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Contents

273 Why the IMF is lending to Russia

273 Turkish earthquake

275 EMU's stability in transition process

277 HIPC Initiative modified

277 How HIPC works

279 Sequencing financial sector reform

280 New on the web

282 Per Jacobsson lecture announced

282 Selected IMF rates

283 News briefs
Benin
Uganda

284 Press release
Romania

284 Recent publications

285 IMF arrangements

286 Institutionalized corruption

287 Use of IMF credit

Why resume lending?

Russia's current economic policies are deserving of IMF support

The rationale for IMF lending to Russia has been widely questioned, as have the record of earlier programs and the use made of previous IMF loans. In the following article, John Odling-Smee, Director of the IMF's European II Department, explains that the resumed lending was fully justified to support Russia's most recent economic policies.

Since joining the IMF in 1992, Russia has made progress in moving from central planning to a market-based economy, with the support of the IMF and the international community. It is a reform effort whose scale and ambition have few parallels, and whose outcome is of vital importance both for the people of Russia and for the rest of the world.

In view of what is at stake, the relationship between Russia and the IMF is also of vital importance. It is one that has, over the past seven years, been marked by both successes and disappointments. As Russia moves forward with the backing of a new IMF loan, there are reasons to look to the future with some hope.

Nevertheless, Russia's relations with the IMF are passing through a period of intense public scrutiny, and it is necessary to answer the many voices questioning the purpose of current lending to Moscow, the record of earlier programs, and the use of previous IMF loans.

Why did the IMF resume lending to Russia in July 1999 (see *IMF Survey*, August 2, 1999, page 247)? For the past several months Russia has been carrying out economic policies that deserve support: a cautious monetary policy, a reduction in the fiscal deficit, and progress in righting the reversals in structural reforms that occurred after August 1998. Moreover, the government, the central bank, *(Please turn to the following page)*

Camdessus expresses IMF's sympathy to the people of Turkey

The IMF expects to send a staff team to Turkey in mid-September to discuss with the authorities the possibility of emergency balance of payments assistance. The Turkish authorities are currently assessing the economic effects of the earthquake. In a news brief dated August 17, Michel Camdessus, Managing Director of the IMF, expressed his deepest sympathy to the people of Turkey for the tragedy. Following is the text of News Brief No. 99/48, which is also available on the IMF's website (www.imf.org).

"The IMF will do all it can to help the Turkish government deal with this disaster," Camdessus said. "We have been discussing with the government of Turkey for some time an economic program that the IMF could support financially. The government has already made considerable progress in implementing reforms that were discussed with us in June, in the areas of privatization and social security reform, and has shown itself well able to deal with economic problems.

"As Prime Minister Ecevit and his colleagues devote their energies and abilities in the days ahead to deal with this latest crisis, they can be assured that we stand ready to help them in any way that we can. In the meantime, our thoughts and prayers are with them and with the people, who have lost so much."

The devastation in Gölcük, western Turkey.

Why the IMF has resumed lending to Russia

Odling-Smee: The world community has clearly expressed the view that Russia continues to deserve support as long as it is taking appropriate steps to tackle the difficult problems it faces.

(Continued from front page) and the parliament had implemented many key macroeconomic and reform measures in advance of the latest loan, and more are scheduled over the period of the program. All this explains why on July 28 the Executive Board, representing the IMF's 182 member countries, unanimously approved an SDR 3.3 billion (about $4.5 billion) Stand-By credit over 17 months. The program is available on the IMF website (www.imf.org).

In most respects, the program, which was adopted by both the Primakov and Stepashin governments and has been broadly endorsed by Prime Minister Vladimir Putin, contains updated versions of the measures in the July 1998 program of the Kiriyenko government that was interrupted in August 1998.

Need to reform

Even when the program is implemented, there will, of course, remain the need for radical reforms, including additional steps to overcome nonpayment and corruption, impose the rule of law, create a favorable climate for private business, and reform key sectors such as agriculture, energy, and social services. The IMF will continue to urge Russia to make more progress in these areas. However, it is in the setting of an IMF program, when there is a continuous dialogue between Russia and the IMF and where departure from agreed-upon policies can halt IMF lending, that the prospects for economic reform are greatest. If the IMF had signaled after August 1998 that it would provide no new lending to Russia even if it adopted appropriate policies, Russia's willingness over the past year to improve economic policy and mend relations with its creditors would have been much less evident.

The second critical question asks why, even if the current loan is fully justified, the IMF has lent so much to Russia over the years when economic reforms have moved so slowly. The response is that we underestimated the complexity of the whole transition process, in which the economic and political dimensions are intertwined. So, of course, did most observers. As a result, insufficient attention was paid, not least in Russia's own priorities, to the development of institutions and changes in governance that are needed to support institutions.

Similarly, the fact that the authorities adopted an excellent economic program in the past did not mean that it would be implemented. If the economic programs the IMF has supported in recent years had been *fully* implemented, the Russian economy would look very different today. This is why, looking forward, the IMF's membership has insisted on numerous prior actions before approving the loan and why further disbursements of the loan will depend on continued implementation of the program.

Use of IMF loans

Part of the skepticism surrounding IMF lending to Russia has, not surprisingly, been prompted by the various allegations that money from the IMF has simply disappeared abroad. One allegation is that capital flight has been financed with IMF money. Another is that the money was diverted into the wrong hands or even stolen. It *is* true that loans from the IMF eased Russia's external financial situation, although they were small compared to total capital flight and to Russia's other sources of foreign exchange, especially export earnings. But the capital flight was caused, not by the loans themselves, but by the failure to establish economic and political stability and to create a favorable climate for investment. Despite the disappointments of the past, we believe that the current program offers a good chance of gradually improving the economic situation and discouraging capital flight.

Regarding the allegation that IMF money was diverted, there is no evidence that any of the IMF's money was stolen or otherwise misappropriated. The PricewaterhouseCoopers reports on the use made of a tranche of IMF money drawn by Russia in July 1998 and the role of the central bank subsidiary, Financial Management Company (FIMACO), did not find any such evidence. These reports were commissioned by the central bank at the insistence of the IMF and have been published.

PricewaterhouseCoopers did, however, find instances of misreporting to the IMF a few years ago when domestic transactions by the central bank were channeled through FIMACO. The problem is not the nature of the transactions themselves—the central bank had lent to commercial banks and the government before, and has done so since. But hiding the transactions created a misleading impression of the true state of reserves and monetary and exchange rate policies, and may have caused the IMF to disburse funds in 1996 that would otherwise have been delayed. This was a total breach of the trust on which the relationship between the IMF and its members must rest. But Russia now has committed itself to report data to the IMF in a more transparent and comprehensive way, and it knows the very serious consequences of any future misreporting.

A common thread runs through these questions about IMF support for Russia: is it better for the IMF to stand aside in the face of Russia's challenges or to remain engaged? The world community, through the members of this institution, has clearly expressed the view that Russia continues to deserve support as long as it is taking appropriate steps to tackle the difficult problems it faces. ■

Large asymmetric shocks could pose challenges in EMU's transition process

The third and final phase of European Economic and Monetary Union (EMU) was successfully launched on January 1, 1999, when the exchange rates of 11 participating countries were irrevocably locked, the European Central Bank (ECB) assumed responsibility for executing a unionwide monetary policy, and the euro was adopted as the common currency. Over a three-and-a-half-year transition period, the euro will gradually replace national currencies, with the transformation scheduled to be complete by July 1, 2002, when the euro becomes the only legal tender for participating EMU countries. In a recent IMF Working Paper, *Real Wage Rigidities, Fiscal Policies, and the Stability of EMU in the Transition Process*, Norbert Berthold, Rainer Fehn, and Eric Thode, participants in the IMF Research Department's Visiting Scholar program, suggest that political considerations dominated the design and launch of EMU. They argue that the failure to take economic considerations into sufficient account could have serious consequences for the stability of EMU, particularly during the unsettled transition period.

