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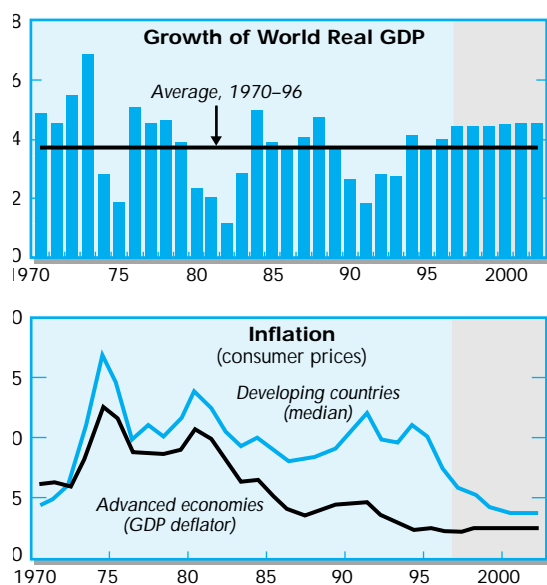
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World Economic Outlook Building on Global Prosperity to Ensure Sustained Growth

World Growth and Inflation (percent a year)



ote: Shaded areas indicate IMF staff projections.

ta: IMF, *World Economic Outlook*, October 1997.

The global economy is enjoying the fourth episode of relatively rapid growth since the early 1970s, according to the October 1997 *World Economic Outlook*, the IMF's biannual survey of economic developments, policies, and prospects among its member countries. World output is expected to expand by 4¼ percent in both 1997 and 1998—the strongest pace in a decade and one likely to be sustained over the medium term. Despite the strong growth, inflation is projected to remain subdued in the advanced economies and to decline further in the developing countries and in the countries in transition. World trade volume is projected to expand by about 7 percent in both 1997 and 1998.

The expansion in world output is underpinned by continued solid growth with moderate inflation in the United States and the United Kingdom, a strengthening recovery in Canada, a broadening of recovery across continental western Europe, robust growth in most of the developing world, and an apparent end to the decline in output in Russia and in the transition countries as a group.

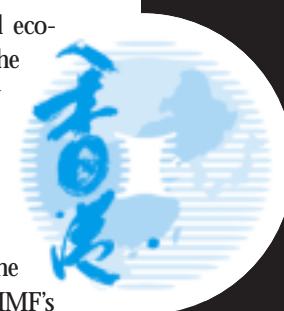
The generally favorable outlook for the global economy should not, however, lead to complacency, the IMF study cautions. A wide range of risks and (Please turn to the following page)

Surveillance, Capital Account Issues, Debt Relief Are High on Hong Kong Meetings Agenda

Finance ministers and central bank governors will meet in Hong Kong, China, on September 23–25 for the Fifty-Second Annual Meetings of the IMF and the World Bank. The IMF's principal advisory body—the Interim Committee of the IMF's Board of Governors on the International Monetary System (the Interim Committee)—will meet on September 21 under the Chairmanship of Philippe Maystadt, Deputy Prime Minister and Foreign Trade Minister of Belgium. The Annual Meetings will be chaired by Mohammed K.

Khirbash, Minister of State for Finance and Industry of the United Arab Emirates.

The Interim Committee will assess global economic prospects and IMF surveillance over the policies of its member countries, particularly in the light of pressures posed by increasingly integrated world financial markets, including recent turmoil in financial markets of emerging market economies. The Committee will also discuss guidelines for an amendment to the IMF's Articles of Agreement extending the IMF's jurisdiction to cover capital movements, as well as progress in implementing the (Continued on page 282)



The IMF's *Annual Report 1997* is reviewed on page 277.



fragilities could affect world economic and financial conditions. Among the main concerns are:

- *Overheating.* Although world inflation has subsided to the lowest rates seen since the early 1960s, inflationary pressures could re-emerge, especially in countries that have attained high levels of resource use.

- *Uncertainties about economic and monetary union in Europe (EMU).* Convergence of interest rates among prospective members of EMU suggests that financial markets expect the project to go ahead in accordance with the agreed timetable, which calls for the euro to be in place by January 1999. Investor sentiment could still change, however, if the feasibility of the timetable were perceived to be threatened.

- *Sustainability of capital flows to emerging market countries.* Many emerging market countries have been experiencing record capital inflows in recent years. The availability and costs of these flows are vulnerable to higher interest rates in world financial markets, how-

ever, as well as to perceptions that large current account deficits may not be sustainable in all cases.

Advanced Economies: Labor Market Issues and EMU

Almost all of the advanced economies have maintained an impressively high degree of price stability. In 1996, the rate of consumer price inflation averaged 2½ percent, and only four countries had inflation above 5 percent. Real GDP growth of the advanced economies as a group is projected to increase to 3 percent in 1997 and 1998—from 2¾ percent in 1996. There are considerable differences in resource utilization and unemployment. Several economies—the United States, the United Kingdom, Australia, New Zealand, Denmark, and the Netherlands—are operating at high levels of resource use, while most of continental western Europe—including Germany, France, and Italy—has suffered protracted economic weakness accompanied by a dramatic rise in unemployment. Output in both Germany and France is projected to rise by 2¾ percent in 1998, which would narrow output gaps modestly, but few forecasters are projecting more than a mild dent in unemployment.

Labor Market Reform Is Key. By far, the most important reason for continental Europe's lack of economic dynamism and persistent unemployment, according to the *World Economic Outlook*, is the slow pace of structural reform. Most of these countries suffer from high structural unemployment rates—on the order of 8 to 9 percent in Germany, France, and Italy. The root cause of the problem is the adverse consequences of elaborate job and income-protection arrangements that raise the cost of labor, discourage job creation and job search, and favor substitution of capital for labor. Several countries in the European Union (EU) have made attempts to reform their labor markets. But except in a few countries—the United Kingdom and the Netherlands, in particular—only minor inroads have been made in reducing unemployment. One reason for the lack of success, according to the *World Economic Outlook*, is the piecemeal approach most countries have taken to labor market reform.

The experience of the United Kingdom and the Netherlands, in contrast to that of the rest of the EU, suggests that unless labor market reforms are comprehensive, the current recovery in output is likely to have only a marginal impact on reducing unemployment and could fail to prevent further increases in unemployment. In addition, a particularly critical factor for the success of EMU will be the extent to which governments succeed in improving Europe's labor market performance.

EMU, Europe, and the World Economy. The establishment of EMU will constitute the largest change to the international monetary system since the breakup of the Bretton Woods par value system. EMU could also herald a new era of stronger and steadier economic growth

Bolivia Eligible for HIPC Initiative

Following is a summary of IMF Press Release No. 41, issued on September 12.

On September 10, the IMF's Executive Board decided that Bolivia had reached the "decision point" (at which it has completed the first stage of strong adjustment and reform) under the initiative for highly indebted poor countries (HIPC Initiative) and that it was eligible for exceptional assistance to reduce its debt burden to a sustainable level. (The World Bank reached a similar decision on September 9.)

This will reduce Bolivia's external debt by \$448 million in net present value (NPV) terms, with the IMF providing \$29 million.

The Board agreed that Bolivia could reach its "completion point" (after the second stage of adjustment and reform) in September 1998, and that the target NPV of external public and publicly guaranteed debt at the completion point be set at 225 percent of exports, compared with a projected ratio of 259 percent before assistance. To achieve the 225 percent target at the completion point, Bolivia requires a projected \$448 million in exceptional assistance in NPV terms. This compares with a debt in NPV terms of \$3.4 billion and entails a debt reduction of about 13 percent.

In view of the heavy debt-service burden facing Bolivia over the next few years, the IMF and the World Bank would deliver their exceptional assistance in a front-loaded fashion. The total nominal debt-service relief is estimated at \$0.6 billion. All assistance is conditional on Bolivia's continued adherence to an IMF- and World Bank-supported program—including the observance of social development targets—as well as satisfactory assurances of action under the Initiative by all other creditors. The IMF's exceptional assistance of \$29 million will be provided at the completion point in the form of a grant into an escrow account to be used exclusively to pay debt service to the IMF.



for Europe. A common currency shared by a majority of EU member countries would lower transaction costs and generally promote economic integration. In addition, the commitment to price stability and prudent fiscal policies underpinning the euro promises to produce lower real interest rates, on average, than have been observed over the past couple of decades.

