

## IMF Executive Board Adopts New Arrangements to Borrow

**O**n January 27, the IMF's Executive Board approved new borrowing arrangements to enhance the IMF's ability to safeguard the international monetary system. Under the New Arrangements to Borrow (NAB), 25 participant countries and institutions stand ready to lend the IMF additional resources—up to SDR 34 billion (about \$47 billion)—to supplement its regular quota resources when needed to forestall or cope with an impairment of the international monetary system or deal with an exceptional situation that threatens the stability of the system. In an announcement following the Board's approval, IMF Managing Director Michel Camdessus hailed the Board's decision as "a milestone in the membership's efforts to strengthen the IMF," which would "enable the institution to fulfill more effectively its role in the international monetary system."

The NAB do not replace the supplemental credit lines available to the

IMF under the General Arrangements to Borrow (GAB), which remain in force. Under the GAB, the Group of Ten industrial countries and Switzerland stand ready to lend up to SDR 17 billion (about \$24 billion); in an associated agreement, Saudi Arabia is prepared to make available SDR 1.5 billion (about \$2.1 billion). Nonetheless, the NAB will be the facility of first recourse. It enters into force—for five years and subject to renewal—when adopted by participants with credit arrangements totaling SDR 28.9 billion (about \$40 billion), including the five participants with the largest credit arrangements.

NAB credit lines may be drawn on for the benefit of all NAB participant countries, or for nonparticipants under circumstances similar to those under the GAB. Activation procedures for nonparticipants under the NAB, however, are somewhat more flexible. Moreover, a country or institution not currently a participant may become one when the NAB is renewed, if the IMF and participants representing 80 percent of credit arrangements agree, or at other times through amendment to the NAB.

*(Please turn to following page)*

### NAB Participants and Credit Arrangements

Participant	Million SDRs
Australia	810
Austria	412
Belgium	967
Canada	1,396
Denmark	371
Deutsche Bundesbank	3,557
Finland	340
France	2,577
Hong Kong	
Monetary Authority	340
Italy	1,772
Japan	3,557
Korea	340
Kuwait	345
Luxembourg	340
Malaysia	340
Netherlands	1,316
Norway	383
Saudi Arabia	1,780
Singapore	340
Spain	672
Sveriges Riksbank	859
Swiss National Bank	1,557
Thailand	340
United Kingdom	2,577
United States	6,712

IMF Executive Board clears way for IMF participation in debt initiative for indebted poor countries. See page 35.

## The GAB

The IMF's General Arrangements to Borrow (GAB) are lines of credit, available at market-related interest rates, from 11 industrial countries or their central banks (the United States, the Deutsche Bundesbank, Japan, France, the United Kingdom, Italy, Canada, the Netherlands, Belgium, the Swedish Riksbank, and the Swiss National Bank). GAB credit lines total SDR 17 billion (about \$23.6 billion), plus SDR 1.5 billion (about \$2.1 billion) available under an associated agreement with Saudi Arabia. The credit lines are to be drawn upon when needed to finance exchange transactions between the IMF and GAB members "to forestall or cope with an impairment of the international monetary system." GAB credit lines may also be drawn upon for non-GAB member countries with IMF-supported adjustment programs and under certain conditions.

The GAB were established in October 1962 amid concerns about the adequacy of official sources of global liquidity and the disruptive effects of short-term capital movements on the world monetary system. (The associated arrangement with Saudi Arabia was agreed in 1983.) The GAB have been revised and renewed several times. To date, the GAB have been activated nine times—most recently in 1977, when the IMF borrowed to lend to the United Kingdom and Italy under stand-by arrangements, and in 1978, to finance a reserve tranche drawing by the United States.

The wider participation under the NAB reflects the changing character of the global economy and a broadened willingness to share responsibility for managing the international monetary system. Camdessus characterized the agreement as "an important and timely reflection of ongoing changes in the world economy" that illustrates the "sense of responsibility with which both a significant number of countries and institutions in a position to make their resources available to the IMF and the current and associated members of the GAB are ready to contribute, through the IMF, to

the stability of the international monetary system.

"But as members of the Board reiterated, the NAB cannot be a substitute for the strengthening of quotas—which is the capital basis of the IMF," Camdessus said. He said he hoped for rapid progress in reaching a conclusion on a significant increase in IMF quotas under the Eleventh General Review. A significant increase would, he said, further complete the effort of adapting the IMF's resources to the current world situation and risks. (See press release on page 46.)

## European Transition Economies Confront Social Issues

**F**ollowing is a summary of a paper on *Social Issues in the Transition* delivered by Mark Allen, the IMF's Senior Resident Representative in Hungary, at a seminar entitled "Countries in Transition in Eastern Europe: The Way Ahead," sponsored by the World Confederation of Trade Unions on November 7–8, 1996, in Budapest.

The collapse of the Soviet Union inaugurated a major transition from communist societies to modern capitalist democracies for the countries of Central and Eastern Europe, the Baltics, and other countries of the former Soviet Union. But the transition is not purely, or even principally, an economic one; it involves the creation of new political systems and social orders and institutions, according to Mark Allen.

Some of the consequences associated with the transition were unexpected, said Allen. In light of the Chinese experience, where modest liberalization helped launch a period of virtually uninterrupted growth,

some economists may have expected the same in Central and Eastern Europe. But the sharp fall in output, following the collapse of central planning and the liberalization of the transition economies of Central and Eastern Europe, was deeper and more prolonged than expected. Nevertheless, in a number of these countries, economic recovery has finally begun, although it has not necessarily been translated yet into improved welfare for all segments of society. Ultimately, the ability of these countries to satisfy the needs and aspirations of their populations depends on sustaining growth, raising investment, and increasing productivity.