An inherent problem with EMU from its inception, the authors note, is that although it is a monetary union and its members constitute a currency area, it does not fit easily into the standard definition of an optimum currency area. A well-functioning monetary union is characterized by one or more of the following features: low incidence of asymmetric shocks, a highly mobile labor force, flexible real wages, and a system of fiscal federalism. Even with these features in place, there is no guarantee of permanent stability. This is probably the principal reason, the authors observe, that monetary unions not accompanied by political unification always remain somewhat unstable.

Asymmetric shocks

The 11 participating EMU countries have widely varying production structures, so sector-specific shocks are bound to affect each country differently. This is not at all surprising, the authors note, considering that the prospective boundaries of EMU stretch from the Mediterranean to the Arctic Circle. Furthermore, given that the capacity to adjust to adverse shocks also differs considerably among countries, even symmetric shocks can be expected to exert asymmetric effects on member countries. Given the current economic and structural diversity of prospective member countries, asymmetric shocks are still bound to occur from time to time. The transition phase, in which asymmetric shocks pose the greatest threat to the stability of EMU, will therefore be particularly fragile.

In principle, four channels are available through which countries can adjust to adverse shocks without raising unemployment: labor mobility, real-wage flexibility, monetary policy, and fiscal policy. The first of these, the authors note, is not an option for Europe; intercountry mobility is already low, and deeply entrenched cultural and language barriers will likely keep it so.

Real-wage flexibility

Real-wage flexibility, because it relies on market forces, seems to be the most desirable alternative to labor mobility. However, even though persistent unemployment has been an issue in Europe since the late 1980s, resistance to labor market reforms has been strong, and little progress has been made in reducing real-wage rigidities. The authors demonstrate that with current high levels of real-wage rigidities in Europe—coupled with the entrenched resistance to reform—real wages cannot be relied upon to absorb adverse shocks. It is therefore safe to assume that the current rigidity of European labor markets will persist during the transition phase.

Accommodative demand policies

In the absence of real-wage flexibility and high labor mobility, the pressure to use accommodative demand policies in the face of negative shocks is particularly marked. In a review of the experience of representative European countries from 1970 to 1995, the authors find that all countries surveyed used demand policies to some extent to counter the negative employment effects of adverse shocks. Monetary policy was the chief instrument

until the 1980s and 1990s, when concerns about high and volatile inflation prompted a switch to fiscal policy.

In countries with high real-wage rigidity, the pressure to adopt a discretionary accommodative fiscal policy is particularly strong. Rigid real wages are an important cause of high unemployment, which needs to be financed. Moreover, an expansionary fiscal policy helps keep unemployment down, at least in the short run. But both channels lead to higher fiscal deficits and, during periods of very high unemployment, higher government debt.

Recourse to accommodative fiscal policy by EMU members may, however, be circumscribed by the Stability and Growth Pact. Signatories to the pact, which was adopted in July 1997, have committed themselves to attaining medium-term budgetary balance and to keeping the general government deficit below 3 percent of GDP. It has been argued that these restrictions on fiscal policy are necessary to prevent excessive levels of government debt from undermining monetary stability in EMU. Without such constraints, countries with high levels of government debt and unsustainable fiscal deficits could pressure the ECB to adopt a more lenient monetary policy, which would very likely trigger higher inflation.

Instability in transition

Currency risk between EMU participants presumably disappeared forever on January 1, 1999. This assumption, as embodied in the Maastricht Treaty, implies that none of the initial EMU members will withdraw and EMU will not only persevere but grow in time. However, because the issue of dealing with asymmetric shocks and the tensions between fiscally conservative and fiscally profligate members has not been adequately addressed, countries may regard the transition phase as a testing period and decide to abandon the system if the costs of staying in are too high.

For EMU members, monetary policy is no longer available as a policy instrument for adjusting to idiosyncratic shocks. Thus, the pressure to use expansionary fiscal policy will be greater than in the past, but the Stability and Growth Pact theoretically limits the use of expansionary fiscal policy at the national level. The authors question whether the pact will actually be able to restrain fiscal deficits, particularly since loopholes make it possible for countries to misbehave fiscally without being penalized. Large asymmetric shocks, which could well occur during the transition phase, could put the stability of EMU under severe strain, while conflicts between fiscally conservative and fiscally profligate EMU participants are bound to arise if the Stability and Growth Pact is not enforced. If, however, the pact is successful in limiting the use of national fiscal policy, rising unemployment in some countries could strengthen calls for a system of fiscal federalism to accompany the euro, even though such a system would impose a disproportionate burden on fiscally prudent members.

The experience of other monetary unions supports the suggestion that some form of fiscal federalism will evolve in the medium to long run, the authors observe, but such an elaborate system takes a long time to develop and would certainly not be available to EMU members during the transition period. Both fiscally conservative and fiscally profligate countries will then have to decide either to stay in EMU and accept the associated costs, which could include unsustainably high rates of unemployment, or to drop out.

Although currency risk within EMU is technically eliminated by the establishment of the euro as legal tender, the authors caution that an economic risk remains. In economics, "nothing is forever," and history has demonstrated that there is no such thing as irrevocably fixed exchange rates. This is true not only for fixed exchange rate systems but also for monetary unions. Whether a country decides to stay in a monetary union or to leave depends on a cost-benefit analysis. The Maastricht Treaty has no provision for countries wishing to leave EMU, but a sovereign country can hardly be forced to stay in EMU against its will. A country wishing to withdraw unilaterally and reintroduce its national currency cannot reasonably be prevented from doing so. Such a pullout is more likely to happen during the transition phase, according to the authors, because it is much cheaper to reintroduce a national currency that is still in circulation as the only legal tender than to recreate a national currency from scratch.

Conclusion

When EMU officially came into existence, economic considerations based on concerns about fiscal policy in several member countries and the lack of labor market flexibility throughout Europe were brushed aside. The three-and-a-half-year transition period between the irrevocable locking of participants' exchange rates and the replacement of national currencies with the euro as the only legal tender is therefore a crucial time for EMU, the authors observe. Large asymmetric shocks could pose a serious challenge to the union's viability. Without real wage flexibility and an appropriate mechanism for dealing with asymmetric negative shocks—either at the country level or EMU-wide—speculative attacks against currencies in economic distress could cause the country concerned to leave the system if the costs of staying inside EMU become too large to bear. ■

Copies of IMF Working Paper 99/83, *Real Wage Rigidities, Fiscal Policies, and the Stability of EMU in the Transition Process*, by Norbert Berthold, Rainer Fehn, and Eric Thode, are available for $7.00 each from IMF Publication Services. See page 284 for ordering information.

IMFSURVEY

IMF Executive Board reviews proposals to modify debt-relief initiative

On August 5, the IMF Executive Board reviewed IMF and World Bank proposals to modify the framework of the Heavily Indebted Poor Countries (HIPC) Initiative (see box below). This review is part of ongoing discussions to enhance the HIPC Initiative, including financing of the Enhanced Structural Adjustment Facility (ESAF)–HIPC Trust and the modalities for strengthening the link between debt relief and poverty reduction. In a Public Information Notice (PIN), IMF First Deputy Managing Director Stanley Fischer summarized the Board's discussion as follows. (The full text of PIN 99/76, as well as the modifications paper discussed by the Board, is available on the IMF's website (www.imf.org).)

"Executive Directors considered the paper entitled "Modifications to the Heavily Indebted Poor Countries (HIPC) Initiative"—which had been prepared jointly by the staffs of the International Development Association (IDA) and the IMF.

"Directors welcomed the paper, which builds on the current HIPC Initiative framework with a number of specific modifications to strengthen it while adhering to the principles for change set forth by the managements of the IMF and the World Bank in April. Directors agreed with the general approach, including lower targets and thresholds that would provide deeper and broader debt relief. They underscored the importance of retaining the basic elements that had guided the HIPC Initiative, including participation by all creditors and a focus on sustainable development. Directors also cautioned that debt relief will only achieve its goals if it is integrated into an overall poverty reduction strategy. A few Directors stressed that in setting policy requirements for a completion point, governance issues should be addressed as a matter of priority.