Compliance with the inflation, interest rate, and exchange rate criteria—the conditions for participation in EMU as set out in the Maastricht Treaty of 1991—has now been achieved by all those EU members that plan to participate from the start. Progress in meeting the fiscal deficit criterion—3 percent in 1997—has been more difficult to assess, however. It seems likely, according to the *World Economic Outlook*, that several candidates—including France and Germany—may not fully achieve the 3 percent target in 1997. On a cyclically adjusted (that is, structural) basis, however, IMF staff estimates suggest that the deficits of all EU members except Greece will be within about 2 percent of GDP in 1997, indicating that underlying fiscal imbalances pose less of a risk to macroeconomic and financial stability than might be inferred from the unadjusted deficits. The best way to minimize uncertainties about the start of EMU and to ensure that a sustainable and strong EMU begins on time, according to the *World Economic Outlook*, would be for countries to take fiscal actions during the remainder of 1997 and 1998 that demonstrate their commitment to the requirements of the Maastricht Treaty and the 1997 Stability and Growth Pact.

The rest of the world has a strong interest in a successful EMU and a solid euro, according to the *World Economic Outlook*, since it would make Europe a better place in which to do business and to invest. But how strong and stable the euro becomes will depend on many factors, including the credibility and consistency of policies in the monetary union. A reasonable degree of variability in the exchange value of the euro will have to be accepted to reflect divergences in cyclical conditions across the major currency areas. But in the absence of effective policy coordination with other major countries, the exchange rate may fluctuate considerably. The anti-inflation mandate of the ECB and the prudent fiscal rule embodied in the Stability and Growth Pact suggest that the euro will have the key attributes of a reserve currency.

Developing Countries and Global Integration

Real GDP growth in the developing countries is expected to remain relatively buoyant, at about 6½ percent in 1997 and 1998. In most developing countries, low or declining inflation and generally prudent fiscal policies suggest that threats to growth arising from policy imbalances have been reduced. In several countries, however, the emergence of large external imbal-

ances and fragile banking systems has affected investor confidence. These problems, according to the *World Economic Outlook*, underscore both the existence of downside risks to the near-term growth outlook and the desirability of some cooling off of domestic demand pressures as well as the need for financial sector reforms. So-called second-generation reforms are likely to contribute to medium-term growth potential.

In the Western Hemisphere, Argentina and Mexico have continued to recover following the 1995 crisis, and growth is expected to remain fairly strong in the period ahead. Chile's economy remains the strongest among the developing countries of the Western Hemisphere, but stronger macroeconomic discipline and intensified structural reform efforts appear to be improving the growth outlook for other countries in the region.

In Asia, despite impressive growth in recent years, several countries have experienced financial market pressures linked to concerns about large external deficits. These pressures have been most acute in Thailand, where fragilities in the banking system have contributed to market concerns that have led to a sizable depreciation since the baht was floated in early July. Several countries in the region—the Philippines, Malaysia, and Indonesia—have experienced spillovers from the Thai crisis. In all cases, according to the *World Economic Outlook*, the authorities will need to contain external deficits and reduce reliance on foreign borrowing to diminish the risk of disruptive changes in investor confidence. Elsewhere in Asia, China's economy has achieved a soft landing, maintaining growth at over 9 percent while bringing inflation down to an estimated 4½ percent in 1997.

Developing countries in the Middle East and European regions have witnessed significant improvements in economic performance in recent years. Average growth is expected to continue in the 4–5 percent range in 1997–98, despite a slight decline in oil prices.

For Africa, the estimated growth for 1997 has been revised down to 3¾ percent from 4½ percent in the May 1997 *World Economic Outlook*, owing largely to developments in a few larger countries. While recent setbacks and political uncertainties have highlighted the fragility of Africa's recovery, the significant number of relatively successful economies illustrates the region's potential for reversing the long-run decline in living standards. Growth is projected to recover to about 5 percent in 1998.

The rest of the world has a strong interest in a successful EMU and a solid euro.

Photo Credits: National Bank of Croatia, page 279; Denio Zara and Padraic Hughes for the IMF, pages 282 and 288.



Minimizing Risks Associated with Capital Inflows. The weight of developing countries in the global economy is increasing rapidly, according to the *World Economic Outlook*. At the same time, their growing integration into world financial markets poses major challenges. Although capital inflows—particularly of foreign direct investment—can enhance countries' growth performance, large inflows risk becoming a substitute for domestic saving, contribute to overheating, and result in excessive current account deficits. Experience has shown that, sooner or later, persistently large external deficits are likely to result in highly disruptive changes in market sentiment. Certain policy actions can be taken, the IMF study notes, to minimize such risks:

- strengthening of fiscal policy;
- prudential rules limiting the banking system's exposure to foreign exchange risks; and
- gradual introduction of capital account convertibility.

Exchange Regime Choices for Developing Countries. The pressures of globalization have accentuated both the benefits of good economic policy management and the costs of inappropriate policies. Sound economic management includes maintaining an appropriately valued currency, and "getting the exchange rate right" has long been recognized as an essential condition for achieving sustained macroeconomic stability. Moreover, as recent exchange rate crises in a number of emerging market countries have demonstrated, challenges change over time, suggesting a need to adapt exchange rate arrangements to changing circumstances.

Following the breakdown of the Bretton Woods par value system of fixed but adjustable parities and the widespread adoption of floating exchange rates by the major advanced economies in the early 1970s, most developing countries pegged their currencies either to a key currency or to a basket of currencies. Starting from the late 1980s, however, flexible exchange rate arrangements have gradually, but increasingly, been adopted. The preference for greater flexibility has also been associated with the adoption of more open, outward-looking policies toward trade and financial flows and an increased emphasis on market-determined exchange rates and interest rates.

Considerations affecting the choice of exchange rate regime may change over time. When inflation is high, a pegged exchange rate may prove more effective at reducing it, at least in the short run. When stabilization is achieved, countries may prefer to shift toward a more flexible regime. This option is particularly relevant when countries face large capital inflows and a risk of overheating. Under these circumstances, a more flexible exchange rate may help alleviate pressures associated with capital inflows and also help signal the possible need for domestic policy adjustments. Regardless of the exchange arrangement, however, macroeconomic policies must be supportive of the arrangement to ensure its success.

Transition Countries: Moving into The Mainstream

Despite slow progress in some countries, 1997 seems likely to be the first year the transition countries overall will register positive growth, according to the *World Economic Outlook*. Those countries that have pursued the most comprehensive stabilization and reform policies—Poland, the Baltic countries, the Czech and Slovak Republics, Hungary, and Slovenia—are experiencing relatively solid growth, moderate inflation, and good progress in reintegrating into the world economic and financial system. Activity appears to be picking up in Russia as well. Progress elsewhere in the region is mixed, however. Ukraine has only recently achieved macroeconomic stability, and growth remains hampered by the lack of structural reform. Other countries that have maintained tight financial policies and are implementing structural reform—Armenia, Azerbaijan, Georgia, Kazakhstan, and the Kyrgyz Republic—are realizing sustained growth and further declines in inflation.

Clearly, many challenges remain to be addressed to safeguard and further extend the progress achieved so far. In the less-advanced transition countries, the institutions of a market economy are still rudimentary. Financial systems are generally underdeveloped and plagued by nonperforming loans, restructuring of former state-owned enterprises has not gone far, and governments are often unable to honor obligations for lack of tax revenues.

Transition countries also face substantial challenges in the area of monetary policy. In many countries, macroeconomic stability is still fragile and can easily be reversed. Further progress is needed in putting in place the instruments and institutions through which monetary policy can be conducted in a market economy. A key priority is to foster the establishment of sound market-based banking systems.

Economic policies in the most advanced transition countries—for example, the Czech and Slovak Republics—are beginning to face additional challenges associated in part with large capital inflows. As has been witnessed in many developing countries, however, large-scale capital flows are typically associated with widening external imbalances, which eventually risk provoking sudden reversals of short-term inflows. While both fiscal and monetary policies need to take into account the dangers from excessive external imbalances, some countries may also need to allow for greater flexibility in the exchange rate regime. ■

Copies of the fall edition of the 1997 *World Economic Outlook* will be available in mid-October. Copies are \$35.00 (academic rate: \$24.00) and may be ordered from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org.

