP at market prices	1.7	2.0	2.1	3.5	3.7	3.6	3.9	4.5	5.3	5.7
Traditional consumer price index (average)	49.0	19.7	19.8	6.7	4.5	6.3	6.2	6.6	4.8	3.0
Total overall government balance (cash basis)	–5.8	–5.4	–4.9	–2.3	–3.2	–6.2	–6.3	–4.9	–3.2	–2.4
	(weeks of imports of goods and nonfactor services)									
Gross official reserves	5.4	9.3	12.3	14.9	14.0	13.6	7.8	13.6	14.5	13.4

[1]Figures contained in a 1997 Executive Board document.
Data: Malagasy authorities and IMF staff estimates and projections

Medium-term strategy

The program for 1999–2001 is designed to provide a strong signal to potential investors and an impetus for growth. It seeks to accelerate real GDP growth from 3.9 percent in 1998 to 4.5 percent in 1999 and 5.3 percent in 2000; reduce annual inflation from an expected 6.6 percent in 1999 to 4.8 percent in 2000; and narrow the external current account deficit from 7.9 percent of GDP in 1998 to 7.3 percent of GDP in 1999 and 7.0 percent of GDP in 2000. Rising aid flows and foreign exchange receipts from privatization are expected to help replenish gross official reserves, to a level equivalent to 3½ months of imports.

The government is committed to keeping the fiscal deficit at 4.9 percent of GDP in 1999 and at 3.2 percent of GDP in 2000. Monetary policy will remain geared toward achieving the program's inflation and balance of payments targets.

As part of its strategy to eradicate poverty, which is estimated to afflict 70 percent of the population, the government intends to raise budget allocations for health care and education by 0.4 percentage points of GDP in 2000 from 3.4 percent of GDP in 1999.

Given Madagascar's low income level, its domestic savings capacity will remain constrained, implying that the achievement of the high investment strategy will hinge on concessional foreign aid and foreign direct investment. The country's debt-to-export ratios over the next years suggest that Madagascar may qualify for assistance under the Heavily Indebted Poor Countries (HIPC) Initiative, assuming a decision point in 2001.

Structural reforms

The authorities are committed to accelerating the implementation of structural reforms, particularly the privatization of key enterprises; the removal of barriers to competition in sectors with high growth potential, such as mining, fishing, and tourism; and the creation of a more effective legal framework and judicial system.

Madagascar joined the IMF on September 25, 1963, and its quota is SDR 122.2 million (about $162.4 million). Its outstanding use of IMF financing currently totals SDR 36.1 million (about $48.0 million).

Press Release No. 99/33, July 23

IMF completes Brazil review, approves next credit tranche

In a news brief dated July 28, the IMF announced that the Executive Board had completed the third review under the Stand-By credit for Brazil. As a result, Brazil will be able to draw up to the equivalent of SDR 1.7 billion (about $2.3 billion) from the IMF. Excerpts from IMF First Deputy Managing Director Stanley Fischer's statement on the Executive Board's discussion of the review follow.

"During the discussion, Executive Directors expressed satisfaction that recent developments in Brazil's economy have been, on balance, significantly better than projected in the revised program formulated last March. In particular, inflation has remained relatively low, and economic activity is showing initial signs of recovery from the downturn in the second half of 1998. For the year as a whole, real GDP is now expected to decline by 1 percent or less, and consumer price inflation to be contained at around 8 percent.

"Directors commended the Brazilian authorities for their commitment to the policies supported by the arrangement with the IMF, including, in particular, the achievement of a primary fiscal surplus of the consolidated public sector equivalent to at least 3.1 percent of GDP in 1999 and a firm monetary policy, consistent with the announced inflation target. They stressed that the principal challenge now facing the authorities is to consolidate progress achieved so far and to lay the foundation for a sustained recovery. Directors expressed confidence that the authorities would stand ready to take additional measures, if needed, to ensure fulfillment of the fiscal and inflation targets.

"Directors supported the authorities' view that the floating exchange rate regime had served Brazil well so far and that the substantial improvement in competitiveness resulting from the depreciation of the *real*, together with the continuation of appropriate macroeconomic polices and structural reform, would contribute to a significant and sustained improvement in the current account of the balance of payments in the period ahead.

"Directors urged the authorities to deepen and accelerate efforts in important pending reforms, in particular, of the social security and the tax system. They also encouraged the authorities to continue their efforts to strengthen well-targeted and cost-effective social programs."

The full text of News Brief 99/45 is available on the IMF's website (www.imf.org).