Allen identified two key requirements for continued growth throughout Central and Eastern Europe. The first is successful economic stabilization. Until inflation is brought to below 50 percent a year, growth is not possible. It takes about two years after the adoption of a serious economic adjustment program for

growth to resume in these countries. The second is far-reaching structural reform. This includes privatization and the establishment of a broad array of institutions appropriate to a market economy.

The correlation between systemic reform and recovery in output is especially striking, Allen noted. The recovery in output has been accompanied by sharp rises in labor productivity and, in many cases, a jump in the real value of average wages from their immediate post-stabilization lows throughout most of the region.

Fiscal policy poses especially difficult problems for the transition countries, according to Allen. The collapse of revenues has led to severe expenditure restraints, forcing governments to rethink their spending priorities amid large salary and pensions arrears. Resolution of this problem will require more effective and equitable taxation of a growing tax base, combined with systemic reforms of government spending patterns. Fiscal retrenchment has in turn made it harder for these countries to address a number of the following social problems:

- *Unemployment.* Jobless rates of between 10 and 20 percent have become increasingly common throughout Central and Eastern Europe. The full impact of unemployment in some of these countries has been temporarily blunted by the continued operation of large enterprises that were also spared the cost of making severance payments. Nonetheless, overall labor market participation rates in most Central and Eastern European countries have declined, with working women hit especially hard.

In countries further advanced in the transition, employment is beginning to rise, Allen said. Job creation is especially pronounced in the long-neglected services sector. New jobs are being generated even as productiv-

ity is increasing. This development will likely translate into a more rapid rise in living standards.

Job creation throughout the region ultimately depends on profit-making activities, in the context of competitive exchange rates, flexible labor markets, and appropriate legal and business-friendly infrastructures. The IMF has worked closely with the authorities of these countries to help ensure the effective implementation of appropriate policies.

- *Low wages and deteriorating employment conditions.* In the transition countries, these are a direct expression of persisting egalitarian wage structures and a different incentive system than that existing in industrial countries, Allen observed. With the transition to

a market economy, wages have become more differentiated, with greater value now being accorded to higher education. The salary and status of less-skilled work have correspondingly declined, with the wages of those in previously favored heavy industrial sectors of the old system—such as miners and steel workers—especially affected. In countries where unemployment has been kept low because of labor hoarding, real wages for the less skilled have declined further. Much less is known about the wage situation in the informal sector, Allen said. One possibility is the simultaneous existence of both very low and very high-paying jobs.

Transition countries have generally been reluctant to use minimum wage

### IMF Ready to Participate in Debt Initiative

On February 4, the IMF Executive Board agreed on the structure and modalities for implementing special operations under the enhanced structural adjustment facility (ESAF) to permit IMF participation in the joint IMF-World Bank debt initiative for the heavily indebted poor countries (HIPC). The Board's agreement on the operational details for implementing IMF participation in the initiative is based on the consensus reached in the September 1996 meetings of the Executive Board and of the Interim Committee—the IMF's principal advisory body—and the joint IMF-World Bank Development Committee (see *IMF Survey*, October 14, 1996).

At its February 4 meeting, the Board established a *Trust for Special ESAF Operations for the Heavily In-*

*debted Poor Countries and Interim ESAF Subsidy Operations*, and agreed to conduct semiannual reviews of the financing of the ESAF-HIPC Trust. The Trust will permit the IMF to deposit in that account resources that have already been accumulating for these purposes. In addition, the Board decided to allow an early transfer of resources now held in the ESAF Reserve Account to the Special Disbursement Account, to be used in financing special ESAF operations. Once all creditors to the ESAF Trust consent to this transfer (expected in the coming weeks), the IMF will be able to commit its resources as a participant in the HIPC initiative as the first countries reach their "decision points" under the initiative and are judged to require assistance.

laws actively, in part because of concerns about the potential effects of higher minimum wages on the budget. Labor market reform has likewise not resulted in uniform observance of internationally agreed labor standards, which Allen attributed to weak trade unions, a socially unaware private sector, and inadequate government enforcement powers. Greater efforts should nevertheless be made by these countries to uphold international labor standards. "There is no contradiction between effective adjustment and the enforcement of international labor conventions," he said.

- *Growing income inequality and rising poverty.* Throughout the transition countries of Central and Eastern Europe, income inequality and poverty are on the rise as a result of low wages, growing unemployment, and a "flat," unprogressive, tax system. Even so, existing data should be interpreted with caution, Allen said. Reasonably accurate payroll records had been kept under the old system, for example, but less reliable data are available on the incomes generated in the informal sector. Allen suggested that some alteration in the older egalitarian system of income distribution is overdue. A less protective society forces growing numbers of people to understand the relationship between individual effort and improved living standards. The emerging specter of poverty at the lower end of the income pyramid, however, requires some redress for moral, political, and economic reasons. In many transition countries, the pension and unemploy-

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### Selected Countries in Transition: General Government Budget Balance

(percent of GDP)

	1993	1994	1995	1996	1997
<b>Countries in Transition</b>	<b>-6.9</b>	<b>-6.7</b>	<b>-3.9</b>	<b>-3.7</b>	<b>-2.3</b>
Armenia	...	-16.5	-9.9	-6.8	-4.6
Bulgaria <sup>1</sup>	-15.7	-7.0	-5.7	-4.7	-2.6
Czech Republic <sup>2</sup>	1.4	-1.3	-2.1	-1.3	0.9
Estonia	-1.1	1.3	-0.8	-1.4	-0.5
Hungary	-6.3	-7.6	-3.7	-0.5	-2.8
Kazakstan <sup>1</sup>	-1.2	-6.8	-3.0	-2.8	-2.4
Latvia	0.6	-3.9	-1.0	-0.7	0.6
Lithuania	-4.9	-4.7	-3.0	-3.5	-2.4
Mongolia	-14.6	-24.6	-11.1	-10.9	-10.6
Poland	-4.0	-2.0	-2.7	-2.7	-2.5
Romania	-0.1	-1.0	-2.5	-2.2	-2.0
Russia	-7.6	-10.1	-5.0	-5.5	-3.0
Slovak Republic	-7.1	-1.3	0.1	-1.5	...