IMF Responds to Globalization's Challenges on Many Fronts in 1996/97

In response to an intensifying pace of globalization and the widening implications for member countries of more closely integrated goods, services, and capital markets, the IMF continued to adapt its policies, operations, and resources in financial year 1996/97 (May 1, 1996–April 30, 1997). Its *Annual Report 1997* spotlights the steps its Executive Board took during the financial year to ensure that the organization's surveillance activities broadened and deepened in response to globalization's new challenges. This entailed bold steps in the areas of banking soundness, capital account liberalization, and governance; continuing efforts to address the problems of low-income countries and the new IMF-World Bank HIPC Initiative to ease the debt burden of the heavily indebted poor countries. The Board also sought to advance measures to ensure that the organization continues to have the resources it needs to fulfill its mandate in the new global environment.

Meeting Globalization's Challenges

As earlier and current crises amply demonstrate, globalization has made the management of the international monetary system more complex and demanding. The IMF has responded by modifying its chief instrument—surveillance over member country policies and global economic developments—to provide fuller and more candid advice. The lessons of recent years have underscored the importance of effective surveillance and the key contributions that sounder banking systems, full and timely data dissemination, and good governance can make to the quest for a sound policy environment and sustained growth.

Surveillance Strengthened. Surveillance over members' exchange rate policies lies at the heart of the IMF's advice to its members and its efforts to promote the stability of the international monetary system. The strengthening of surveillance remained a principal concern of the IMF Executive Board in 1996/97. The Interim Committee's Declaration on Partnership for Sustainable Global Growth, issued on September 29, 1996, takes explicit account of the challenges posed by globalization and emphasize the importance of market-oriented reforms, sound banking systems, trade and investment liberalization, and good governance.

In a six-monthly review of issues that figure prominently in Article IV country consultations, the Board highlighted the impact of the composition of fiscal adjustment on both the quality and sustainability of fiscal consolidation, the importance of reducing inflation to sustain growth, and the crucial role that persis-

tent pursuit of trade reforms can play in transition economies.

Every two years, the Executive Board also takes a more in-depth look at the principles and procedures underpinning IMF surveillance. In the March–April 1997 review, the Board cited progress in detecting financial tensions at an early stage. It also welcomed the increased focus on data issues, observed an improvement in the continuity of surveillance, supported the increasing focus on regional surveillance, and debated the scope for further openness in the IMF's Article IV consultation process. In the context of this discussion, the Executive Board, in April 1997, approved the publication, on a voluntary basis, of Press Information Notices, which contain the IMF Executive Board's assessments of members' economic prospects and policies and background on these economies.

Banking Soundness. In view of the strong links between systemic bank restructuring and macroeconomic policy, as well as the potential for spillover in a globalized financial market, the Executive Board, in February 1997, directed the organization to devote more attention to banking issues and their implications for IMF operations. The IMF is uniquely placed to help members identify weaknesses in their banking systems and legal and regulatory environments. By virtue of its continuous dialogue with members, the IMF can both encourage and monitor adherence to international supervisory and prudential guidelines. The Board emphasized that the IMF should use its comparative advantage to focus on the macroeconomic implications of banking soundness.

Capital Account Convertibility. An open and liberal system of capital movements can foster growth by facilitating the efficient allocation of world saving and investment. The IMF can also play a central role in promoting capital account liberalization and facilitating the smooth operation of international capital markets. In early 1997, discussions of the IMF's role in capital account convertibility, the Executive Board recommended—and in April 1997 the Interim Committee endorsed—an appropriate amendment to the IMF's Articles of Agreement that would formally add this goal to the organization's mandate.





Data Dissemination. In November 1996, the Board emphasized that the quality and integrity of data provided by member countries to the IMF were key elements in the effectiveness of IMF surveillance. Since the Mexican financial crisis of December 1994, the IMF has sought to make its assessments of country data capabilities more comprehensive and candid. The Board recommended that in future the IMF take further action to ensure that Article IV consultations do more to identify data deficiencies, address the causes of these problems, and outline remedial steps. In September 1996, in conjunction with efforts to improve the dissemination of economic and financial statistics, the IMF inaugurated an electronic bulletin board for its Special Data Dissemination Standard, which provides full and timely data for members having, or seeking, access to capital markets. In March 1997, the Board reviewed and welcomed the preliminary framework of a General Data Dissemination System, which is intended to encourage all members to improve the quality of their data and the production and dissemination of their statistics.

Governance. In recent years, the IMF and its Executive Board have grown increasingly aware that good economic performance depends on the efficient use of public resources, the creation of an environment conducive to private sector activity, and public support for economic reforms—all issues of good governance. The Interim Committee, in its September 1996 Declaration, called for a heightened awareness of governance issues, and the Board endorsed the IMF's involvement in governance issues in its surveillance, use of resources, and technical assistance work. The Board agreed this was in keeping with such traditional IMF concerns as reducing the scope for perverse incentives and opportunities for corruption and enhancing the capacity of member countries to design and implement economic policies and improve public sector accountability. The Board stressed that in its governance-related efforts the IMF should work within its macroeconomic mandate, be evenhanded in its approach, and strengthen collaborative efforts with relevant multilateral organizations, bilateral donors, and official creditors.

ESAF and HIPC. Globalization offers great promise to countries able to compete but poses potentially serious risks for those left behind. For low-income countries, particularly those mired in debt, globalization has heightened the urgency and importance of development. In 1996/97, the Executive Board gave considerable attention to ensuring the continuation of the Enhanced Structural Adjustment Facility (ESAF)—the IMF's principal means of assisting low-income countries that are pursuing extensive economic restructuring—and to giving form and impetus to an initiative designed to help highly indebted poor countries (HIPC) develop a sound track record of stability and reform and attain a sustainable level of debt over the

medium term. In February 1997, the Board set up the ESAF-HIPC Trust to finance special ESAF grants or highly concessional loans to countries participating in the HIPC Initiative and to subsidize the interest rate on ESAF operations between 2001 and 2004—the interim period before ESAF becomes self-sustained. It also approved the eligibility of Uganda under the HIPC Initiative.

Adequate Resources. A vital element in the IMF's ability to adapt and meet evolving needs is the adequacy of its resources. The chief source of the IMF's liquidity is its quotas—capital subscriptions of members that relate to the size of their economies. These quotas are adjusted periodically to reflect the growth in the world economy and the relative roles of national economies in the global economy. In 1996/97, the Executive Board advanced its work on the Eleventh General Review of Quotas, focusing on the size and distribution of an increase in quotas, as well as the size of ad hoc increases for those members whose economies were most out of line with their relative positions in the world economy.

To supplement its own resources in exceptional circumstances and to ensure that mechanisms were in place to provide for adequate borrowed resources, the Executive Board in January 1997 approved a recommendation for New Arrangements to Borrow, which would add to resources available under the General Arrangements to Borrow and permit the IMF to borrow up to SDR 34 billion if additional resources are needed to forestall or cope with a monetary crisis of international proportions.

IMF Financial Activity

During 1996/97, new IMF financial commitments fell substantially from record levels for the previous two years, reflecting the degree of success that many members had had in implementing policy reforms. Outstanding credit remained at a historically high level, however, and was indicative of the ongoing efforts in many transitional and developing countries to implement reforms and adapt their economies to the demands of highly competitive global markets. Fully one-third of the IMF's members received financing for IMF-supported adjustment programs in 1996/97. (For a more detailed look at the IMF's financial activity in 1996/97, see the September 1997 *IMF Survey Supplement*.) ■

The *IMF Annual Report 1997* includes a summary of 40 Article IV consultations with member countries as well as comprehensive data on international reserve holdings, IMF financial and policy decisions, and budget and financial statements. Copies of the English, French, German, and Spanish editions of the *IMF Annual Report 1997* are available free of charge from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org.

Dubrovnik Conferees Discuss External Sector Issues in Transition Economies

Experts from governments of transition economies, academia, and from the IMF, the World Bank, the Bank for International Settlements, and the European Bank for Reconstruction and Development gathered in Dubrovnik in late June for the third Dubrovnik Conference on Transition Economies. Featured topics were balance of payments trends, exchange rates, and competitiveness in the transition economies; the two previous conferences dealt with macroeconomic stabilization and banking sector reforms, respectively. The Dubrovnik conferences—which seek to facilitate systematic analyses and a free exchange of ideas on problems of transition economies—are sponsored by the National Bank of Croatia and organized by Marko Škreb, Governor of the National Bank of Croatia, and Mario I. Blejer, Senior Advisor in the IMF's Monetary and Exchange Affairs Department.