Additional financing

"Directors underscored that decisions on the enhancements to the Initiative need to proceed in parallel with agreement on additional financing—not yet secured—for the Fund's contribution to the HIPC Initiative, as

Debt initiative for the heavily indebted poor countries

For 41 low-income countries, mostly in Africa, the external debt situation has become extremely difficult. The IMF and the World Bank have designed a framework—the HIPC Initiative—to provide special assistance for those that pursue adjustment and reform programs supported by the two institutions but for which traditional debt-relief mechanisms do not go far enough. The HIPC Initiative entails coordinated action by the international financial community to reduce these countries' debt burden to sustainable levels—that is, to levels that will enable them to comfortably service their debt through export earnings, aid, and capital inflows.

How the HIPC Initiative works

First phase. To qualify for assistance, the country must adopt adjustment and reform programs supported by the IMF and the World Bank and pursue those programs for three years. During that time, it will continue to receive traditional concessional assistance from all the relevant donors and multilateral institutions, as well as debt relief from bilateral creditors.

Decision point. At the end of the three years, an analysis of the country's external debt situation will be carried out. It is essentially a medium-term balance of payments projection that assesses the country's debt burden and its ability to meet those obligations. If the country's external debt ratios fall within or above applicable ranges, it will be considered for special assistance. The ranges are 200–250 percent for the present value of debt to exports, and 20–25 percent for the ratio of debt service to exports.

At the decision point, the Executive Boards of the IMF and the World Bank will formally decide on a country's eligibility, and the international community will commit to provide enough aid at the completion point (see below) for the country to achieve debt sustainability. The assistance committed by the IMF and the World Bank will depend on satisfactory assurances of action by other creditors.

Second phase. Once eligible for support under the HIPC Initiative, the country must—for three additional years—perform satisfactorily under programs supported by the IMF or the World Bank. This period may be shortened for countries that already have a sustained record of strong performance. During this phase, bilateral and commercial creditors are generally expected to reschedule obligations coming due, with a reduction in present value of up to 80 percent.

Completion point. Creditors provide assistance at this juncture in a variety of forms, which may include up-front debt reduction or debt-service reduction, debt buybacks, or grants.

Strengthening the HIPC Initiative

The Interim and Development Committees have endorsed a strengthening of the current framework of the initiative to provide deeper debt relief to strengthen countries' incentives to adopt and implement economic and social reform programs and that provides a clear exit from unsustainable debt burdens. The IMF and the World Bank will consider proposals to enhance this framework in the run-up to their annual meetings scheduled for late September.

IMF Executive Directors agreed that lower targets and thresholds would provide deeper and broader debt relief.

well as that of other multilateral creditors, and the Bank in particular. Hence, today's discussion could only be considered preliminary. Decisions should also reflect an agreement on how to strengthen the link between debt relief and poverty reduction, on which a further paper is expected. Directors emphasized the need for all creditors, including the non–Paris Club bilateral creditors, to participate fully and equitably in an enhanced framework. A few of these Directors noted that some regional multilateral creditors may be constrained in their ability to participate.

"Directors agreed that the debt sustainability targets under the current framework should be lowered to provide a greater cushion for the achievement of debt sustainability. To this end, Directors supported a lower net present value of debt-to-exports target of 150 percent, thereby replacing the current target range with a single target. With respect to the fiscal window, Directors agreed to a lower net present value of debt-to-fiscal revenue target of 250 percent, and supported the lowering of the eligibility thresholds for the openness of an economy to an export-to-GDP ratio of 30 percent, and a revenue effort of 15 percent of GDP.

"Directors also agreed to change the assessment base for debt relief under the Initiative from data projected for the completion point to actual data at the decision point. Directors noted that this would increase potential relief. These overall changes would broaden the number of countries that could potentially qualify for HIPC Initiative assistance.

Interim assistance

"Directors supported the provision of interim assistance and more front-loaded relief, as this could free up more resources for increased social and other poverty-reduction expenditures, subject to a country's capacity to make effective use of this earlier assistance and debt service falling due. They emphasized, however, that assistance should be provided in a way that maintains debt sustainability over the medium term, and results in a falling debt-service profile in relation to both exports and fiscal revenue. Some Directors noted that the cost implications for multilateral creditors of different profiles of front-loaded relief would have to be considered.

"Most Directors were in favor of providing interim assistance by the IMF and other multilateral creditors in a cautious and pragmatic manner, provided that the country was able to make effective use of early assistance and that adequate funding was available. Directors supported the proposals made by the staff on how the IMF could provide interim assistance under an enhanced HIPC Initiative framework, underscoring that the provision of interim assistance should be conditioned on the pursuit of sustainable macro and social policies.

"Directors supported the introduction of floating completion points in the HIPC Initiative as this would base the assessment of a country's performance on particular outcomes rather than on the length of the track record. The use of floating completion points could also provide an incentive to implement reforms quickly and develop ownership over the timetable. In other words, this would put the countries themselves in the driver's seat in determining the timing of debt relief. However, several Directors noted that this was a major change in practice, and expressed concern that the reforms to which floating completion points were tied might be more ambitious than under the current framework, possibly leading to delays, which should be avoided. They therefore drew attention to the need to set clear policy priorities to avoid overloading the reform agenda. Others were concerned that it could be difficult to ensure fair treatment across countries. In view of these points, it was considered useful to provide examples of what a floating completion point would entail in practice, and there was general support for a review of floating completion points in one year.

"Most Directors agreed that the proposed modifications to the framework would simplify implementation of the Initiative. In this context, country-specific vulnerability analyses and the category of borderline cases would no longer be required.

"Most Directors agreed that the adoption of a decision point–based calculation of assistance would no longer require automatic reassessment at the completion point of the amount of assistance to be provided. Several Directors suggested that additional assistance could be provided on a discretionary basis to countries where exogenous shocks had led to a sharp deterioration in the debt situation at the completion point, underscoring the importance of providing a clear and permanent exit from unsustainable indebtedness at the completion point. A few other speakers, however, were concerned that such discretionary 'topping up' at the completion point could give rise to false expectations.

Debt-service indicators

"Directors welcomed the inclusion of a more detailed analysis of debt-service indicators in HIPC Initiative documents, including an analysis of the debt-service-to-fiscal-revenue ratio and the overall budgetary context, and agreed that the delivery of debt service should, on a country-by-country basis, reflect these indicators. They agreed that the debt-service-to-export ratio should fall within the 15 to 20 percent range or below, although this would not be a binding constraint. A few Directors suggested that the debt-service-to-fiscal-revenue ratio should be the focus of the analysis of debt service.

"Directors agreed with the proposed mechanism for retroactivity, namely, for countries that have already passed their decision points to benefit from the proposed enhancements to the framework based on their current (end-1998) situation. Directors stressed the

importance of strong performance by countries eligible for retroactivity on both macroeconomic stability and the strengthened framework for poverty reduction emphasized under the enhanced HIPC Initiative, but they underscored that this should not lead to a third stage and unnecessary delays in the provision of debt relief to these countries. A few Directors, however, felt that countries may require additional time to put in place the reforms needed under the new framework to achieve effective poverty reduction. Directors stressed the need for continued aid flows to HIPCs and urged donor countries to encourage policies in HIPCs related to poverty reduction and sustainable development. To help sustain progress by HIPCs, they considered that the international community should work to improve the access of these countries to industrial country markets and restrain export credit lending and lending for unproductive expenditure to HIPCs. Several Directors also attached importance to new lending being provided on concessional terms and to the strengthening of debt management in HIPCs.