Note: 1996 and 1997 figures are projections.

<sup>1</sup>Central government balance.

<sup>2</sup>Includes privatization revenues.

Data: IMF, *World Economic Outlook*, October 1996

ment compensation systems have been used as emergency social safety nets. But resort to such measures has not proven effective in reducing poverty. Well-targeted social assistance programs remain the most effective means for ameliorating poverty and social disruption within existing budget restraints, he said.

- *Deteriorating social services.* Dwindling financial resources have forced the transition countries to re-evaluate and restructure their previously ambitious social programs. The current situation is far from satisfactory, according to Allen. Staffing and servicing levels have been significantly reduced, and morale has plunged. This, in turn, has weakened political and social support for the transformation process. Scarce financial resources in the social service sector must accordingly be spent more efficiently. The psychological shift toward greater personal autonomy is one of the key challenges of the transition period, said Allen. Faced with these new realities, the long-term evolution of social policy throughout the region will likely consist of various combinations of tar-

geted benefits and limited, publicly provided services.

Despite these obstacles, most transition countries face a bright future, Allen said. Inflation is down in many of these countries and growth prospects are up. Provided there is no slippage in policies, these countries could achieve sustained long-term growth rates of 4–5 percent annually. To improve their prospects, governments must complete the process of macroeconomic stabilization, pursue enterprise restructuring more actively, step up efforts to reform the financial and social security sectors, and attract foreign capital and use domestic savings to assist in industrial restructuring.

What about the supposed trade-off between the speed of stabilization and structural transformation and the growing incidence of unemployment, poverty, and deteriorating social services? Once a country has gotten through an initial adjustment period—usually about a year—there is very little, if any, such trade-off. In general, the more rapidly conditions for a flourishing market economy are established, the faster these transitional problems can be resolved, Allen concluded. ■



# Study Examines Exchange Rate Changes and Impact on APEC Trade and Investment

**T**he 18 members from Asia and the Western Hemisphere that form the Asia-Pacific Cooperation Council (APEC) include many of the world's fastest growing economies over the past decade. APEC, which also includes the United States and Japan, offers a valuable sample against which to test the link—exemplified by Japan's experience—between rapid output growth and exchange rate appreciation and to examine the influence that exchange rate fluctuations exert on trade and investment decisions.

A recent IMF Economic Forum, based on IMF Occasional Paper No. 145, *Exchange Rate Movements and Their Impact on Trade and Investment in the APEC Region*, analyzed APEC's experience. Takatoshi Ito and Peter Isard of the IMF's Research Department and Tamim Bayoumi of the IMF's Asia and Pacific Department analyzed comparative data from the region and reviewed the relevant literature. They found several instances in which the rapidly growing APEC economies did not follow the Japanese example of real exchange rate appreciation in association with rapid growth. Their findings did, however, support the widely held views that medium-term movements in exchange rate levels have clear and important implications for trade volumes and that exchange rate changes appear to influence foreign direct investment decisions.

## Growth and Exchange Rates

Long-term changes in nominal exchange rates are often explained to a significant extent by inflation differentials. More resistant to ready explanation have been the long-term movements in real exchange rates, defined as nominal



**Tamim Bayoumi (left), Takatoshi Ito, and Peter Isard: Medium-term movements in exchange rate levels have clear and important implications for trade volumes.**

exchange rates adjusted by differences in national inflation rates. One theory—advanced by Bela Balassa and Paul Samuelson in the 1960s—posits that relatively rapid output growth tends to be associated with more rapid productivity growth in the tradable goods sectors than in the nontradables sectors, which thus puts upward pressure on the price of nontradables relative to that of tradables. If the relative price of tradable goods remains approximately constant across countries, the Balassa-Samuelson hypothesis argues, a rise in the relative price of nontradables will lead to real exchange rate appreciation.

This was Japan's experience in the high-growth phase of its economic development. The IMF study queries whether this has been the norm for other APEC members that have experienced high growth. The authors' research suggests that it has not. Over the two decades ending in 1992, Korea and Taiwan Province of China followed a pattern similar to Japan, showing a strong relationship between sharply rising per capita income and real exchange rate changes, according to Ito. Hong

Kong and Singapore experienced high growth but with only a slight appreciation in their exchange rates. (Ito cautioned, however, that the findings depend to some extent on the data period, noting that more recent data suggest Hong Kong and Singapore have also experienced real appreciations.) By contrast, high growth was associated with mild real depreciations in Thailand, Indonesia, and Malaysia, and with large real depreciations in China. Among the Latin American APEC members, Chile and Mexico had similar but relatively low average growth rates and recorded little change in their real exchange rate levels.

Noting that the study decomposed the changes in exchange rates into their "proximate determinants," Isard explained that the contradictions of the Balassa-Samuelson hypothesis, at least over the 1972–92 data period, could be attributed to two different factors:

- In some rapidly growing APEC economies (including Singapore, Malaysia, Thailand, and Indonesia), the limited data available suggested that the price of nontradables may have de-

clined relative to that of tradables, contrary to the Japanese model.

- The relative price of tradables across countries was not constant over time. The latter fact may have reflected a combination of three considerations: the composition of tradables tended to change as countries developed; the relative prices of different tradables had changed over time and interacted with different weights in domestic and foreign price indices; and the cost of goods arbitrage had declined over time as countries removed trade restrictions.