An outward-oriented economic strategy is important for the economies in transition, but it presents policymakers with the challenge of achieving the multiple objectives of economic restructuring and increased competitiveness and integration with Europe and the world economy. Most, if not all, transition economies have followed a similar reform path: initial currency undervaluation and trade opening, leading to rapid growth in trade, followed by real exchange rate appreciation and expanding current account deficits. In some cases, the deficits have grown large, posing questions about their sustainability. At the same time, the transition economies have received net capital inflows, which in some cases fueled money growth and inflationary pressures. The experts gathered in Dubrovnik considered these and the related issue of choice of exchange rate regime.

Developments in External Accounts

Leading off the conference, Paul Wachtel and Nouriel Roubini of New York University attributed the widening current account deficits of transition economies in 1995–96 mainly to reduced competitiveness caused by real exchange rate appreciation. Appreciation and worsening current account balances had been greater in countries with pegged exchange rates—in particular, in the Czech Republic. Countries that followed policies closer to real exchange rate targeting experienced smaller appreciations and less current account deterioration. Wachtel and Roubini were concerned about further widening of external imbalances, especially given prospects for “capital inflow fatigue” and weak banking systems in transition economies.

The external debt of many transition economies was growing rapidly and needed to be monitored and managed better, cautioned John Odling-Smee, Director of

the IMF's European II Department, who presented a paper on borrowing by the Baltics, Russia, and the other countries of the Commonwealth of Independent States, co-authored with Basil Zavoico. External debt circumstances were most favorable in the Baltic states, but indebtedness in Armenia, Georgia, the Kyrgyz Republic, Moldova, and Tajikistan was a growing concern. Odling-Smee argued that this concern would be less, the more the breathing space provided by external borrowing was used to advance and strengthen reforms. He urged stronger and deeper reform of the government sector, with reduced spending; government restructuring, with health and education services leading to a smaller official labor force; “new-style” regulation (for example, regulation of the banking system and improved tax administration); and further dismantling of “old-style” regulation. Odling-Smee also stressed the need to reform the energy sector to address nonpayment of energy bills.

Taking a broad view of financial market stability in transition economies, André Icard, Assistant General Manager of the Bank for International Settlements, said that emerging markets had much to gain from openness



Pero Jurković, Economic Advisor to Croatia's President (left), Vito Tanzi, John Odling-Smee, Mario Blejer, and Marko Škreb during a break at the Dubrovnik Conference.

to capital markets, but that the financial environment had become more volatile and unpredictable. This called for more prudent policymaking and greater attention to the stability of financial systems. Icard emphasized that financial market participants must be discriminating and assess all risks—especially country risk—carefully.

Exchange Rate Issues

Robert Mundell of Columbia University assessed prospects for using exchange rate policies as a vehicle for stabilization and monetary control in transition econ-

omies. He reviewed alternative nominal frameworks for stabilization—monetary, inflation, or exchange rate targeting—and noted that the differences among them were smaller than between any one, relative to the “non-mechanisms” prevailing in many transition economies. The differences, however, became more important in the final stages of stabilization—once inflation had moderated to 5 percent or less and the fiscal budget was in balance. At this point, fixing the exchange rate became a feasible tool of stabilization. Implementing an effective exchange-rate-based stabilization, Mundell emphasized, demanded strong monetary leadership.

European economic and monetary union (EMU) will permit the transition economies to rationalize their exchange rates, said Ronald McKinnon of Stanford University, especially if they seek eventual accession to the union. After the adoption of the euro, nonparticipants with close links to European Union (EU) members—including EU members who defer joining EMU, such as the United Kingdom and

Denmark, as well as the transition economies—should pursue a long-term fix to the euro to enable these countries to adopt the Bundesbank’s “low-inflation culture,” which is expected to prevail under the European central bank. Temporary deviations from the fixed rate would be followed by gradual restoration of the parity, as under the international gold standard. McKinnon noted that the associated risk of heavy capital inflows would require prudential controls on banks to restrain unusual short-term inflows without significantly affecting foreign direct investment or normal trade credit.

Several participants presenting country case studies also leaned toward an exchange-rate-based approach to stabilization for transition economies, with some suggesting a peg to the deutsche mark. But Fabrizio Coricelli of the University of Siena advocated a more flexible exchange rate policy, with monetary or inflation targeting to gain credibility. He questioned the merits of the large Czech devaluation of 1990, to which he attributed the country’s subsequent problems. The authorities should have allowed an initial real appreciation, Coricelli said. He stressed the difficulty of managing exchange rate policy with structural changes affecting the equilibrium exchange rate, including temporary shocks to the real rate arising mainly from capital inflows.

Jacob Frenkel, Governor of the Bank of Israel, saw no need for distinct theories of the appropriate exchange rate for transition economies. He described Israel’s exchange rate strategy, which entailed moving from a fixed exchange rate to a currency band that was subsequently widened to prevent a loss of competitiveness. Frenkel emphasized that the key challenge was to com-

bine an exchange rate system with a monetary policy aimed at low inflation. The issue was not fixed versus floating rates, he added, but good versus bad policy.

Integration into the Global Economy

Oleh Havrylyshyn, of the IMF’s Policy Development and Review Department, presented a paper co-authored with Hassan Al-Atrash on global integration through trade. Following the collapse of the former Soviet Union, he said, trade among former centrally planned economies plummeted. While the trend since then has reversed and such trade is now rising, a full recovery has not occurred. Indicators of the increased trade of the countries of the former Soviet Union suggest that these countries are still not as open as one might expect based on preliminary econometric analysis, which is subject to a wide margin for error. Nevertheless, trade-to-GDP ratios for the larger economies of Russia and Ukraine are quite a bit higher than for many countries in the region. In general, those transition economies more advanced in their structural reforms were also integrating more rapidly into the global economy through greater diversification of their export destinations toward European markets. For a small open economy, Havrylyshyn said, the optimal strategy remains unilateral trade liberalization—which, in turn, stimulates further structural reform.

Gur Ofer of Hebrew University, presenting a paper co-authored with Vladimir Drebentsov of the World Bank, described the opening of the Russian economy and its unique experience with transition. He noted that Russia’s de facto gradualist approach to trade reform was the result of balancing trade liberalization with pressures for protectionism. Ofer saw a continuing risk for Russia of further ruble appreciation and “Dutch disease” (currency appreciation owing to the rapid development of the natural gas sector in the Netherlands and the resulting squeeze put on traditional export sectors), owing to the fast development of energy and raw material resources, rising capital flows, lags in restructuring manufacturing, and delayed rises in the price of services. The question was whether Russia would be able to use the proceeds from natural resources and energy productively while avoiding the Dutch disease. Ofer recommended restructuring research and development funds, possibly temporary protectionism, and some industrial policy. The risk of government failure, however, raised doubts about this last measure.

Arye Hillman of Bar Ilan University looked at the real forces underlying international transactions. The technology gap with respect to producing consumer goods was especially relevant for transition economies, he said, as were the related prospects for technological and quality advance through privatization that allows for foreign investment. Foreign investment determines the quality of domestic consumer goods, Hillman said, yet both governments and foreign investors can miscal-

An effective exchange rate-based stabilization demands strong monetary leadership.

—Mundell

culate. For example, the foreign investor may invest with the expectation that tariffs will continue in place, while a government may privatize by selling to foreigners and expecting them to invest, but then find no technological transfer forthcoming. These problems are best avoided through quick liberalization, which, in turn, facilitates the best outcome, with profitable foreign investment complementing privatization of domestic industries. The former east Germany had a “big brother” (west Germany) that tied its hands in trade policy and made technology-improving investment; in return, east Germany received access to the west German market. In the absence of a big brother and with a government that requires popular support, protectionist pressures impede privatization and foreign investment, which are part of the solution to exiting from the transition. Transition economies, said Hillman, could obtain a “surrogate” big brother by joining the EU.

Vito Tanzi, Director of the IMF’s Fiscal Affairs Department, considered the fiscal implications of trade liberalization. He suggested that the transition economies might have imposed—as a “second-best” policy—a low uniform tax on imports to be phased out over three to four years to help offset large fiscal deficits. Such a tax would have been preferable to the highly distorting domestic taxes that were used and would also have been a way to tax money made in the underground economy. The transition economies had not done this, he ventured, because they had hopes of joining the World Trade Organization and did not have well-developed customs agencies. But they would need to develop these institutions in any event, Tanzi said, to collect much of the value-added tax.