J.K. Galbraith takes a fresh look at the "unfinished business" of our century

The issues that continue to plague the international community on the eve of the new millennium were the subject chosen by John Kenneth Galbraith, Harvard University Professor Emeritus and internationally known economist, who delivered the twenty-second annual Frank M. Engle Lecture in Economic Security at the American College in Bryn Mawr, Pennsylvania, in early May.

Much has been accomplished in this past century—particularly in the advanced countries of the globe, Galbraith began. These accomplishments include a vast range of scientific discoveries and technical developments and of things to which we have become accustomed and on which we have become dependent.

We have also seen in this past century, Galbraith continued, an enormous change in the basic substance of life—particularly the production of food, shelter, and clothing. In the 1930s, when he began his career in economics with the study of agriculture, Galbraith said, just under half of all the gainfully employed people in the United States were engaged in producing food—as was most of the population for centuries before. Now, it is only a handful—maybe 5 or 6 percent. Only in the past century, Galbraith said, have men and women escaped the repetitive, dismal drudgery that was required to keep people fed. This is an extraordinary achievement.

What GNP leaves out

This century has also witnessed extraordinary technological advances. A consequence of these technological advances has been the realization of a greater intellectual equality and achievement. For many—although not everyone—the new technology has provided an escape from one of the worst features of modern existence—tedious, hard, repetitive, boring labor. In fact, in this century, the number of people who are engaged in what is called "work"—that is, the activity that some find fine and pleasant and others find hard, boring, and physically painful—has been reduced. It is an anomaly of our system, however, Galbraith said, that those who do fine work are also the best paid, and those who find their work most pleasant are those who are allowed the most leisure.

This anomaly—that those who bear the burden of the hardest and most tedious work are the least rewarded—is reflected in the way national economic achievement is measured, according to Galbraith—that is, by the gross national product. Doubtless, he said, the increase in the GNP—the total of everything we produce and everything we do for money—is an important measure. But there is also a major fault in measuring the quality and achievement of life by the total of economic production. There is a strong tendency for such a measure to override and obscure deeper and, indeed, more important aspects of economic life. In particular, the measure does not take sufficient account of the value and enjoyment of what is produced. We have to ask ourselves: what is the cultural and artistic content? Would we remember Florence or Paris if we relied exclusively on their production? he asked. The wonders of the artistic world are not economic. And the wonders of other countries depend on the cultural content as much as—and perhaps more than—simple economic production.

Instability

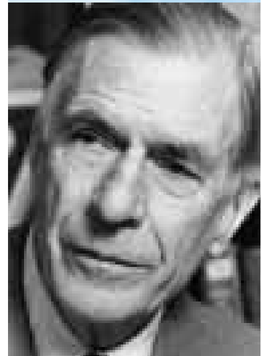
A more immediate legacy from the past century—in fact, one that goes considerably beyond the past century—is the ancient economic problem of instability, the succession of boom and bust, Galbraith noted. Ticking off the great speculative bubbles of the past three hundred years, he alluded to the tulip bubble that gripped Holland in the 1630s, the speculative boom in Paris at the beginning of the eighteenth century when investors bet on the prospect that gold would be discovered in Louisiana, and the famous eighteenth-century South Sea bubble that blew up in London, based on the seemingly wonderful prospect of trade with the Americas.

In the past century, in the United States, Galbraith continued, these boom and bust cycles continued. And, to this day, these cycles remain an uncorrected feature of the system. In fact, we may be having another exercise in optimism and speculation at the present time. Galbraith declined to go into detail, but he suggested that there may be far more people participating in common stocks, derivatives, and index funds—and above all, in the holding of stock funds—than there is intelligence to manage them. Galbraith said he was not predicting that a crash was imminent, "because I discovered some years ago that my right predictions were always forgotten and my wrong ones were always wonderfully remembered." He did suggest, however, that it might be time to "run for cover" when people start saying too often that we have entered a new era of permanent prosperity with an absolute tendency for the prices of financial instruments to go up.

Poverty and income inequality

In spite of everything that has been achieved in this century, Galbraith said, two major problems persist that must attract the attention of anybody who speaks "in any degree from the heart." The first is the continuing problem of the very large number of the very poor in the United States and in Europe, and the second is the persistence of and increase in income inequality.

IMF SURVEY



John Kenneth Galbraith: There is a major fault in measuring the quality and achievement of life by the total of economic production.