### Trade and Exchange Rates

The rapid growth of the East Asian economies and their openness to trade and foreign investment have been vital elements in the APEC region's strong growth, noted Ito. Bilateral trading relations—notably with the United States and Japan—play a crucial role in trade patterns and have features that are distinctive to the region, he explained. The United States is the dominant trading partner of Canada and Mexico, and to a lesser extent, Chile. For the rest of the region, the United States and Japan are both important trading partners.

The APEC region, Ito remarked, is also characterized by several important trading patterns: East Asian economies are generally net importers from Japan and net exporters to the United States, with the Asian countries typically importing machinery, tools, and other semi-finished goods from Japan for assembly and export to the United States. Australia and New Zealand, in contrast, run trade surpluses with Japan and trade deficits with the United States.

In discussing the impact of exchange rate changes on trade, it is useful, Bayoumi said, to differentiate between exchange rate volatility—the day-to-day or week-to-week movement of rates—and more persistent movements, a classic example of which is the apprecia-

tion and subsequent depreciation of the U.S. dollar in the mid-1980s. The APEC region has been particularly susceptible to “quite dramatic” exchange rate changes in the dollar and the yen over the past 15–20 years, he said.

Exchange rate volatility has risen sharply since the breakup of the Bretton Woods system and the introduction of floating exchange rate regimes, according to Bayoumi, and many studies have looked at the relationship between volatility and trade. While these studies have come to varied conclusions, the consensus is that volatility has a secondary impact on trade. By contrast, there is “completely overwhelming evidence,” he said, that medium-term changes in exchange rates do affect trade volumes. Exchange rate changes affect the prices of traded goods almost immediately but affect the volume of trade with a lag. As a result, exchange rate changes have little influence on the trade balance immediately but have a significant effect over time.

The APEC region's two key currencies—the dollar and the yen—have a particularly significant impact on most APEC members, observed Bayoumi. (The exceptions are Canada and Mexico, which are strongly affected by movements in the dollar but relatively immune to shifts in the yen.) Since most APEC members are affected by the yen and the dollar, large movements in the dollar-yen real exchange rate can and do create considerable complications for their economies.

### Investment and Exchange Rates

Over the past twenty years, APEC's developing countries have attracted substantial flows of foreign direct investment, reflecting underlying trends in productivity, capital account liberalization, and real exchange rates. Fewer studies have been done on the impact of exchange rate volatility on

the volume of foreign direct investment than on trade, but those that have been done suggest a small, yet positive, impact. In the APEC region, producers have responded to volatility, in many instances by diversifying geographically to minimize the risk attached to exchange rate fluctuations.

The IMF study, noted Bayoumi, confirmed the findings of most earlier studies that a depreciation is often associated with an increased flow of foreign direct investment into the country. Depreciations make the country more attractive to foreigners, lowering the cost of assets and reducing operating costs.

The IMF study also looks at the impact of exchange rate movements on U.S. and Japanese foreign direct investment. Japanese investment flows appear to be more sensitive to exchange rate movements than U.S. flows, but more research is needed, Bayoumi said, to confirm this observation.

In summing up the findings of the IMF Occasional Paper, Ito noted that the research generally confirmed the findings of much of the current literature on the long-run behavior of exchange rates and the impact of exchange rate changes on trade and investment. What remains a puzzle, and what could be a fruitful subject for further research, he said, is why several of the rapidly growing APEC economies appear not to conform with the Japanese experience in which high economic growth is associated with real exchange rate appreciation. ■

Copies of IMF Occasional Paper 145, *Exchange Rate Movements and Their Impact on Trade and Investment in the APEC Region*, by Takatoshi Ito, Peter Isard, Steven Symansky, and Tamim Bayoumi, are available for \$15.00 (academic rate: \$12.00) from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: [publications@imf.org](mailto:publications@imf.org)

# Dynamic Private Sector Key to Thailand's Resilient Growth in 1970–93

Only thirty years ago, Thailand ranked among the world's poorest economies. Since the mid-1960s, however, its growth performance has been remarkable. Hard hit by the external shocks of the late 1970s and the early 1980s that severely destabilized many other developing countries, Thailand showed remarkable resilience. Authorities quickly restored price stability, and the Thai economy emerged with strong recovery in growth and investment and in an environment of overall macroeconomic stability.

*Thailand: The Road to Sustained Growth*, IMF Occasional Paper No. 146, examines Thailand's experience with investment and growth between 1970 and 1993 and reviews the country's macroeconomic and structural policies to develop a better understanding of what led to this impressive economic performance. Although Thailand's experience may not provide the definitive blueprint for macroeconomic and structural adjustment, a few clear messages emerge from the analysis. First, Thailand benefited from entering the period of adjustment with relatively small macroeconomic imbalances and structural distortions. Its adjustment problems were thus less severe than those in many other developing countries. Second, its well-developed and dynamic private sector afforded it a flexible and vigorous means of meeting adjustment challenges and generating an appropriate and efficient response. Finally, the authorities had built up a high degree of policy credibility, which was grounded in a long-standing and unwavering emphasis on macroeconomic stability.

Specific policies and developments also appear to have contributed to



**Thai cement tile factory: A strong private sector has given Thailand the flexibility and vigor to meet adjustment challenges.**

Thailand's successful adjustment. These included:

- A sustained improvement in external competitiveness. Exchange rate adjustment was supported by prudent financial management and a shift in the composition of public expenditures away from import-intensive capital goods.
- A lack of labor market segmentation and a relatively high degree of labor mobility. Both facilitated the resource movements needed to generate Thailand's export boom.
- An outward-oriented development strategy, including elimination of export taxes. This strategy provided a highly favorable environment for private investors, both domestic and foreign.
- An effective fiscal consolidation laid the basis for future growth and macroeconomic stability. The consolidation, which began in the mid-1980s, resulted in sizable fiscal surpluses. Thailand's solid fiscal posi-

tion enabled it to accommodate the subsequent surge in capital inflows and the investment boom within an environment of low inflation.