Publication

"Finally, Directors agreed that the modifications paper be made available to the public by posting it—as well as this summing-up—on the IMF's HIPC Initiative website (www.imf.org). This document should be viewed in conjunction with the forthcoming discussions on the other elements proposed to enhance the HIPC Initiative, including the financing of the ESAF-HIPC Trust and the modalities for achieving a strengthened link between debt relief and poverty reduction." ■

Crisis prevention

Appropriate sequencing of financial sector reform can play key role in successful liberalization

A country with a tightly controlled financial sector embarks on a series of ambitious reforms. It introduces market-based procedures for monetary control, promotes competition in the financial sector, and relaxes restrictions on capital flows. The moves stimulate the financial sector and spur growth.

At the same time, a second country begins to dismantle its repressed financial system, embracing similar reforms and pursuing many of the same policies. But instead of providing a boost, the reforms spark a full-fledged financial crisis that plunges the country into a recession.

Why was the loosening of financial sector controls associated with a boom in one country and a crisis in another? The connection between financial sector liberalization and financial crisis is complex, and a broad range of interrelated economic forces can influence events. The implications of these developments are analyzed in a new book, *Sequencing Financial Sector Reforms: Country Experiences and Issues*, edited by R. Barry Johnston and V. Sundararajan. The book looks at the practical experiences of Argentina, Chile, Indonesia, and other IMF member countries with financial sector reforms since the late 1970s and concludes that these point to a critical piece of the puzzle: the sequencing of reform.

An orderly and well-supported financial sector liberalization can mean the difference between stabilization and collapse. Countries pursue liberalization hoping that it will lead to higher and more sustainable rates of growth. Some fear that a failure to loosen controls in the financial sector will shut them off from global capital markets and make them unattractive to potential investors.

But these financial reforms can lead to trouble if they are sequenced inappropriately or are insufficiently supported. Academic literature has tended to place financial sector reform relatively late in the overall sequence of economic reform and to favor a gradual approach.

Still, the potential role of financial systems in improving economic performance argues for examining ways of accelerating the financial sector reforms while seeking to reduce the chances of an economic downturn due to poorly sequenced or poorly managed

reforms. Maintaining controls on the financial sector is costly—in terms of low savings mobilization, capital flight, lack of monetary control, and an inefficient allocation of resources. The challenge of financial sector reform is to evolve strategies that can improve financial sector efficiency while achieving or maintaining financial stability.

R. Barry Johnston

Financial sector reform

Financial sector liberalization can be viewed as a set of reforms and policy measures designed to deregulate and transform the financial system and its structure. Throughout the world, financial sector reforms have led to greater flexibility in interest rates; an enhanced role for markets in credit and foreign exchange allocation; increased autonomy for commercial banks; greater depth for money, securities, and foreign exchange markets; and significant increases in cross-border flows of capital.

V. Sundararajan

Such reforms have usually involved

- increasing autonomy for central banks in monetary management;
- developing market-based monetary control procedures and money and interbank markets to bolster interest rate regimes;
- reforming prudential regulations and the banking supervision system;
- recapitalizing and restructuring weak financial institutions, supported by enterprise restructuring policies;
- reforming selective credit regulations and reducing the scope of directed credit and interest subsidies;
- fostering autonomy and competition in the financial system and promoting institutional development of both banks and nonbank financial intermediaries;
- developing long-term capital markets, including domestic public debt management and government securities markets;
- reforming clearing and settlement systems for payments;
- developing foreign exchange markets supported by appropriate prudential regulations on foreign exchange exposure; and
- eliminating restrictions on payments and transfers for current international transactions and liberalizing controls on capital movements.

Country experiences

A number of IMF member countries have pursued financial sector liberalization since the 1970s, the study notes, and their experiences reveal close structural linkages among specific components of financial sector reforms. These linkages have implications for the appropriate sequencing of reform. Examinations of data from 40 countries, and of selected individual country experiences, such as Argentina, Chile, Indonesia, Korea, and the Philippines, yield lessons in a number of areas, including monetary reform, banking crises and prudential supervision, real sector effects, and capital account liberalization.

Monetary reform. Two types of monetary and portfolio shocks are evident from the experiences of various countries. First, in nearly all countries, financial liberalization has been followed by a period in which credit growth exceeded the growth of deposits, and in several countries, the gap between the growth of credit and the growth of deposits widened following the reforms. Second, eliminating controls on capital inflows has, at least initially, resulted in stronger capital inflows.

Available on the web (www.imf.org)

News Briefs

99/49, August 23. IMF Completes Review and Approves $5.1 Million Credit Tranche for Benin (see page 283)

99/50, August 26. IMF Completes Review and Approves $22.78 Million Credit Tranche for Uganda (see page 283)

Public Information Notices (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. Recently issued PINs include

99/75: Japan, August 13
99/76: HIPC, August 13 **(see page 277)**
99/77: Ethiopia, August 16
99/78: Mauritius, August 18
99/79: Ireland, August 20
99/80: Suriname, August 19
99/81: Moldova, August 23
99/82: Brazil, August 23
99/83: Denmark, August 26
99/84: Dominican Republic, August 25

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 support from the IMF. Recent releases include

Mali, July 12
Romania, July 12 and August 5
Benin, August 24

Policy Framework Papers are prepared by the member country in collaboration with the staffs of the IMF and the World Bank. These documents, which are updated annually, describe the authorities' economic objectives and macroeconomic and structural policies for three-year adjustment programs supported by Enhanced Structural Adjustment Facility resources.

Mali, July 12

To cope effectively with these monetary and credit shocks and the potential foreign capital inflow, the study suggests, policymakers need to develop indirect instruments of monetary control. Countries that implemented successful reforms have tended to liberalize monetary controls in stages, ensuring that necessary concomitant reforms are implemented in a timely manner. They have also relied on a range of monetary instruments during the initial stages of reform. Countries have generally found it necessary to speed up the introduction of and reliance on indirect monetary controls to help manage the effects of foreign inflows of capital.

Banking crises and prudential supervision. The failure to strengthen bank supervision appears to have been a critical weakness in a number of financial sector reforms, in the view of the study. Reforms in several countries—for example, Argentina, Chile, and the Philippines—were undermined by financial crises that stemmed from banking sector weakness. These crises disrupted the entire financial sector and were accompanied by a sharp contraction in GDP. Also, banking sector problems and weaknesses in Asia contributed to the inefficient use of capital inflows and were an important ingredient in the currency crises that enveloped the region in 1997. These episodes indicate the significant two-way correlation between banking soundness and macrostability and point to the importance of implementing financial sector reforms with due regard to the soundness of financial institutions.

Early and timely attention to developing vigilant bank supervision and well-designed prudential regulations could have helped detect and contain the buildup of financial fragility, the study finds. In some countries, financial reform was accompanied by strengthened prudential regulations, but implementation of the regulations was weak. This underscores the importance of having not only adequate regulations but also the capacity to implement them.

Real sector effects. The transition from repressed to more market-oriented financial systems involves shocks to interest rates, the exchange rate, and financial flows, and policymakers' reactions to these shocks can affect economic performance, the authors report. Many countries have improved economic growth and efficiency through financial sector reforms, but several other countries, industrial and developing, have experienced financial crises and disruptions to economic growth.

When properly managed, financial reforms can contribute to strong improvements in economic growth and efficiency. Key elements of successful reforms included increases in real interest rates; management of credit growth following the reforms; and improvements in banking efficiency in the postreform period.

Capital account liberalization. Removing restrictions on the movement of capital into and out of a country can boost growth. But a poorly timed or badly managed liberalization of the capital account can expose a country to dramatic reversals in short-term capital flows and to other external shocks. The speed at which a country abandons controls on its capital account came under intense scrutiny in the wake of the Asian currency crisis of 1997, with some observers pointing to the opening of the capital account as a critical force in the crisis.

The experiences of the Asian countries confirm that it is necessary to approach capital account liberalization as an integral part of a comprehensive program of economic reform, coordinated with appropriate macroeco-

Sequencing Financial Sector Reforms: Country Experiences and Issues examines how financial sector reforms proceeded in a number of Asian and Latin American countries. The table below illustrates how Chile structured its financial reforms.