Country Cases

The above themes were addressed in broad terms and in the context of presentations on individual transition economies. In addition to Gur Ofer’s discussion of Russia’s trade policy and foreign exchange regime, papers were presented on Croatia, the Czech Republic, Hungary, Poland, and Slovenia. On the Czech Republic, Fabrizio Coricelli argued that the country’s recent crisis owed to global investors reacting to news and signals not necessarily linked to fundamentals, but that it did highlight inconsistencies in policies and a fragile financial system. Boris Vujčić, of the National Bank of Croatia, urged quick fiscal retrenchment in Croatia, with restructuring and/or privatization, to allow the central bank to retain the exchange rate as the anchor of poststabilization macroeconomic policy. Velimir Bole of Slovenia’s Economic Institute of Law Faculty expressed concern that the worsening in Slovenia’s external trade competitiveness could endanger the sustainability of its current account performance. D. Mario Nuti of the London Business School said that Poland’s recent trade balance

deterioration appeared manageable, given the more moderate current account deficit, the high investment component of imports, rapid export growth, plentiful reserves, and sustained foreign direct investment. And Laszlo Halperin of the Hungarian Academy of Sciences and Judit Nemenyi of the National Bank of Hungary cited the need for Hungary to prepare for a more flexible exchange rate regime, one that can cope well with shocks.

General Themes

The Dubrovnik conference did not arrive at any consensus about the best approach to balance of payments, exchange rate, or trade issues in transition economies. Participants nonetheless appeared to agree that certain indicators—such as the ability to mobilize domestic savings, attract foreign savings, and use the proceeds productively to advance reforms and growth—determined the sustainability of current account deficits and that these should be watched carefully. Many favored fixing exchange rates in the early stabilization stage. Others advocated flexible rates to avoid currency appreciation and the difficulties of exiting fixed regimes. On trade policy, all agreed that transition economies should remain open, with views differing somewhat on whether countries should simultaneously pursue complementary reforms.

In summing up the discussions, Mario Blejer grouped participants’ views under three issues:

- *The implications of the evolution of the exchange rate for competitiveness and for current account developments.* It is important to consider and evaluate the possible reasons for external imbalances. Some participants felt that deficits were positive at this stage of the transition as long as they were well financed and domestic and foreign savings were used appropriately.
- *The role of the nominal exchange rate in stabilization.* While nominal exchange rate stability is important, flexibility in the design of exchange rate policies is also necessary to avoid excessive real appreciation and prevent destabilizing shocks.
- *The real side of the balance of payments.* Oleh Havrylyshyn advocated reform to accompany economic opening, while others stressed the need to look at outcomes prior to reform. Arye Hillman stressed the need to eliminate incentives for not reforming, while Vito Tanzi suggested temporary import taxes to supplement fiscal revenues.

The Dubrovnik conference raised more questions than it answered, underscoring the complexity of the transition process. It pointed to the need for continuing and systematic research and case studies on the problems faced by individual transition economies as they progress through the transition process. ■

(Continued from front page) IMF-World Bank initiative to alleviate the debt burden of heavily indebted poor countries (HIPC) and in funding the IMF's participation in the HIPC Initiative through the Enhanced Structural Adjustment Facility (ESAF)—the IMF's concessional financing facility for poor countries engaged in comprehensive macroeconomic and structural adjustment.

The Committee will discuss a special "equity" allocation of SDRs to allow all IMF members to participate in the SDR system. And to ensure that the IMF has adequate financial resources to carry out its mandate in a more complex and volatile world economic environment, Governors will seek to advance the Eleventh General Review of IMF Quotas.

The Interim Committee session will be followed by a meeting of the Joint Bank and Fund Committee on the Transfer of Real Resources to Developing Countries (the Development Committee), on September 22. The Development Committee will be chaired by Moroccan Finance Minister Mohamed Kabbaj. Topping the agenda will be issues related to the World Bank and the private sector—specifically, adequate resources for the Bank's Multilateral Investment Guarantee Agency (MIGA), and measures to facilitate private involvement in infrastructure development. The Development Committee will also consider progress in implementing the HIPC Initiative, and ways to help member countries fight corruption and improve governance.

The Annual Meetings will be preceded by meetings of the Group of Ten industrial countries, Ministers of the Group of 24 developing countries, and Deputies of the Group of 24. Also, on September 17, Michael Mussa, Economic Counsellor and Director of the IMF's Research Department, will brief the press on the October 1997 edition of the IMF's *World Economic Outlook* (WEO). A series of IMF and World Bank seminars on a wide range of topics, many open to the public, will take place before and during the Annual Meetings.

Annual Meetings Info on Internet

For updated information on the Hong Kong Annual Meetings and related events—including transcripts of press conferences and briefings, public statements of the Interim and Development Committees, and communiqués—please visit the IMF's web site (<http://www.imf.org>).

IMF Surveillance

First on the Interim Committee's agenda will be a discussion of IMF surveillance of member country policies. In recent years, the IMF has reinforced its surveillance through more continuous and candid dialogue with member countries and by encouraging them to disseminate high-quality and timely data through its establishment of the special data dissemination standard (SDDS)—for members with, or seeking access, to capital markets—and its ongoing work to develop a general data dissemination system (GDDS) for all member countries. At the same time, the IMF has given greater attention in its surveillance to banking system soundness—aimed at promoting early detection of financial problems—transparency, and good governance. It has also paid increasing attention to capital account developments and financial flows and to regional issues, notably, the implications of the impending European economic and monetary union (EMU).

On the multilateral surveillance front, the Interim Committee will discuss the world economic outlook in the context of the Declaration on Partnership for Sustainable Global Growth, adopted at the Committee's September 1996 meeting. The Declaration embodies a comprehensive medium-term strategy to achieve sustained noninflationary growth in both industrial and developing countries and the full participation of all countries in the global economy. The Committee will hold its discussions amid generally favorable prospects for sustaining the expansion of global output and trade, possibly into the next decade. Concerns tempering this favorable scenario include risks of economic overheating in some countries, uncertainty about the starting date of EMU (owing to challenges posed by high unemployment and budget deficits), and the sustainability of capital flows to emerging market economies (see *WEO* article on page 273).

Interim Committee members will discuss EMU and its prospective implications for the international monetary system and for the IMF. The IMF's Executive Board sees the recent increasing convergence in EMU countries as having reduced the risks in the run up to EMU, especially with respect to the timetable. The Board views EMU as a particularly important international financial event, which is likely to foster improved efficiency of global markets, including through the creation of EMU-wide financial markets, bringing beneficial changes to European banking systems, and promoting a more efficient European payments system.

Capital Market Issues

The increasing integration of global capital markets has heightened the importance of IMF surveillance of



Mohammed K. Khirbash of the United Arab Emirates is Chairman of the 1997 Annual Meetings.

From the Executive Board

the international monetary system—underscoring the IMF's attention to financial sector and capital account issues. In this connection, the Committee will consider the IMF's role in the ongoing international effort to promote sound banking principles and practices among its members, in concert with such other relevant international institutions as the Basle Committee on Banking Supervision, the World Bank, and the Bank for International Settlements.

Also on the agenda is a consideration of issues surrounding capital account liberalization, given that an open and liberal system of capital movements contributes to an efficient allocation of global savings and investment. Ministers are expected to discuss the appropriate pace and sequencing of capital account liberalization with other structural reforms, especially in the financial sector. In this context, Ministers will discuss the main elements of an amendment to the IMF's Articles of Agreement that makes the promotion of capital account liberalization a specific purpose of the IMF and gives it appropriate jurisdiction to cover capital account movements.

Debt Initiative

The IMF has endorsed continuation of the ESAF beyond the year 2000 when current ESAF resources are expected to be fully committed. The ESAF is the centerpiece of IMF support for poor countries, including in the context of the HIPC Initiative to reduce their external debt burden to sustainable positions over the medium term. The Interim and Development Committees will discuss progress in implementing the HIPC Initiative; in April 1997, the IMF approved Uganda's eligibility for assistance under the Initiative and on September 10, it approved the eligibility of Bolivia (see box on page 274).