- While structural reforms in the trade and financial sectors did not always conform to "best practices," they were not obstructive. Long-term growth was not hindered because the initial distortions in the economy were small and the authorities responded pragmatically to redress problems before they became acute.

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Copies of IMF Occasional Paper 146, *Thailand: The Road to Sustained Growth*, by Kalpana Kochhar, Louis Dicks-Mireaux, Balazs Horvath, Mauro Mecagni, Erik Ofverdal, and Jianping Zhou, are available for \$15.00 (academic rate: \$12.00) from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: [publications@imf.org](mailto:publications@imf.org)

# Statistical Yearbook Data Show World Trade And Finance Were Buoyant in 1995

**T**he U.S. dollar value of world trade in goods continued on an upward trend in 1995, growing by nearly 20 percent, the highest growth rate since 1990, according to data in the IMF's 1996 *Balance of Payments Statistics Yearbook*. Trade in services also increased in 1995, by 12 percent. The developing countries of Asia and Europe accounted for much of the 1995 increase in trade in goods and services, with industrial country trade growing more slowly. Developing countries' share in world trade in goods and services reached 32 percent in 1995, compared with 28 percent in 1990. For most industrial and developing countries, external trade in goods and services as a share of GDP rose during the same period.

The industrial countries posted a current account surplus of about \$10.5 billion and net financial outflows of some \$30 billion in 1995. The developing countries and the economies in transition saw their combined current account deficit widen by 35 percent in 1995, while net financial inflows rose by 45 percent. Reserves in both industrial and developing countries increased considerably in 1995, to \$80 billion and \$118 billion, respectively, reflecting large-scale intervention by some countries (especially Japan, China, and Brazil) facing upward pressure on their national currencies and heavy capital inflows.

## Industrial Countries

The shift from deficit in 1994 to surplus in 1995 in the industrial countries' combined current account resulted mainly from the continuing growth in exports and a decline in net outflows of current transfers. During 1990–95, industrial

countries consistently recorded trade surpluses; in 1995, the surplus was \$141.3 billion. At the same time, net outflows of current transfers (official aid flows, humanitarian aid, workers' remittances, and other private transfers) totaled \$105 billion in 1995. The overall deficit in the investment income component of the current account of industrial countries remained at about \$18 billion in 1995. Since 1990, changes in current transfers and investment income have been largely responsible for swings between deficit and surplus in the industrial countries' current account balance.

Inward and outward direct investment in industrial countries rose by 50 percent and 30 percent, respectively, in 1995. Inward portfolio investment flows increased by 70 percent and outward flows by 30 percent. Meanwhile, "other" investment flows grew even more substantially. ("Other" investment includes loans, currency and deposits, trade credits, and other financial assets and liabilities not included in direct and portfolio investments.) The surge in other investment flows in 1995 partly reflected the active international syndicated credit market and the rise in loan

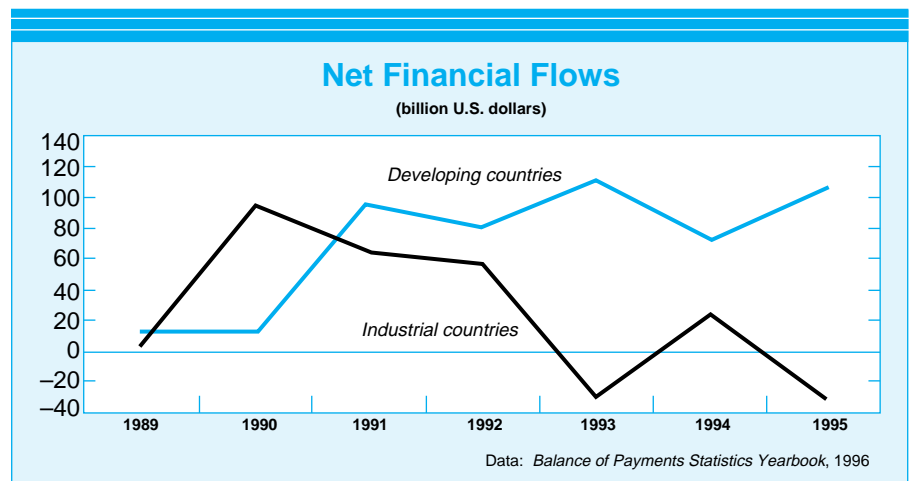
trading in international financial markets.

Other trends in the financial flows of industrial countries since 1990 include the retrenchment in Japan's international lending activities and the expansion of cross-border lending in Europe (especially in Germany). Also, during this period, international securities transactions grew rapidly in the United States, and direct investment flows stayed strong in the United States, the United Kingdom, and Germany.

## Developing and Transition Countries

Despite a narrowing in their combined trade deficit in goods and services in 1995, the developing countries' current account deficit widened to \$103 billion—owing largely to a rise of about \$22 billion in net interest payments. Such payments rose by nearly \$20 billion in Asia, by about \$2 billion each in Africa and the Western Hemisphere, and by \$1 billion in European developing countries. In contrast, such net payments declined by about \$3 billion in the Middle East.

Most of the increase in net interest payments in Asia arose in relation to the





surge in the recorded income payments on direct investment (about \$10 billion in China and \$1 billion each in Indonesia and Korea). In the case of China, the recorded increase can be attributed partly to improved data collection.

Developing countries showed a net financial inflow of nearly \$110 billion in 1995, up sharply from \$75 billion in 1994, albeit with differences among countries and regions. For example, inflows doubled in developing European countries (especially the Czech Republic, Hungary, and Poland) rose by nearly 30 percent in Asia (in particular, in China, Indonesia, Korea, and Thailand), by about 12 percent in the Western Hemisphere (especially in Argentina and Brazil), and by about 6.5 percent in Africa (mainly in South Africa). In contrast, such inflows declined in the Middle East.