Chile: sequence of financial reforms

	1974	1975	1976	1977	1978	1979	1980
Deregulation of the financial sector							
Short-term money market rates freed	•						
Most commercial banks privatized	•						
Barriers to entry lowered		•					
Subsidized and selective credits reduced		•					
Quantitative credit controls removed		•					
Interest rates liberalized		•					
Saving and dollar deposit rates indexed		•					
Only real interest received is taxable		•					
Restrictions on scope of activities eased			•				
Foreign bank branches allowed			•				
Commercial banks free to borrow abroad			•	•	•		
Strengthening of supervisory, regulatory, and legal systems							
Disclosure requirements enforced	•						
Capital requirements raised and indexed	•						
Noncompliance penalties introduced	•						
Limits on concentration of bank ownership introduced		•				*	
Supervisory jurisdiction widened	•	•	•				
Limits on credit to a bank customer rationalized							•
Maximum firm shares doubled for banks							•
Reform of monetary control instruments							
Foreign exchange rate primary monetary target		•					
Interest paid on reserve requirements		•					
Reserve requirements lowered and unified					•		
Interest payments on reserve requirements phased out					•		
Auctions of central bank credit and treasury bills introduced			•				

* Measure rescinded.

Data: IMF, *Sequencing Financial Sector Reforms: Country Experiences and Issues*

nomic and exchange rate policies. The question was not so much one of capital account liberalization having been too fast, since some of the countries in Asia followed a gradualist approach. Rather, successful opening of the capital account appears to call for coordinated and concurrent reforms irrespective of the pace of reforms.

Conclusion

Financial sector reforms require mutually supporting reforms in a number of areas, the study concludes. Reforms to certain sectors, such as monetary and exchange systems, can enhance economic performance, but without simultaneous moves to strengthen financial institutions, they can also contribute to banking crises and other economic problems.

Financial reforms involve monetary and portfolio shocks. To prevent such shocks from leading to financial crises, policymakers should introduce indirect instruments of monetary control early, strengthen financial institutions, and implement prudential regulation and supervision, according to the study. A mix of these instruments can help ensure adequate monetary control and support financial market development.

The study recommends that capital account liberalization be approached as an integrated part of comprehensive reform strategy and should be paced with the implementation of appropriate prudential measures and macroeconomic exchange rate policies.

Countries that implemented successful financial sector reforms and avoided financial crises significantly boosted their economic performance. Those that experienced financial crises, however, suffered a decline in performance. The study's finding argues forcefully for ensuring that financial reforms, when undertaken, be properly managed and implemented with requisite attention to both stabilization and financial system soundness. ■

Jeffrey Hayden
IMF External Relations Department

Copies of *Sequencing Financial Sector Reforms: Country Experiences and Issues*, edited by R. Barry Johnston and V. Sundararajan, are available for $27.50 each from IMF Publication Services. See page 284 for ordering details.

Duisenberg to deliver Per Jacobsson lecture

Wim Duisenberg, President of the European Central Bank, will deliver this year's Per Jacobsson lecture "The Past and Future of European Integration—A Central Banker's View." The lecture will be given on September 26, 1999, at 3:00 p.m. at the Omni Shoreham hotel in Washington, D.C. The lecture takes place two days before the formal opening of this year's IMF–World Bank Annual Meetings.

A national of the Netherlands, Duisenberg has been the president of the European Central Bank since its establishment on June 1, 1998. Prior to that, he was president of the bank's precursor, the European Monetary Institute. In the course of a distinguished career in the international monetary field, he has served as president (1982–97) of the De Nederlandsche Bank—the Netherlands central bank—and as its executive director (1981–82). He was chairman of the board and president of the Bank for International Settlements from 1988 to 1990 and from 1994 to 1997, as well as a member of the bank's board of directors (1982–97). He also served as his country's minister of finance from 1973 to 1977 and was a member of parliament for the socialist party from 1977 to 1978. Duisenberg is a graduate of the University of Groningen, where he was awarded a Ph.D. in 1965, and a former staff member of the IMF.

Photo copyrighted, not available

Wim Duisenberg, European Central Bank President.

Established in 1964 in honor of the third managing director of the IMF, the Per Jacobsson lectures are usually held annually and are designed to promote informed international discussion of current issues in monetary affairs.

* * *

Attendance at the Per Jacobsson lecture is by invitation only and is restricted for reasons of space. Persons interested in being added to the invitation list should write to

The Secretary
Per Jacobsson Foundation
International Monetary Fund
700 19th Street N.W.
Washington, D.C. 20431

Photo Credits: EPA-Hurriyet for AFP page 273; Denio Zara and Padraic Hughes for the IMF, pages 274, 280, and 288; and Ralph Orlowski for Reuters, page 282. **Artwork:** Massoud Etemadi page 286.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
August 16	3.36	3.36	3.82
August 23	3.38	3.38	3.84

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

IMF completes review and approves $5.1 million credit for Benin

In a news brief issued on August 23, Stanley Fischer, Deputy Managing Director of the IMF, said: "The Executive Board of the IMF today completed the first review under the second annual arrangement under the Enhanced Structural Adjustment Facility for Benin. As a result, Benin will now be able to access SDR 3.624 million (about $5.1 million) from the IMF.

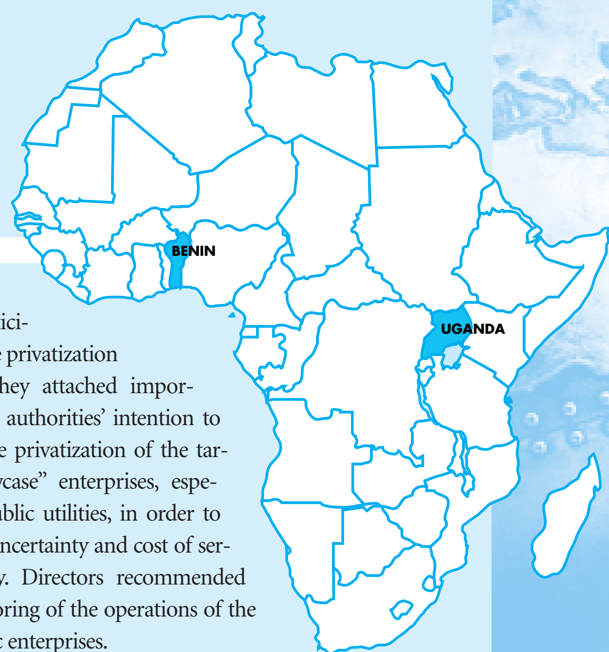
"Directors welcomed the authorities' commitment to maintain a stable macroeconomic framework, implement structural reforms, improve social services, and reduce poverty. These were the key determinants of Benin's economic performance in 1998 and early 1999, when real per capita GDP growth remained robust, inflation continued to be moderate, and fiscal performance was satisfactory, despite difficulties in the cotton sector.

"Directors welcomed the authorities' efforts to improve the efficiency of the public sector by strengthening tax administration and budget procedures, as well as by adopting a performance-based compensation system for the civil service. These measures would allow for adequate levels of expenditure on the social sectors and public investment.

"Directors, however, expressed concern about the worsening situation in the cotton sector following the recent sharp drop in production and world prices, and the broad repercussions that this was expected to have on the rest of the economy. They urged the authorities to act promptly to ensure the sector's long-run competitiveness by resolving financial problems and by adhering to the timetable for its full liberalization.

"Directors regretted delays in implementing structural policies and stressed the need to accelerate the pace of reform. In the period ahead, Directors urged the authorities to complete the civil service reform and open all sectors to private investment so as to broaden and strengthen Benin's economic base. They were encouraged by the improvement in social policies and outcomes but stressed that stronger budget management was required to ensure an adequate level of social spending and public investment," Fischer said.

The full text of News Brief 99/49 is also available on the IMF's website (www.imf.org).