IMF Quotas and SDR Allocation

The Interim Committee is expected to entertain proposals for an IMF quota increase under the Eleventh General Review of Quotas to ensure the adequacy of IMF quotas to respond to unexpected developments and to potentially large demands on its resources in a world of integrated financial markets. The distribution of the increase is intended to be in large part equiproportional, but it will also seek to address major anomalies in the distribution of quotas among members.

Ministers will also seek to make progress with an "equity" allocation of SDRs to correct for the fact that more than one-fifth of IMF members have joined since the last SDR allocation in 1979–81 and some other members have not participated in every SDR allocation. An equity allocation will require an amendment of the IMF's Articles of Agreement, providing for a special one-time SDR allocation that would raise each member's ratio of cumulative allocations to quotas to a common benchmark level. ■

Following is an excerpt of a recent IMF press release. Full texts are available on the IMF's web site (<http://www.imf.org>) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Thailand: Stand-By

The IMF approved a stand-by credit for Thailand, authorizing drawings of up to SDR 2.9 billion (about \$3.9 billion) over the next 34 months to support the government's economic program. Of the total, SDR 1.2 billion (about \$1.6 billion) is available immediately, and a further SDR 600 million (about \$810 million) will be available after November 30, 1997, provided that end-September performance targets have been met and the first review of the program has been completed. Subsequent disbursements, on a quarterly basis, will be made available subject to the attainment of performance targets and program reviews. The stand-by credit is equivalent to 505 percent of Thailand's quota of SDR 573.9 million (about \$780 million) in the IMF.

In approving Thailand's request for the stand-by credit, the IMF made use of the accelerated procedures established under the Emergency Financing Mechanism (EFM), which was adopted in September 1995. The EFM strengthens the IMF's ability to respond swiftly in support of a member country facing an external financial crisis and seeking financial assistance from the IMF in support of a strong economic adjustment program.

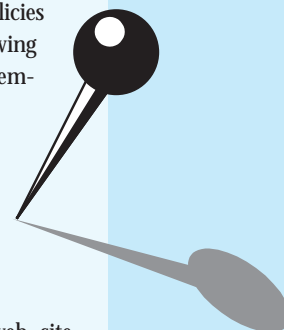
From mid-1996, Thailand was confronted with a series of adverse developments, including a sharp slowdown in exports and GDP growth; growing difficulties in the property sector; a sharp fall in the stock market; and some weakening of the fiscal position. During the first half of 1997, the authorities took some measures to address the growing signs of fiscal deterioration, as well as to strengthen the financial and property sectors, but these proved insufficient to restore market confidence. Growth and investment continued to slow, support for financial companies accelerated progressively, and there was evidence of growing financial disintermediation. In this environment, there followed a series of increasingly serious attacks on the baht.

Press Information Notices

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

- South Africa, No. 97/20, August 25
- Senegal, No. 97/21, August 26
- Mauritania, No. 97/22, August 27
- Germany, No. 97/23, August 29
- Sweden, No. 97/24, September 2
- Mongolia, No. 97/25, September 3

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



On July 2 the authorities introduced a managed float of the baht, which subsequently depreciated about 20 percent against the U.S. dollar during July. However, reports that borrowers were facing increasing difficulties rolling over short-term debt, intensified outflows from finance companies, and accelerated injections of financial support from the Financial Institutions Development Fund (FIDF) precipitated a widespread loss of confidence. Recognizing that the economic and financial situ-

ation had now become precarious, the authorities moved swiftly to put together a comprehensive economic package.

Medium-Term Policy Strategy

The Thai government's 1997-2000 policy framework, which the stand-by credit supports, is designed to restore confidence and economic stability at an early stage and lay the foundation for sound growth over the medium term. The measures under the program are designed to bring

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

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			6,038.42	3,752.72
Argentina	April 12, 1996	January 11, 1998	720.00	214.00
Bulgaria	April 11, 1997	June 10, 1998	371.90	186.50
Djibouti	April 15, 1996	March 31, 1998	6.60	2.63
Egypt	October 11, 1996	September 30, 1998	271.40	271.40
El Salvador	February 28, 1997	April 27, 1998	37.68	37.68
Hungary	March 15, 1996	February 14, 1998	264.18	264.18
Lesotho	September 23, 1996	September 22, 1997	7.17	7.17
Pakistan	December 13, 1995	September 30, 1997	562.59	267.90
Papua New Guinea	July 14, 1995	December 15, 1997	71.48	36.14
Romania	April 22, 1997	May 21, 1998	301.50	241.20
Thailand	August 20, 1997	June 19, 2000	2,900.00	1,700.00
Ukraine	August 25, 1997	August 24, 1998	398.92	398.92
Uruguay	June 20, 1997	March 19, 1999	125.00	125.00
EFF Arrangements			10,500.63	5,721.87
Algeria	May 22, 1995	May 21, 1998	1,169.28	337.68
Azerbaijan	December 20, 1996	December 19, 1999	58.50	44.46
Croatia	March 12, 1997	March 11, 2000	353.16	324.38
Gabon	November 8, 1995	November 7, 1998	110.30	49.63
Jordan	February 9, 1996	February 8, 1999	238.04	98.08
Kazakhstan	July 17, 1996	July 16, 1999	309.40	309.40
Lithuania	October 24, 1994	October 23, 1997	134.55	10.35
Moldova	May 20, 1996	May 19, 1999	135.00	97.50
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Philippines	June 24, 1994	December 31, 1997	791.20	245.95
Russia	March 26, 1996	March 25, 1999	6,901.00	4,064.74
ESAF Arrangements			3,624.59	1,497.14
Armenia	February 14, 1996	February 13, 1999	101.25	50.63
Azerbaijan	December 20, 1996	December 19, 1999	93.60	52.64
Benin	August 28, 1996	August 27, 1999	27.18	18.12
Bolivia	December 19, 1994	December 18, 1997	100.96	33.65
Burkina Faso	June 14, 1996	June 13, 1999	39.78	26.52
Cameroon	August 20, 1997	August 19, 2000	162.12	135.10
Chad	September 1, 1995	August 31, 1998	49.56	16.52
Congo, Republic of	June 28, 1996	June 27, 1999	69.48	55.58
Ethiopia	October 11, 1996	October 10, 1999	88.47	73.73
Georgia	February 28, 1996	February 27, 1999	166.50	83.25
Ghana	June 30, 1995	June 29, 1998	164.40	109.60
Guinea	January 13, 1997	January 12, 2000	70.80	47.20
Guinea-Bissau	January 18, 1995	March 31, 1998	10.50	2.36
Guyana	July 20, 1994	April 17, 1998	53.76	8.96
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	July 20, 1994	March 31, 1998	88.15	16.13
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	45.47
Madagascar	November 27, 1996	November 26, 1999	81.36	67.80
Malawi	October 18, 1995	October 17, 1998	45.81	22.91
Mali	April 10, 1996	April 9, 1999	62.01	31.01
Mauritania	January 25, 1995	July 13, 1998	42.75	7.13
Mongolia	July 30, 1997	July 29, 2000	33.39	27.83
Mozambique	June 21, 1996	June 20, 1999	75.60	37.80
Niger	June 12, 1996	June 11, 1999	57.96	28.98
Senegal	August 29, 1994	January 12, 1998	130.79	—
Sierra Leone	March 28, 1994	December 31, 1997	101.90	5.06
Tanzania	November 8, 1996	November 7, 1999	161.59	110.18
Togo	September 16, 1994	June 15, 1998	65.16	21.72
Uganda	September 6, 1994	November 17, 1997	120.51	—
Vietnam	November 11, 1994	November 10, 1997	362.40	120.80
Zambia	December 6, 1995	December 5, 1998	701.68	40.00
Total			20,163.64	10,971.72

EFF = Extended Fund Facility.

ESAF = Enhanced Structural Adjustment Facility.

Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

EFF arrangements, which normally run three years, seek to rectify external payments difficulties stemming from structural problems and thus require a longer adjustment period.

about orderly shifts in domestic saving-investment balances that will underpin the reduction in the external current account deficit to a more sustainable 3 percent of GDP in 1998. Additional structural measures to reinforce the outward orientation of the economy are an important part of the package to bring about a recovery of the economy to Thailand's annual growth potential of 6-7 percent over the medium term.

Central to the medium-term strategy is the new exchange rate regime. The managed float adopted on July 2, 1997, should alter the incentive framework for short-term capital flows and protect the future level of foreign exchange reserves. Fiscal policy aims at maintaining the public sector in surplus to provide a necessary margin to absorb financial restructuring costs. In the monetary field, strict control over the monetary aggregates includes ending the recent practice of open-ended, unconditional financial support to insolvent institutions and the development of further monetary policy instruments.