In the United States, the very poor are now part of the mass of the great cities, partially disguised by being melded in with the larger urban mass, Galbraith observed. These are people who are still deeply in fear of the one thing that costs more people their liberty than anything else—the total absence of money. And that poverty, Galbraith said—particularly urban poverty—is perhaps the greatest of the economic and social legacies we have inherited.

To dissipate the effects of this legacy, Galbraith said he belonged firmly to the community that believes everybody should be guaranteed a basic income: "A rich country such as the United States can afford to keep everybody out of poverty, and I would like to see a renewed discussion of measures that would bring this about," he said. There is a long-run security associated with the mitigation of hardship and anger that such a system could bring about.

A related and larger issue, Galbraith said, is that the United States also has the greatest concentration of income in the very top income brackets and the largest number of people in the lower income brackets. No other country, Galbraith stressed, distributes its income as badly, with the possible exception of modern Russia.

Nothing ensures hardship, poverty, and suffering like the absence of responsible collective action.
—Galbraith

Unfinished business

One of the great transcending achievements of this century was the ending of colonialism in Africa and Asia, Galbraith said. But this achievement has created serious problems. In a considerable part of the colonial world, the end of colonialism meant the end of colonial government—and, too often, its replacement by either corrupt government or no government. We should be deeply aware, Galbraith said, that nothing ensures hardship, poverty, and suffering like the absence of responsible collective action—that is, responsible government. We should not doubt, he stressed, that while we can talk about economic aid or social reform, nothing is quite so serious in our time as the need for decent, competent government.

Finally, the most serious legacy of our century—particularly the latter part of it—Galbraith said, is the fact that we are living, and will continue to live, on the edge of the total destruction of civilization. Available in the United States, to some extent elsewhere, and to a serious extent in what was the Soviet Union are the nuclear weapons that have the potential for ending all civilized existence, and quite possibly all existence. This threat, he concluded, is the greatest piece of unfinished business of this century—and of the past millennium. ■

John Kenneth Galbraith's talk will shortly be available as a video. Further information is available from the American College, 270 S. Bryn Mawr Avenue, Bryn Mawr, PA 19010; telephone: (610) 526-1450.

Dubrovnik conference

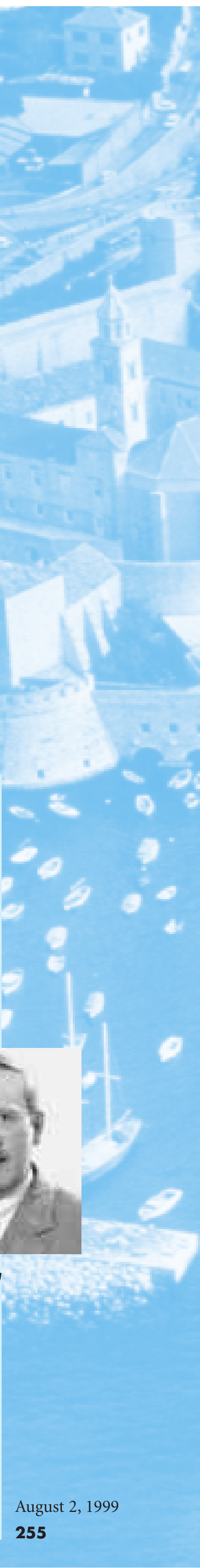
Participants conclude economic transition was more difficult than expected

From the perspective of 10 years of transition, the fifth annual Dubrovnik Conference on Transition Economies considered what had been learned from that experience and what lay ahead. The four-day gathering, held in late June, was sponsored by the Croatian National Bank and organized by Marko Škreb, Governor of the Croatian National Bank, and Mario I. Blejer, Senior Advisor in the IMF's Monetary and Exchange Affairs Department. Experts from academia, multilateral financial institutions, and transition economies agreed that the economic transformation had often been more painful and prolonged than many expected. They pointed to a growing disparity of accomplishments across countries, with some in danger of falling into a corruption-induced transition trap, while others still struggled with institutional shortcomings that could yet undermine their stability and impede their convergence with the European Union.

Dangers of partial reform

The most significant disparity in the transition experience was between the countries of Central Europe and the Baltics, which have broadly returned to positive growth rates, and many countries of the former Soviet Union, which are still in recession, Johannes Linn of the World Bank noted. Differences in overall macroeconomic policy adjustment were less striking than those in the quality of adjustment and structural reforms, and high levels of economic distortion still prevailed in the laggard economies. This reflected weak public institutions, high levels of corruption, and a legacy of deeper central planning. Jan Svejnar of the William Davidson Institute noted that a significant disparity in growth rates across transformation economies had emerged in 1994–95, when countries that had initially undertaken more substantial structural reforms began to perform better. Many countries now found it difficult to catch up, with reforms more difficult to undertake later on.