IMF completes review and approves $22.78 million credit for Uganda

In a news brief issued on August 26, Shigemitsu Sugisaki, Deputy Managing Director of the IMF, said: "The Executive Board of the IMF today completed the second review under the Enhanced Structural Adjustment Facility (ESAF) for Uganda. As a result, Uganda will now be able to access SDR 16.7375 million (about $22.78 million) from the IMF.

"Directors welcomed the authorities' commitment to the continued implementation of prudent macroeconomic policies, strong structural adjustment reforms, public service rationalization, improvement of social services, and a robust poverty reduction program. These policies had sustained Uganda's track record of rapid economic growth and moderate inflation and had contributed to a notable drop in the incidence of poverty in Uganda.

"Directors welcomed the authorities' efforts to strengthen fiscal performance through measures designed to enhance expenditure monitoring and control. These measures would help to achieve the targeted reduction of defense outlays, the provision of increased resources to the social sectors, and the successful elimination of domestic arrears and avoidance of further such arrears. Directors also emphasized the need to boost revenue performance through actions to improve tax enforcement and compliance and through steps to broaden and deepen the tax base. They also underscored the importance of extending the ministerial restructuring exercise to all other functions of government, and of reforming the pension system and the related benefit formula.

"Directors urged the authorities to continue their efforts—including through appropriate legislative changes—to ensure greater transparency, accountability, and efficiency, as well as broader participation in the privatization process. They attached importance to the authorities' intention to speed up the privatization of the targeted "showcase" enterprises, especially the public utilities, in order to reduce the uncertainty and cost of service delivery. Directors recommended close monitoring of the operations of the major public enterprises.

"Directors emphasized the need to strictly enforce the existing prudential regulations in the banking sector, so that undercapitalized banks are either promptly recapitalized or closed. The authorities were urged to move forward expeditiously with the reprivatization of the Uganda Commercial Bank. Regarding the existing commitments to repay net deposits at three failed banks and the recapitalization of the Uganda Commercial Bank, Directors urged that all the related costs be transparently reported, and their liquidity impact fully sterilized.

"Directors welcomed the increased priority given to poverty reduction. They supported the authorities' intention to increase public outlays on poverty and social areas within the context of disciplined expenditure management. In this connection, they welcomed the various initiatives under way in these areas aimed at making good use of the resources freed up by the Initiative for Heavily Indebted Poor Countries, recalling that Uganda had been the first recipient of assistance under the HIPC Initiative," Sugisaki said.

The full text of News Brief 99/50 is also available on the IMF's website (www.imf.org).

Press release

Romania: Stand-By

The IMF approved an eight-month Stand-By credit for Romania in an amount equivalent to SDR 400 million (about $547 million) to support the government's economic stabilization and reform program. The loan will be made available in four installments. The first installment, which will be available immediately, will be in an amount equivalent to SDR 53 million (about $73 million).

Following are excerpts from IMF First Deputy Managing Director Stanley Fischer's statement on the Executive Board discussion.

"Executive Directors welcomed the authorities' renewed commitment and effort to correct severe economic imbalances and long-existing structural weaknesses. Directors considered that the authorities' program, if fully implemented, would mark a major step forward in Romania's quest for financial stability and establish the basis for sustainable growth. They noted with satisfaction the authorities' recent up-front actions in several policy areas, including fiscal strengthening and progress in bank restructuring and privatization.

"However, against the background of the uneven implementation of previous IMF programs, and in light of the weakness of the economy, Directors urged the authorities to hold firm to their policy commitments, as this is essential for regaining market confidence. Directors stressed the importance for the recovery of the economy of persevering with both fiscal and structural adjustment, and cautioned against a premature relaxation of financial policies.

"Medium-term fiscal sustainability and structural reforms were seen as key for the establishment of sustained noninflationary growth.

"Directors regretted that, despite the authorities' efforts, it had not been possible for them to obtain the desired amount of private sector financing. They emphasized that it is vital that Romania continue to work vigorously toward obtaining additional private foreign financing in support of its reform program and that implementation of their stabilization and structural reform program would contribute both to restoring access to capital markets and to economic recovery and growth."

Program summary

Romania has lagged behind most other transition economies in Central and Eastern Europe in economic reform and stabilization, mainly because of a lack of sustained policy efforts. Although prospects improved in early 1997, when a coalition government tightened macroeconomic policies and implemented

Romania: selected economic indicators

	1995	1996		1997		1998[1]	1999	2000[2]
		Program	Outturn	Revised program	Outturn		Proposed program	
	(annual percent change)							
Real GDP	7.1	4.0	3.9	−1.5	−6.6	−7.3	−3.5	2.5
	(period average)							
Consumer prices	32.3	23.0	38.8	150.0	154.8	59.1	41.4	18.6
	(percent of GDP)							
General government balance (excluding privatization receipts)	−2.6	...	−4.0	...	−4.6	−5.7	−3.9	−2.1
Current account balance	−4.9	−3.2	−7.4	−3.6	−6.2	−7.9	−7.5	−7.0
	(months of imports of goods and services)							
Gross reserves[3]	2.8	...	3.0	4.2	4.6	3.6	3.9	4.3

[1]Estimates.
[2]Projections.
[3] Including gold and excluding Bancorex deposits. Imports of goods and services of the following year.

Data: Romanian authorities and IMF staff estimates

Recent publications

Working Papers ($7.00)

99/95: *The Structural Budget Balance: The IMF's Methodology*, Robert Hagemann

99/96: *Measures of Potential Output: An Application to Israel*, Fabio Scacciavillani and Phillip Swagel

99/97: *A Dynamic Model of Inflation for Kenya, 1974–96*, Dick Durevall and Njuguna S. Ndung'u

99/98: *The Rise and Fall of the Pyramid Schemes in Albania*, Chris Jarvis

99/99: *Adjustment Costs, Irreversibility, and Investment Patterns in African Manufacturing*, Arne Bigsten and others

99/100: *Global Moral Hazard, Capital Account Liberalization, and the "Overlending Syndrome,"* Eduardo Levy Yeyati

99/101: *We Just Averaged Over Two Trillion Cross-Country Growth Regressions*, Eduardo Ley and Mark F.J. Steel

99/102: *Ratchet Effects in Currency Substitution: An Application to the Kyrgyz Republic*, Joannes Mongardini and Johannes Mueller

99/103: *Public Debt Management and Bailouts*, Torbjörn Becker

IMF Staff Country Papers ($15.00)

99/77: Latvia: Article IV Staff Report (Pilot Project)

99/83: Japan: Article IV Staff Report (Pilot Project)

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For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey*'s annual *Supplement on the IMF*, *Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.

overdue reform measures, this latest effort proved short-lived as economic imbalances increased. Economic performance continued to worsen in 1998 and early 1999 as market sentiment toward Romania became less favorable following the Russian crisis in August 1998.

The objectives of Romania's 1999 program are to narrow external imbalances on the basis of domestic demand restraint and improved competitiveness; contain inflation to about 40 percent; limit the decline in output in 1999 to 3.5 percent; and restructure the economy, with a view to setting the basis for sustainable growth.

Fiscal policy under the program targets a sizable reduction in the fiscal deficit through major tax increases and strict limits on discretionary spending. The goals of Romania's program are to reduce the general government deficit by nearly 2 percentage points to 3.9 percent of GDP in 1999. A significant tightening of fiscal policy will help to reduce the current account deficit while also easing pressure on monetary policy.