Structural reforms to address the causes of the present economic difficulties are essential to the strategy, in particular the strengthening of the financial system, while minimizing moral hazard risks. The success of the program hinges crucially on isolating insolvent institutions and ensuring the viability of those remaining through early recapitalization and strengthened regulatory requirements and supervision. The medium-term strategy also contains accelerated privatization of strategic sectors, increased emphasis on secondary education and training, and other efforts to strengthen competitiveness.

Program for 1997-98

The principal objective of the program for 1997-98 is to achieve an orderly adjustment of the domestic economy to the sharp, forced reduction in the current account deficit to about 5 percent of GDP in 1997 and 3 percent of GDP in 1998. This will involve ensuring positive growth of 2.5 percent in 1997 and 3.5 percent in 1998; maintaining gross official reserves at the equivalent of 4.2 months of imports in 1997 and 4.4 months in 1998; limiting the end-period rate of inflation to 9.5 percent in 1997 and 5 percent in 1998; and initiating a credible and up-front restructuring of the financial sector.

Fiscal policy is the key to the credibility of the overall program. The focus of fiscal policy will be to restore a small over-

all surplus in the public sector by 1998 through an increase in the rate of the value-added tax to 10 percent from 7 percent and initiating expenditure cuts in a number of areas, while protecting spending on health and education. Monetary policy is designed to support the inflation and balance of payments objectives of the program.

Thailand: Selected Economic Indicators

	1994	1995	1996	1997 ¹	1998 ¹
			(percent change)		
Real GDP growth	8.9	8.7	6.4	2.5	3.5
Consumer prices (end of period)	5.3	7.1	4.8	9.5	5.0
			(percent of GDP)		
Overall public sector balance	1.8	2.5	2.2	-1.6	1.0
External current account balance	-5.6	-8.0	-7.9	-5.0	-3.0
			(months of imports)		
Gross official reserves	6.8	6.3	6.6	4.2	4.4

¹Program.

Data: Thai authorities and IMF staff estimates

Structural Policies

Under the program, re-establishing domestic and external confidence in Thailand's financial system is crucial to maintaining an open capital account within existing financing constraints. A solvent and profitable financial sector is also a clear precondition for the restoration of rapid growth and for removing the threat of recurring financial crises. Recognizing that the financial system will face deteriorating conditions for some time, the authorities will require all remaining financial institutions to strengthen their capital base expeditiously. This will include a policy of encouraging mergers, as well as foreign capital injection.

Financing Need

On August 11, 1997 in Tokyo, the IMF convened a meeting of interested countries to discuss Thailand's efforts to address its economic problems and to fill the financing gap. At that meeting, pledges were received from Japan (\$4 billion); Australia, Hong Kong (China), Malaysia, and Singapore (\$1 billion each); and Indonesia and Korea (\$0.5 billion each). Subsequently, China pledged \$1 billion, and the World Bank and Asian Development Bank announced contributions of \$1.5 billion and \$1.2 billion, respectively. The total financing

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
August 18	4.15	4.15	4.55
August 25	4.12	4.12	4.52
September 2	4.14	4.14	4.54
September 8	4.11	4.11	4.50

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (the U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 109.6 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171.

Data: IMF Treasurer's Department

Members' Use of IMF Credit

(Million SDRs)

	August 1997	Jan.-Aug. 1997	Jan.-Aug. 1996
General Resources Account	1,262.2	4,012.9	3,917.1
Stand-by Arrangements	1,262.2	1,857.1	1,934.5
EFF Arrangements	0.0	2,048.2	1,808.0
CCFF	0.0	107.6	174.6
SAF and ESAF Arrangements	44.4	378.4	389.5
Total	1,306.6	4,391.3	4,306.6

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

Data: IMF Treasurer's Department

from these sources amounts to \$12.7 billion. The proceeds from the credits extended by the IMF and the bilateral lenders will be used solely to help finance the balance of payments gap and to rebuild the official reserves of the Bank of Thailand.

What the reaction to the Thai crisis underscores is that impressive regional support has been mobilized and that the

EFM has allowed a speedy international response, demonstrating the ability of the international community, acting through the IMF, to face in an appropriate way the challenges of globalized markets.

Press Release No. 97/37, August 20

Recent IMF Publications

Books

Systemic Bank Restructuring and Macroeconomic Policy, edited by William E. Alexander and others (\$23.50). Essays offering a global and macroeconomic perspective on systemic bank restructuring with an emphasis on the need for detailed, microlevel restructuring of individual banks as well.

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

No. 151: *Currency Board Arrangements: Issues and Experiences*, Tomás J.T. Baliño and Charles Enoch. A comprehensive analysis of the attractions and disadvantages of currency board arrangements in their various institutional configurations.

No. 152: *Hong Kong, China: Growth, Structural Change, and Economic Stability During the Transition*, John Dodsworth and Dubravko Mihajek. An analysis of Hong Kong's economic success, which, although unique in many respects, provides universal lessons.

Working Papers (\$7.00)

97/93: *Effects of the European Economic and Monetary Union (EMU) on Taxation and Interest Spending of National Governments*, Francesco Paolo Mongelli. An analysis of the interest spending and taxation channels through which EMU could affect public finances; it argues that "high-debt" and "high-tax" countries pursuing prudent fiscal policies could benefit most from EMU.

97/94: *The Role of Fiscal Policy in Sustainable Stabilization: Evidence from Latin America*, Teresa Ter-Minassian and Gerd Schwartz. A review of fiscal policy in a number of Latin American stabilization programs since the early 1980s, highlighting the importance of sustainable fiscal adjustment.

97/95: *Debt Reduction and New Loans: A Contracting Perspective*, John A. Carlson and others. An examination of a series of international debt contracts that allow for the possibility of rescheduling, forgiveness, and rescheduling with forgiveness.

97/96: *Public Disclosure and Bank Failures*, Tito Cordella and Eduardo Levy Yeyati. An assessment of how public disclosure of banks' risk exposure affects their risk-taking incentives and how the presence of informed depositors influences the soundness of the banking system.

97/97: *Growth and Productivity in ASEAN Countries*, Michael Sarel. An enquiry into the nature of growth in ASEAN countries and whether it has been generated by more inputs or greater efficiency.

97/98: *Some Evidence on Exchange Rate Determination in Major Industrial Countries*, R. Barry Johnston and Yan Sun. An examination of the role of long-run monetary and cyclical factors in major industrial countries in determining exchange rate movements.

97/99: *The Design of EMU*, David Begg. A discussion of the monetary strategy of the European central bank and the implications for accountability, transparency, and reputation.

97/100: *Controlling Fiscal Confusion*, Sheetal K. Chand and Karl O. Moene. An assessment of the effectiveness of incentives in controlling fiscal corruption, concluding that corruption at higher management levels must be contained for such incentives to be effective.

97/101: *Fiscal Policy and Growth in the Middle East and North Africa Region*, Sena Eken and others. An assessment of fiscal consolidation, concluding that the ongoing process of fiscal reform is key to ensuring macroeconomic stability and fostering growth.

97/102: *On the Speed of Transition in Central and Eastern Europe: Does On-the-Job Search Matter?*, Zuzana Bixiova. A discussion of how on-the-job workers seeking jobs in the private sector can account for the coexistence of a fast-growing private sector and long-term high unemployment.

97/103: *Japanese Foreign Direct Investment and Regional Trade*, Tamim Bayoumi and Gabrielle Lipworth. An examination of the relationship between Japanese foreign direct investment outflows, domestic and foreign fixed investment, and the exchange rate.

Other Publications

Exchange Arrangements and Exchange Restrictions Annual Report, 1997 (\$76.00; academic rate: \$38.00)

Staff Papers, June 1997 (\$16.00; annual subscription: \$50.00; academic rate: \$25.00)

A Global Integration Strategy for the Mediterranean Countries: Open Trade and Market Reforms, Oleh Havrylyshyn (\$15.00)

IMF Staff Country Reports (\$15.00)

97/70: St. Kitts and Nevis

97/71: People's Republic of China

97/72: People's Republic of China (appendix)

Publications are available from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org.