Arye Hillman of Bar Illan University offered a sobering illustration of how countries could get stuck in an unproductive phase. An increase in rent-seeking activity by insiders in the first stages of transition could result in an equilibrium wherein more resources were switched to unproductive activities. Such a low-productivity equilibrium could be stable, especially in the context of a culture of subservience as had been



promoted in the socialist tradition, and would be very difficult to challenge by disorganized outsiders. To escape from this situation, transition economies needed either a strong leader or a substantial shock and, in many cases, neither had been forthcoming, Hillman noted.

In support of this rent-seeking paradigm, three speakers focusing on the former Soviet Union pointed to the emergence of a culture of corruption that was difficult to dislodge. Yegor Gaidar of the Institute for Economy in Transition explained how in countries adopting a more "populist" approach to reform, the administrative constraints of the old system had not been replaced by market-driven hard budgets. Insider firms had retained preferential access to resources, a lack of clear ownership rights had encouraged theft, and newer enterprises faced unfair competition for resources and markets. In Russia, for example, the triumph of *nomenklatura* capital over the government had made it impossible to introduce meaningful stabilization, and a financial crisis would be required to change this ascendancy. Anders Åslund of the Carnegie Endowment for International Peace showed how piecemeal reforms had led to extraordinary levels of corruption in Ukraine, and he argued that this rent-seeking equilibrium would not be upset without major macroeconomic destabilization. [See also story on page 241.] Mario Nuti of the London Business School said that Belarus, which was still a command economy with a dominant state enterprise sector and controlled prices, had performed better than Russia in some respects because it had not even attempted meaningful reforms and had, therefore, kept corruption in check.

Daniel Daianu of the University of Economics in Bucharest argued that attempts to protect an initial resource misallocation could breed a silent conspiracy against transformation that could eventually overwhelm a fragile institutional structure and undermine stability. The initial misallocation was larger in Romania than in some other transition countries, and the subsequent distribution struggle, far from being resolved through restructuring, led to large interenterprise arrears and bad bank loans that could be resolved only through high inflation. Similarly, Ilian Mihov of INSEAD explained that in Bulgaria, partial reforms had led to an accumulation of enterprise losses that eventually undermined financial stability. The introduction of a currency board regime reimposed financial discipline, but there was a significant cost in terms of the deflationary impact of an appreciating real exchange rate.

Institution building and costs of reform

The development of market-based institutions and incentives was viewed as central to the success of transition, and participants highlighted the danger that institutional failure could lead to a second round of transition costs and undermine stability. Oleh Havrylyshyn (presenting a paper written with Ron van Rooden, both of the IMF's European II Department) concluded that while macroeconomic policies and structural reforms were the most important factors affecting growth in transition economies, indicators of institutional development were also a significant contributor.

Institution building in the financial sector was particularly important, but John Bonin of Wesleyan University and Paul Wachtel of the Leonard Stern School of Business pointed to how difficult this could be. Governments should limit themselves to providing a clear regulatory framework and could even actively help in developing a sound infrastructure. However, in many instances, these efforts had failed, and governments had instead created moral hazard by absorbing risks. Warren Coats of the IMF's Monetary and Exchange Affairs Department and Marko Škreb agreed that the development of an efficient banking system, free of losses and crises, had been slower than expected in most transition economies and had led to a continuation of financial distortions. Also, Velimir Šonje and Boris Vujcic of the Croatian National Bank detailed how a fledgling regulatory supervisor had found it difficult to control opportunistic behavior by banks in Croatia, generating a second round of fiscal transformation costs.

Using a novel approach, Velimir Bole of the Economics Institute of Law Faculty found that the first round of fis-

IMF names Brau to Treasurer's post

Following is a press release issued July 21, announcing the appointment of the new Treasurer of the IMF. The full text is also available on the IMF's website (www.imf.org).

IMF Managing Director Michel Camdessus has named Eduard Brau, a German national, as Treasurer of the IMF, effective September 1, 1999. Brau, who is currently the Director of the IMF Office of Internal Audit and Inspection, succeeds David Williams, who is retiring from the institution after 36 years of service.