Stand-By, EFF, and ESAF Arrangements as of July 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By			**39,036.28**	**13,481.12**
Bosnia and Herzegovina	May 29, 1998	April 28, 2000	77.51	24.24
Brazil[1]	December 2, 1998	December 1, 2001	13,024.80	5,969.70
Cape Verde	February 20, 1998	December 31, 1999	2.50	2.50
El Salvador	September 23, 1998	February 22, 2000	37.68	37.68
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,087.50
Mexico	July 7, 1999	November 30, 2000	3,103.00	2,585.80
Philippines	April 1, 1998	March 31, 2000	1,020.79	475.13
Russia	July 28, 1999	December 27, 2000	3,300.00	2,828.57
Thailand	August 20, 1997	June 19, 2000	2,900.00	400.00
Uruguay	March 29, 1999	March 28, 2000	70.00	70.00
EFF			**11,749.03**	**7,158.03**
Argentina	February 4, 1998	February 3, 2001	2,080.00	2,080.00
Azerbaijan	December 20, 1996	December 19, 1999	58.50	10.53
Bulgaria	September 25, 1998	September 24, 2001	627.62	418.42
Croatia, Republic of	March 12, 1997	March 11, 2000	353.16	324.38
Indonesia	August 25, 1998	November 5, 2000	5,383.10	1,922.40
Jordan	April 15, 1999	April 14, 2002	127.88	117.22
Moldova	May 20, 1996	May 19, 2000	135.00	72.50
Pakistan	October 20, 1997	October 19, 2000	454.92	341.18
Panama	December 10, 1997	December 9, 2000	120.00	80.00
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	September 3, 2001	1,919.95	1,342.50
Yemen	October 29, 1997	October 28, 2000	105.90	65.90
ESAF			**4,147.98**	**2,172.99**
Albania	May 13, 1998	May 12, 2001	45.04	23.69
Armenia	February 14, 1996	December 20, 1999	109.35	20.93
Azerbaijan	December 20, 1996	January 24, 2000	93.60	11.70
Benin	August 28, 1996	January 7, 2000	27.18	14.50
Bolivia	September 18, 1998	September 17, 2001	100.96	67.31
Burkina Faso	June 14, 1996	September 13, 1999	39.78	0.00
Cameroon	August 20, 1997	August 19, 2000	162.12	54.04
Central African Republic	July 20, 1998	July 19, 2001	49.44	32.96
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Ethiopia	October 11, 1996	October 22, 1999	88.47	58.98
The Gambia	June 29, 1998	June 28, 2001	20.61	17.18
Georgia	February 28, 1996	August 13, 1999	172.05	33.30
Ghana	May 3, 1999	May 2, 2002	155.00	132.84
Guinea	January 13, 1997	January 12, 2000	70.80	23.60
Guyana	July 15, 1998	July 14, 2001	53.76	35.84
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Honduras	March 26, 1999	March 25, 2002	156.75	96.90
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	43.00
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	27.28
Madagascar	November 27, 1996	July 27, 2000	81.36	40.68
Malawi	October 18, 1995	December 16, 1999	50.96	7.64
Mali	April 10, 1996	August 5, 1999	62.01	0.00
Mauritania	July 21, 1999	July 20, 2002	42.49	36.42
Mongolia	July 30, 1997	July 29, 2000	33.39	21.89
Mozambique	June 28, 1999	June 27, 2002	58.80	50.40
Nicaragua	March 18, 1998	March 17, 2001	148.96	67.27
Niger	June 12, 1996	August 27, 1999	57.96	9.66
Pakistan	October 20, 1997	October 19, 2000	682.38	417.01
Rwanda	June 24, 1998	June 23, 2001	71.40	47.60
Senegal	April 20, 1998	April 19, 2001	107.01	57.07
Tajikistan	June 24, 1998	June 23, 2001	100.30	53.34
Tanzania	November 8, 1996	February 7, 2000	181.59	29.38
Uganda	November 10, 1997	November 9, 2000	100.43	43.52
Yemen	October 29, 1997	October 28, 2000	264.75	114.75
Zambia	March 25, 1999	March 24, 2002	254.45	244.45
Total			**54,933.29**	**22,812.14**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

Adjustment measures under ESAF-supported programs are expected to strengthen a country's balance of payments position and foster growth.

With the likely availability of foreign financing in the context of an IMF-supported program and the need to strengthen foreign reserves, the current account deficit is targeted to decline to about 7.5 percent of GDP in 1999 and help restore Romania's access to foreign capital markets.

Structural reforms include restructuring the banking and enterprise sectors. With assistance from the IMF and the World Bank, improvements in bank supervision and external audits of major state-owned banks will be key steps toward restructuring and privatization.

As unemployment is expected to rise significantly by the end of the year, the government has intensified a dialogue with its social partners to win support for the program. The government plans to keep unemployment benefits and child allowances stable, provide severance payments, introduce retraining programs, and expand wage subsidies. It has also taken initiatives to improve the pension system and health services.

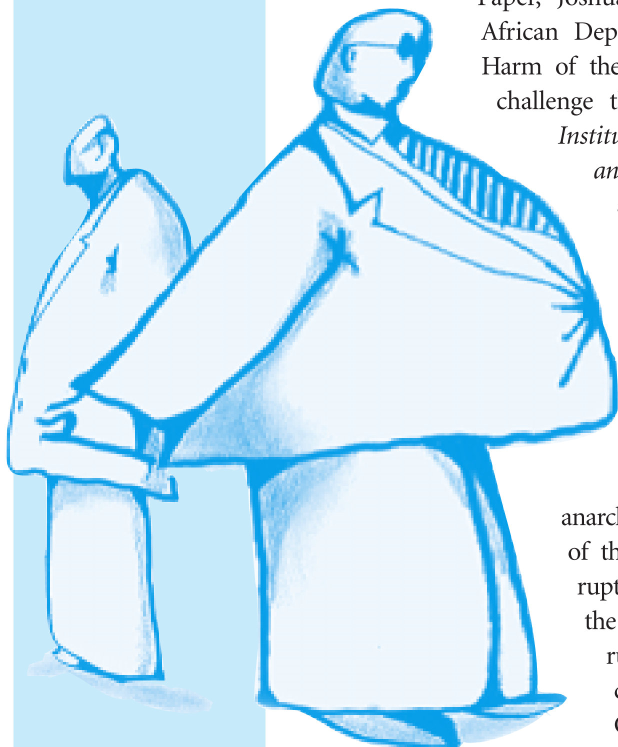
Romania joined the IMF on December 15, 1972, and its quota is SDR 1.0 billion (about $1.4 billion). Its outstanding use of IMF financing currently totals SDR 319 million (about $437 million).

Press Release No. 99/38, August 5

Institutionalized corruption

Is corruption inbred in the "kleptocratic" state?

Corruption is widely viewed as individual acts that undermine the efficient functioning of a society. In a paper originally presented to the Conference of the International Society for New Institutional Economics and recently released as an IMF Working Paper, Joshua Charap of the IMF African Department and Christian Harm of the University of Münster challenge this view. Their paper, *Institutionalized Corruption and the Kleptocratic State*, argues that corruption is an integral part of the political system from which it springs. Their study focuses on the organization and activities of the rudimentary state that emerges from anarchy and examines the role of the bureaucracy and corruption in that state. While the predatory nature of the rudimentary state's hierarchy may be alarming, Charap and Harm suggest that anticorruption efforts may do more to destabilize the country than address the roots of corruption.



IMF Survey: *Corruption is commonly viewed as an aberration, but your work takes an entirely different view. What is your theory?*

Charap and Harm: In this paper, we have tried to explain social aggregation. We have started from the most primitive state and asked how a structure evolves from pure anarchy. Much of the economics literature assumes—magically—the existence of some mechanism to enforce property rights. Thus, the literature discusses economic behavior under a rule of law.

We have tried to start from an earlier point in evolution. Let's say we have a society in which some people are farmers, but others decide to steal grain rather than raise it: the Hobbesian "Each against all." We argue that the first step of societal evolution is the creation of gangs and mafias. We look at the preferences and choices made by gang leaders and the trade-offs these leaders face in balancing the risk of "palace" (those within their gang) and "peasant" (everyone else) coups. We asked how they weigh their "take"—the amount they will extract from their populace. And we looked at their sharing rules—that is, what the leaders will share with other members.

Taking the logic of a mafia or a predatory gang forward, we try to explain how that gang takes the next step and what happens when two gangs come into conflict with each other. We argue that it is optimal for the winning gang to subjugate—not exterminate—the losing gang. If this gang expands its territory by subjugating other gangs, it eventually reaches an optimal hierarchy that is relatively stable and able to survive and maintain control over its territory. Here, subjugation is an organizational innovation that increases the span of control: "divide and conquer."