For information on the IMF on the Internet—including the English edition of the *IMF Survey*; the *IMF Survey's* annual *Supplement on the IMF*; the *IMF Publications Catalog*; full texts of IMF Working Papers and Papers on Policy Analysis and Assessment published in 1997; and daily SDR exchange rates of 45 currencies—please visit the IMF's web site (<http://www.imf.org>).



Asian Experience Underscores Need For Swift, Corrective Policy Action

Hubert Neiss, Director of the IMF's Asia and Pacific Department, responded on September 9 to questions posed by the IMF Survey about recent developments in Asia and their impact on the region's longer-term prospects.

IMF SURVEY: *How do you see the IMF's work in Asia and the Pacific evolving as a result of the ongoing changes in the global economic environment?*

NEISS: The twin pillars of the IMF's work, including that of the Asia and Pacific Department, will remain surveillance and the provision of financial and technical support to countries undertaking adjustment. Major changes in the world economy, however, are having important implications for our work. First, Asia's weight in the world economy continues to increase: its share in world output in terms of purchasing power parity has risen from about one-fifth in 1980 to about one-third now, and it is likely to rise further. The increase in Asia's export share has been even more dramatic.

Second, the deepening of trade and financial linkages both within Asia and with the rest of the world offers great opportunities for expanding investment and growth, but also poses new challenges for domestic policies and for regional and international cooperation. Specifically, the increasing openness and integration of financial markets have increased the costs of inappropriate policies and of delaying corrective action. The consequences can be sudden and severe, as we have seen in Thailand.

So we need to do everything possible to detect emerging problems at an early stage and to persuade member countries to implement corrective policies. This is the core of our surveillance work. And if a crisis does occur, we need to be able to assemble quickly a strong package of financial assistance in support of decisive adjustment measures. This has recently happened in Thailand and the Philippines. Indeed, Thailand and the Philippines were the first cases in which accelerated approval procedures—allowing clearance of the Stand-By Arrangement by the Executive Board in a matter of days for Thailand [see page 283]—and new mechanisms allowing for an exceptional amount of financing (505 percent of Thailand's quota) were used. With globalized financial markets, swift action is essential.

Third, our advice should help to improve the quality of development and ensure that all groups in society share in the benefits of development. Greater attention must, therefore, be given to the establishment of sound public institutions. Of particular importance are a transparent regulatory system that discourages rent-seeking, a sound legal framework, and a fiscal structure that delivers high-quality public expenditures, especially investment in human capital.

IMF SURVEY: *What lessons should be learned from the Thai crisis and the subsequent developments in Southeast Asian financial markets?*

NEISS: The most important lesson is that delaying a policy response to emerging problems is increasingly costly, both for the country itself and for its regional partners. At the heart of Thailand's difficulties were a number of related problems: a rising current account deficit not sustainable over the medium term; heavy reliance on short-term foreign borrowing that increased the economy's exposure to foreign exchange risk and to a potential reversal of capital flows; a rigid link of the exchange rate of the baht to the U.S. dollar, which had appreciated over a considerable period; and serious fragilities in the financial sector linked to excessive growth of property-based lending. These problems, which were increasingly evident over the past year, could have been corrected at much less cost at an earlier stage.

A second lesson is that once the authorities have recognized the need and generated the political will for decisive action, they must move boldly to put in place a comprehensive adjustment package as quickly as possible. This has been done in Thailand; the government's program is comprehensive, and some of the most important measures have been implemented up front. An important feature of the Thailand case has been the role of regional cooperation in putting together a large financial package. This has been vital for the swift implementation of the adjustment program, and it augurs well for future cooperation in the region.

IMF SURVEY: *Are you surprised at the degree of contagion with respect to other countries in the region? What should these countries do to limit contagion effects?*

NEISS: The Thai crisis has demonstrated how quickly exchange and financial market pressures can spread from country to country, whatever the fundamentals. None of the neighboring countries affected had the combination of vulnerabilities that precipitated Thailand's crisis, and their fundamentals are basically sound. The degree of contagion was, therefore, a surprise to me, as even minor weaknesses became a matter of major market concern. Of course, some of the initial policy responses in some countries were misjudged, and this undoubtedly exacerbated the situation. Our advice has been to take quick action to minimize such vulnerabilities, allow greater exchange rate flexibility to absorb market pressures, and, unavoidably, raise interest rates temporarily. To cope with greater exchange rate volatility—a necessary byproduct of the greater freedom of capital flows from which these countries have benefited so much—it is essential to build a strong banking system,



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well capitalized and well supervised. In my view, there is also a role for certain limits, prudential as well as others, on financial flows, but this is a controversial issue and the pros and cons of any such measures should be carefully weighed. Above all, it is most important to preserve the fundamental elements of the region's strong economic performance—in particular, high domestic savings and open trade regimes. While the current market turbulence will moderate growth in the region in the near term, we should take a longer view, and I believe the region's growth prospects remain very good.

IMF SURVEY: *How will the increased emphasis on governance issues affect the IMF's work in Asia?*

NEISS: Some of our policy advice and technical assistance is already directed toward achieving a framework that encourages good governance through unrestricted trade and exchange systems, broad-based tax regimes, and transparent budgetary and expenditure control systems. These will require more emphasis in the future. In addition, we will need to pay much greater attention to encouraging sound banking systems and the effective supervisory regimes that support such systems. In all these areas, technical assistance is playing a vital role.

IMF SURVEY: *What are the prospects for further structural reform in the region? In particular, what are the policy priorities for China, how sanguine are you on India's achieving Asian "tiger" status, and what about the durability of Japan's recovery and its longer-term prospects?*

NEISS: A number of Asian economies have already made considerable progress on key structural reforms. China has made substantial progress in restructuring its economy and the outlook remains favorable, with growth expected to be on the order of 8–9 percent over the medium term. To sustain this performance, further progress must be made with reforms in the state enterprise sector, the financial system, the trade regime, and fiscal policy. The strong economic performance of Hong Kong, China, is also expected to continue—owing much to its open exchange and trade regime and its sound institutions and legal framework, which are firmly embedded in the Sino-British Joint Declaration and in the Basic Law of the Hong Kong Special Administrative Region.

Since India initiated a reform process in the early 1990s, its economy has been undergoing a profound transformation, and the results are evident in stronger economic performance. Growth has averaged around 7 percent over the past three years, with inflation contained and a sound external position. Nevertheless, a second round of reforms is necessary if India is to achieve Asian tiger status and make major inroads on poverty. Fiscal adjustment needs to be broadened and extended to include the states and public enterprises. In addition, bold structural reforms are needed, encompassing fur-

ther trade reform, addressing infrastructure bottlenecks, and accelerating efforts to strengthen the financial system.

In Japan, the economic recovery, which followed the bursting of the asset price bubble of the late 1980s, has been unusually protracted. However, the economy demonstrated encouraging strength in 1996 and early this year. Although activity appears to have weakened considerably since March 1997—owing principally to the withdrawal of the fiscal stimulus of recent years—I am confident the recovery will resume at a moderate pace once the temporary effects of recent tax increases have been unwound. While Japanese macroeconomic policies need to remain focused over the near term on supporting a durable recovery, the pressures that are expected to result from a rapidly aging workforce highlight the need for measures to buttress longer-term growth prospects. In particular, as the fiscal position had substantially deteriorated during the long recession, progress toward achieving a sustainable fiscal position should be continued. The authorities should also follow through with their commitment to deregulation and structural reform. For example, the planned deregulation of Japan's financial markets—the “big bang”—has the potential for significantly improving the efficient allocation of Japanese savings, both domestically and abroad. Since Japan is already the world's largest exporter of capital, these reforms will have a major impact on Asia and on the world economy.

IMF SURVEY: *Is the “Asian miracle” over?*

NEISS: There was never anything miraculous—in the sense of developments that defied rational explanation—about Asia's success story. While growth in the region has been dramatic over the last two decades, it was the result of fundamentally sound economic policies: conservative monetary and fiscal policies combined with high private savings, deregulation of economic activity, external liberalization, and investment in human capital. These policies remain in place; therefore, the region still has considerable potential for rapid development.

Important challenges remain for the period ahead. Economies of the region will need more robust financial systems that can make efficient use of large, and potentially volatile, capital flows. They will also need to manage a transition to higher-technology production, which, for many countries, will require even greater investments in education. But I am confident that the region will soon return to strong, sustained growth, once the current market turbulence has been surmounted. ■



Hubert Neiss