Eduard Brau

Brau joined the IMF in August 1969 and has held various positions in the institution, including that of Deputy Director in the IMF's European II Department until May 1996, when he assumed his current position. The European II Department covers the Baltics and the former Soviet Union. He studied at Goettingen and Berlin universities and holds a doctorate in economics from Duke University.

Williams, a U.K. national, joined the IMF in August 1963 and held various positions prior to joining the Treasurer's Department in May 1969. He was appointed Treasurer in August 1991.

The Treasurer's Department has a wide range of responsibilities in the areas of the IMF's financial policies, financial operations, and financial control.

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cal transformation costs in Slovenia reached a maximum of over 3 percent of GDP in the early stages and still exceeded 1 percent of GDP a year. Highlighting the more general difficulties associated with transition, a paper by Jürgen von Hagen of the University of Bonn and Rolf Strauch of the Bundesbank argued that the east German transition presented only a mixed picture of success. Even though it was conducted in the most ideal circumstances, with large initial transfers and a ready-made institutional and political structure, individual consumption and labor choices in eastern Germany now resemble those in west Germany but are still heavily dependent on transfers from there.

Marko Škreb, Governor of the Croatian National Bank and co-organizer of the conference.

Lessons and future paths

Vito Tanzi, Director of the IMF's Fiscal Affairs Department (in a paper written with George Tsibouris, also of the Fiscal Affairs Department), called for a systematic and realistic reexamination of the role of government in transition economies. Public expenditures had often been cut from desperation rather than consideration, creating an institutional vacuum in which small groups had acquired enormous wealth. Governments needed to undertake a deeper transformation that would entail establishing and enforcing the rules of the game, raising revenues and spending productively, and providing public goods. More generally, David Begg of Birbeck College and Charles Wyplosz of the Graduate Institute of International Studies in Geneva examined the size of government in transition economies. They noted that, while government expenditures had generally fallen in size, they were still larger than would be predicted from a model developed for the Organization for Economic Cooperation and Development countries.

Robert Mundell of Columbia University also advocated a reduction in the size of government and regretted that countries did not universally adopt foreign currencies at the outset of transition to ensure the stability necessary for a new private sector to emerge. This could still be accomplished, in many cases, through the adoption of a stable fix to the euro. However, Begg and Wyplosz (in a second paper) advocated a move to a more flexible exchange rate regime for many countries that had initially adopted pegged exchange rates. The most successful exit strategy was to simultaneously lower the rate of exchange rate crawl, and widen the exchange rate band.

Gur Ofer of the Hebrew University of Jerusalem proposed a stylized development strategy for transition economies that drew on the rich experience of developing economies. This strategy would combine openness, a financial sector based on a small number of banks, and a leading sector composed of large corporations with foreign participation. Constantine Michalopoulos of the World Trade Organization (WTO) also stressed the international dimension in transition, noting that the difficult process of accession to the WTO had provided a useful discipline for many countries in transmitting price signals from the world market to domestic resource allocation.

Those countries facing accession to the European Union faced an additional set of challenges and opportunities. Laszlo Halpern of the Budapest Institute of Economics (in a paper written with Judit Nemenyi of the National Bank of Hungary) called for a flexible interpretation of the convergence criteria such that, in the presence of once-off shocks, fiscal policies would not be overly restricted and exchange rates would not bear the full burden of a real appreciation of the currency. In Poland, Marek Dabrowski of CASE (in Warsaw) regretted that the reform process had slowed in the mid-1990s, but was optimistic that the pace had again picked up, driven by the harmonization requirements of the European Union. Similarly, Vladimir Dlouhy of GSE Prague decried the slowdown of reforms in the Czech Republic in the mid-1990s, which ultimately produced a costly crisis in 1997. He warned that a failure to liberate banks from state control would prove very costly and could yet jeopardize stability.

Summary

Putting the discussion in a broader perspective, Jacob Frenkel, Governor of the Bank of Israel, noted that all economies are constantly in a state of transition as they adapt to market forces. The overriding requirement is for a set of rules and a strategy to guide this evolutionary process; policymakers need to be resolute in applying such rules—avoiding both the creation of moral hazard and the temptation to overregulate. International capital markets will be the bridge to new states of equilibrium and have developed to the extent that they will impose severe punishment for policy mistakes, cheating, or political opportunism. In the same vein, Jacques de Larosière of Banque Paribas noted that transition was now well advanced in those countries that have vigorously pursued structural reforms. He argued that the second phase of transition would need to be based on a coherent legal environment and on a strong institutional and financial framework. ■

Gary O'Callaghan
IMF Resident Representative, Croatia