During 1990–95, while Asian developing countries continued to experience sizable financial inflows of all types, inflows to Africa and the Middle East consisted mainly of loans. For the developing countries of Europe and the Western Hemisphere, loans also represented a major source of financing during 1990–95, but these countries also enjoyed considerable inflows of direct investment and, to a lesser extent, portfolio investment. Western Hemisphere countries experienced pronounced reductions in portfolio investment inflows following the end-1994 Mexican financial crisis.

The key factors underlying recent trends in financial flows have been rates of industrialization and economic growth, the relative easing of capital controls (especially those on financial inflows), and the extent of the development of domestic financial markets.

### International Organizations

The current account balance of international organizations—including the IMF, the Bank for International Settlements,

the European Monetary Institute, and international development banks—posted a surplus of \$10.5 billion in 1995. The surplus derived in part from a rise in net receipts of investment income on portfolio and other investments. Most of the current account surpluses of international organizations, however, reflect their operational surpluses, mainly the result of a positive interest margin on these organizations' lending operations.

### Global Discrepancies

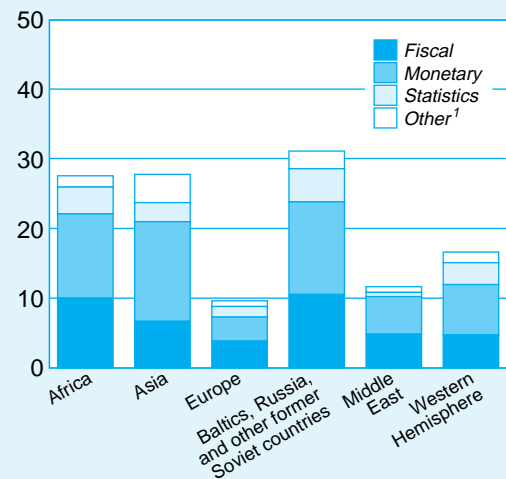
Conceptually, the combined surpluses and combined deficits in the current accounts of all countries and international organizations should offset each other; the same principle applies to the global capital and financial accounts. In practice, global discrepancies are recorded each year, primarily because of incomplete coverage, inaccurate recording of transactions by countries, omission of countries for which data are unavailable, and countries' use of different methods and sources to compile data.

The statistical discrepancy in the global current account for 1995 was about minus \$82 billion, or 0.5 percent of gross current account transactions. (A negative statistical discrepancy in the global current account indicates an excess of recorded debits, which may reflect an under-recording of credits, an overstatement of debits, or both.) Among the different components of the global current account, the largest discrepancy

appeared in investment income (especially for portfolio and "other" investments), followed by that for trade in goods.

What accounts for these discrepancies? With regard to goods, developments such as the European Union's re-

### IMF Technical Assistance: May–October 1996 (in person years)



**Note:** IMF technical assistance is conducted under the IMF's own grant resources and through financing arrangements with the United Nations Development Program, the World Bank, the European Union, the Japanese government, and other donors.

<sup>1</sup>Including legal and computer services.

During May–October 1996, IMF staff, long- and short-term experts, seminars and workshops (excluding IMF headquarters seminars provided by the IMF Institute) delivered approximately 136 person-years of technical assistance. The period saw continued strong multilateral and bilateral donor interest in providing technical assistance, in cooperation with the IMF to strengthen economic and financial management.

In addition to the design and implementation of fiscal and monetary policies, the IMF provided assistance in institution building, collection and refinement of statistical data, and training of officials. As needed, IMF technical assistance reviewed legislation and offered drafting assistance.

In the monetary area, IMF technical assistance addressed central banking and exchange system issues, as well as the design and improvement of monetary policy instruments. In the fiscal sector, it provided policy advice on tax and expenditure reform and helped modernize and streamline operations in tax administration and budget preparation. It also assisted in the production of timely and reliable statistical data, which provide a critical tool in formulating and implementing appropriate macroeconomic policies.

Data: IMF Technical Assistance Committee

liance on the administration of the value-added tax to collect intra-EU trade data directly from enterprises, as opposed to customs data previously, have complicated the measurement of trade among EU members. Most of the

discrepancies related to services trade, found in transportation transactions, can be attributed to difficulties in measuring movements in ocean freight. Meanwhile, estimating investment income has posed a challenge when investment

inflows themselves are not easily measured. The liberalization of financial markets and proliferation of financial instruments have outpaced traditional methods of capturing many portfolio and other investment flows. In many countries, such methods have largely relied on reports of domestic financial institutions on international financial flows that pass through them. Increasingly, however, these investment flows bypass domestic financial channels and are often not captured in countries' balance of payments.

The statistical discrepancy in the global financial account in 1995 was about \$70 billion (2 percent of reported financial flows), compared with \$85 billion in 1993 and 1994 and an average annual discrepancy of \$130 billion during 1990–92. (A positive statistical discrepancy in the global financial account indicates an understatement of capital outflows, an overstatement of recorded inflows, or both.) Among the types of financial flows, the largest asymmetry was recorded for portfolio investment, which includes equity and debt securities. For portfolio investment, recorded flows in liabilities in 1995 exceeded those in assets by nearly \$150 billion. In that year, the discrepancy for other investment was about minus \$40 billion. The asymmetry for direct investment flows remained the smallest, at about \$20 billion.