This gang—to follow from our initial assumption—exists to feed the desires of its members and extract rents from the population in a process similar to what we see mafias or gangs doing in a more conventional sense. That, we postulate, is the beginning of a rudimentary state or nation. The characteristics and capacities of a gang's membership and the peasantry's ability to fight (or not) shape the characteristics of the state. And rent seeking through a predatory hierarchy is an efficient mechanism for the collection of "taxes."

From this basic assumption also comes the supposition that the role of the bureaucracy is to extract rents. Corruption is the mechanism—the glue—that binds the gang together. Members must pass upward a share of the corruption proceeds. For example, in countries where civil servants are paid below subsistence wages, they have no choice but to steal to provide for their families. And they may have purchased their jobs with several years' salary. If they have advanced money to the gang to buy their position within the group, they will have to be corrupt to realize their expected income stream.

The leaders retain control over the bureaucrats, and the moment they become unhappy with the performance of subordinates, they can either denounce the gang member or dilute the member's authority by assigning that authority to others. This arbitrary and capricious leverage is very powerful, because it's not a transparent system and it operates as a self-policing mechanism.

IMF Survey: *Is there no such thing as individualized corruption—that is, corruption not dictated by the political system?*

Charap and Harm: Individualized—or decentralized—corruption may exist in countries with mature political structures but inadequate enforcement mechanisms. Here, the term "corruption" is appropriate. Our contribution to the understanding of this phenomenon is that in some countries, patterns that are interpreted as decentralized corruption would be better defined as organized rent seeking.

In the kleptocratic state, we would argue that individualized corruption is most unlikely. The gang is the system—it provides a legal basis for its actions and self-polices the system. It runs the society. A member of that society must play according to those rules, so the scope for freelance activity is limited. Violators would be in serious trouble.

IMF Survey: *How does a society or a political system evolve from this rudimentary level?*

Charap and Harm: Some avenues have been suggested in the literature, but this is not really the focus of our work. Leaders who have been interested in extracting as much as they can from the populace may reach an evolutionary stage where this is no longer an optimal strategy. That is, leaders may decide that there is more to be gained from benevolence than from predation. At the point where that transition begins to occur—where the leadership finds value in being popular—there is scope to change how the society operates. At that stage, the bureaucracy, which had been created to feed the leadership's desire for wealth, is now perverting its desires and thwarting its interests. When the interests of the leadership and the bureaucracy diverge, you have the opportunity to address "corruption" because the leadership wants to change the role of the government in the society.

In the paper, we discuss, for example, the role of crony capitalism. When leaders are predatory, it is much more efficient to have monopolized industries and to collect rents from them than to allow competition, particularly in large-scale industries. As we have seen in a number of countries, these monopolized industries are run by people close to the leadership. And the same logic applies to the monopolistic power of the state to grant or deny licenses, which can be used for rent-extraction purposes by a corrupt bureaucracy. Formal taxation—and "on-budget activity"—may exist only to mimic institutions of a modern state. If the leader is inclined to change the way the country works, the next level down is likely to be highly resistant. That would be grounds for a "palace revolution"—the elite would rebel because the leader is seeking to change the rules under which they are used to playing. Our paper looks in detail at how a leader normally seeks to minimize the likelihood of either a palace or a peasant revolution.

IMF Survey: *Does the nature of corruption change as the political structure changes?*

Charap and Harm: A key contribution of our paper is to argue that secure dictatorship corresponds to monopolistic corruption, whereas contested dictatorship corresponds to competitive corruption patterns. Corruption evolves along with the evolution of the political system. There is an important contrast between "corruption" and predatory behavior. There is no question that a bandit who steals from a farmer is a predator. But bureaucrats sitting behind their desks and enforcing rules designed to permit them to extract rents from the society are not necessarily performing a different function. Bureaucrats are presumed to have some legitimacy—given the legitimacy and role of the state—but that legitimacy is not necessarily appropriate. As we

Members' use of IMF credit
(million SDRs)

	July 1999	Jan.–July 1999	Jan.–July 1998
General Resources Account	**1,263.80**	**7,369.19**	**11,578.35**
Stand-By arrangements	1,161.43	5,470.50	6,407.74
SRF	0.00	3,636.09	4,400.00
Extended arrangements	102.37	1,232.07	3,014.06
SRF	0.00	0.00	675.02
CCFF	0.00	666.62	2,156.55
ESAF arrangements	**89.05**	**502.25**	**506.71**
Total	**1,352.85**	**7,871.44**	**12,085.06**

Note: SRF = Supplemental Reserve Facility
CCFF = Compensatory and Contingency Financing Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

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model it, the bureaucrats of this rudimentary state do prey on society and do collect rents from society. Corruption is not the right term, though. These bureaucrats are neither bad people perverting sensible rules nor, as much of the older literature would argue, good individuals helping people circumvent nonsensical rules. We argue that governments willfully create rules and obstacles to facilitate rent extraction. That distinction is very important.

Charap: In a kleptocratic state, bureaucrats are neither bad people perverting sensible rules nor good individuals helping people circumvent nonsensical rules. Governments willfully create rules and obstacles to facilitate rent extraction.

Our paper does try to describe the role of the polity and its goals and how this manifests itself in different political situations as society evolves over time. Corruption does not cease; it survives in other forms as political systems evolve. Political corruption, in which the polity extracts rents not for private gain but to improve the probability of election, may be seen as an intermediary stage toward modern democracy. Even mature democracies may reflect the same underlying tendencies of human nature when democratically organized interest groups seek redistribution in a constitutionally legitimized setting, although one might argue that "the beast has been tamed." Our paper is principally focused, however, on a kleptocracy. We are addressing early stages in the evolution of a political system.

IMF Survey: *What are the potential gains, and risks, of efforts to curb corruption?*

Charap and Harm: You have to make a judgment about where a country is in the spectrum of political development that we paint. When you have a system that has just emerged from anarchy and a predatory team holding that territory or country together, you can question the value of efforts that will ultimately destabilize the predatory team. While there are certainly reasons to dislike the predatory nature of that government, it may be creating a system of law and order that is better than the previous anarchy. You have to look at the situation in its historical and political context. As the situation develops over time and there is a real will at the top of the political leadership to change the role of the bureaucracy, then it is possible, in a more conventional sense, to "fight corruption."

IMF Survey: *In what areas would you like to see follow-up research?*

Charap and Harm: There is scope for additional research in at least two areas. This theory could be applied to case studies to investigate more thoroughly the political economy of particular countries. Based on anecdotal evidence, our findings seem to be relevant across countries and cultures.

Another interesting avenue for research is to look at specific sectors of the economy and how the mechanics of a predatory hierarchy work in countries acknowledged to have such a system. For example, what is the interaction between the financial system, the government, the elite, and the role of government guarantees on foreign borrowing? In modern times, developing countries are able to run complex manufacturing plants, build state-of-the-art electronic components, and produce sophisticated computer software—but many seem to be unable to run sound banking systems. Why? ■

Copies of IMF Working Paper No. 99/91, *Institutionalized Corruption and the Kleptocratic State*, by Joshua Charap and Christian Harm, are available for $7.00 each from IMF Publication Services. (See page 284 for ordering information.) In addition, the Charap and Harm paper will appear in the forthcoming *Institutions, Contracts, and Organizations: Perspective from New Institutional Economics*, edited by Claude Menard and to be published by Edward Elgar.

IMF SURVEY SUPPLEMENT

On September 13, the English edition of the annual *Supplement on the IMF,* which is updated every year, will be published. It describes in detail the IMF's structure, activities, and operations and serves as a concise reference to the institution.

In addition to the French and Spanish editions, which will be issued on September 20, the *Supplement* is also translated into Arabic, Chinese, German, and Russian. These language editions will be published by the end of the year.

The next regular issue of the IMF Survey *will appear on September 27.*