Anne Y. Kester  
IMF Statistics Department

## Recent IMF Publications

### Working Papers (\$7.00)

- 96/138: *Disinflation in Transition Economies: The Role of Relative Price Adjustment*, Sharmini Coorey and others
- 96/139: *Social and Political Factors in a Model of Endogenous Economic Growth and Distribution: An Application to the Philippines*, Delano Villanueva
- 96/140: *Government Debt, Life-Cycle Income, and Liquidity Constraints: Beyond Approximate Ricardian Equivalence*, Hamid Faruquee and others
- 96/141: *Globalization, Tax Competition, and the Future of Tax Systems*, Vito Tanzi
- 96/142: *Banking System Fragility: Likelihood Versus Timing of Failure: An Application to the Mexican Financial Crisis*, Brenda Gonzalez-Hermosillo and others
- 96/143: *Union Behavior, Industry Rents, and Optimal Policies*, Phillip Swagel
- 97/1: *Fiscal Imbalances, Capital Inflows, and the Real Exchange Rate: The Case of Turkey*, Pierre-Richard Agénor and others
- 97/2: *Labor Market Adjustment in Canada and the United States*, Eswar Prasad and Alun H. Thomas
- 97/3: *Do Labor Market Policies and Growth Fundamentals Matter for Income Inequality in OECD Countries? Some Empirical Evidence*, Patrick Vanhoudt
- 97/4: *Improving India's Saving Performance*, Martin Muhleisen

### Papers on Policy Analysis and Assessment (\$7.00)

- 96/9: *The Definition of Reserve Money: Does It Matter for Financial Programs?* Kalpana Kochhar

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

- No. 145: *Exchange Rate Movements and Their Impact on Trade and Investment in the APEC Region*, Takatoshi Ito and others
- No. 146: *Thailand: The Road to Sustained Growth*, Kalpana Kochhar and others
- No. 147: *Aging Populations and Public Pension Schemes*, Sheetal K. Chand and Albert Jaeger

### Books

- Interest Rate Liberalization and Money Market Development*, ed. by Hassanali Mehran and others (\$20.00)

### Other Publications

- Staff Papers*, December 1996 (\$16.00; annual subscription: \$50.00; academic rate: \$25.00)

In the January 13 issue, the authors of Working Paper 96/134, *Financial Sector Reform and Banking Crises in the Baltic Countries*, should have been listed as Marta Castello-Branco and others.

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The 1996 *Balance of Payments Statistics Yearbook* presents annual balance of payments data for 160 countries and international investment position data for 35 countries; regional and world totals for major components of the balance of payments; and descriptions of methodologies, compilation practices, and data sources relating to the balance of payments of 108 reporting countries. Copies are \$64.00. To order, write to Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

## From the Executive Board

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

**GUINEA: ESAF**

The IMF approved a three-year loan for Guinea under the enhanced structural adjustment facility (ESAF) for an amount equivalent to SDR 70.8 million (about \$101.4 million) to support the government's economic reform program for 1997–99. The first annual loan, equivalent to SDR 23.6 million (about \$34 million), is available in two equal semiannual installments, the first of which is available immediately.

**Medium-Term Strategy and the 1997 Program**

Guinea's objectives over the next three years focus on promoting private sector growth through improving the performance of public administration in the context of a more efficient legal and regulatory environment and through upgrading the infrastructure. The program for 1997–99 aims at achieving an annual real GDP growth of 5 percent by 1999 and limiting the annual inflation rate to 4 percent, while the external current account deficit (excluding official transfers) will be reduced to 7 percent of GDP by 1999 from 8 percent in 1996–97.

Consistent with this medium-term strategy, GDP growth for 1997 is projected to rise to nearly 5 percent under the first annual program, while the annual rate of inflation will be limited to 5 percent, and the external current account deficit contained at 8 percent of GDP. The program targets an increase in official foreign reserves to the equivalent of 2.9 months of imports in 1997.

**Addressing Social Issues**

In view of large deficiencies in its social and demographic indicators, Guinea is committed to combating poverty by improving the supply of basic health ser-

Guinea: Selected Economic Indicators						
	1994	1995 <sup>1</sup>	1996 <sup>1</sup>	1997 <sup>2</sup>	1998 <sup>3</sup>	1999 <sup>3</sup>
	(percent change)					
Real GDP growth	4.0	4.4	4.5	4.8	4.9	5.0
Consumer prices (average)	4.2	5.6	3.5	5.0	4.0	4.0
	(percent of GDP)					
Primary balance (excluding grants, interest, and foreign-financed investments)	1.4	1.9	1.5	3.1	3.5	4.1
Overall budget balance (excluding grants)	-7.2	-6.7	-5.8	-5.7	-5.3	-5.1
External current account balance (excluding grants)	-9.2	-9.1	-7.7	-8.0	-7.4	-7.1
	(months of imports)					
Official foreign reserves	2.8	2.9	2.2	2.9	3.2	3.4

<sup>1</sup>Estimate.  
<sup>2</sup>Program.  
<sup>3</sup>Projections.

Data: Guinean authorities and IMF staff estimates

vices and primary education, which are accorded top priority in the government budget. Meanwhile, audits of the national social security fund and of the government pension system will be completed during the first year of the program in preparation for actions to improve the future financial viability of the social security system.

**Need for External Assistance**

Guinea remains a heavily indebted poor country, despite an improvement in its external debt indicators that followed the Paris Club rescheduling agreement in January 1995. Guinea's 1997–99 program indicates a financing gap for each of the next three years, which the authorities expect to fill through fresh donor assistance and debt relief that they intend to request from bilateral and private creditors.

Guinea joined the IMF on September 28, 1963, and its quota is SDR 78.7 million (about \$112 million). Its outstanding use of IMF financing currently totals SDR 57 million (about \$82 million).

Press Release No. 97/3, January 13

**SENEGAL: ESAF**

The IMF approved the third annual loan under the enhanced structural adjustment facility (ESAF), in an amount equivalent to SDR 35.7 million (about \$51 million), to support Senegal's economic program in 1997. The loan is available in two equal installments, the first of which is available immediately.

**Medium-Term Strategy and the 1997 Program**

The government's medium-term strategy seeks to build on its successful adjustment

Senegal: Selected Economic Indicators					
	1995	1996 <sup>1</sup>	1997 <sup>2</sup>	1998 <sup>2</sup>	1999 <sup>2</sup>
	(percent change)				
Real GDP	4.8	5.2	4.5	4.8	4.8
Consumer prices (average)	8.1	2.7	2.5	2.5	2.5
	(percent of GDP)				
Overall fiscal balance (excluding grants)	-3.2	-1.9	-1.0	—	0.9
External current account balance (excluding official transfers)	-8.0	-8.0	-6.7	-6.0	-5.3

<sup>1</sup>Estimate.  
<sup>2</sup>Program.

Data: Senegalese authorities and IMF staff estimates

efforts since 1994 and to establish the basis for sustainable, equitable economic growth led by a dynamic private sector. The medium-term macroeconomic objectives are to achieve average economic growth of at least 4.5 percent a year, allowing for annual increases in real per capita incomes of at least 1.5 percent; to maintain low and stable inflation of 2–3 percent a year; and to reduce the external current account deficit, excluding official transfers, to about 5.5 percent of GDP by 1999. To these ends, the overall fiscal balance is targeted to move to a moderate surplus in 1999 from a deficit of about 2 percent of GDP in 1996.

Within the medium-term strategy, the key macroeconomic objectives of the

1997 program are to achieve at least 4.5 percent real GDP growth, to lower inflation to 2.5 percent from 2.7 percent in 1996, and to narrow the external current account deficit, excluding official transfers, to 6.7 percent of GDP from 8.0 percent in 1996. To achieve these objectives, the program aims to reduce the overall fiscal deficit to 1 percent of GDP in 1997.

### Addressing Social Needs

The government's social objectives under the program are to reduce poverty and strengthen human resource development. The program contains measures to raise enrollment rates in primary education and to reduce adult illiteracy, with particular emphasis on the female population in both cases. The

## Palau Applies for IMF Membership

The government of the Republic of Palau has filed an application for membership in the IMF. Under the IMF's prescribed procedures for membership applications, the application must first be considered by the IMF's Executive Board. After its consideration, the Executive Board submits a report to the Board of Governors of the IMF with recommendations in the form of a Membership Resolution. These recommendations cover the amount of quota in the IMF, the form of payment of the subscription, and other customary terms and conditions of membership. After the Board of Governors has adopted the Membership Resolution, the applicant country may become a member once it has taken the legal steps required under its law to enable it to sign the IMF's Articles of Agreement and to fulfill the obligations of IMF membership.

Press Release No. 97/1, January 7

## Shigemitsu Sugisaki Named IMF Deputy Managing Director, Succeeds P. R. Narvekar

IMF Managing Director Michel Camdessus announced the appointment of Shigemitsu Sugisaki, a national of Japan, as Deputy Managing Director of the IMF for a five-year term, beginning on February 3, 1997. Mr. Sugisaki will succeed Prabhakar R. Narvekar, who is retiring.

Mr. Sugisaki is at present Special Advisor to the Managing Director, a position to which he was appointed in August 1994. Born in 1941, Mr. Sugisaki graduated from the University of Tokyo and Columbia University. He joined Japan's Ministry of Finance in 1964 as a member of the Minister's Secretariat. He held various positions in the International Finance Bureau and the Tax Bureau, and was appointed Personal Assistant to the President, Asian Development Bank in 1976.

Mr. Sugisaki rejoined the Ministry of Finance in 1979, holding a number of positions, including that of Deputy Vice Minister of Finance for International Affairs in 1990–91, Deputy Director General of the International Finance Bureau in 1991–92, and Commissioner of the Tokyo Regional Taxation Bureau in 1992–93. From mid-1993 until appointment to the IMF, Mr. Sugisaki held the position of Secretary-General of Executive Bureau of the Securities and Exchange Surveillance Commission.

Mr. Narvekar retires after more than 40 years of distinguished service at the IMF. A national of India, he was born in 1932 and has been Deputy Managing Director since July 1994. Mr. Narvekar joined the IMF in 1953 as a Research Assistant and held various positions in the former Asian and European Departments before being appointed Director of the Asian Department in 1986 and Special Advisor to the Managing Director of the IMF in August 1991.

Press Release No. 97/6, January 28



*Deputy Managing Director Sugisaki*



government plans to expand the availability of health services, place higher priority on preventive health care, and promote greater use of generic drugs to reduce pharmaceutical costs. The government recognizes that rapid increases in population constrain the improvement of living standards and intends to outline a set of policies aimed at reducing the rate of population growth.

Senegal joined the IMF on August 31, 1962; its quota is SDR 118.9 million

(about \$170 million); its outstanding use of IMF credit currently totals SDR 226 million (about \$324 million).

Press Release No. 97/2, January 13

### GEORGIA: Article VIII

The National Bank of Georgia has notified the IMF that it has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement, with effect from December 20, 1996. IMF members accepting the obligations

of Article VIII undertake to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval. A total of 137 countries have now assumed Article VIII status.

Georgia joined the IMF on May 5, 1992. Its quota is SDR 111 million (about \$156 million).

Press Release No. 97/4, January 27

## Deputy Managing Director Narvekar Bids Farewell

*Following are excerpts of Prabhakar R. Narvekar's parting comments to the Executive Board on January 29, on the occasion of his retirement after 44 years with the IMF, during which he rose from a Research Assistant to Deputy Managing Director.*

The IMF's ability to blend all manner of people into a functioning team is perhaps its greatest strength. Nowhere is this more evident than in the work of staff missions to member countries. Missions are made up of staff coming together from different backgrounds, different countries—perhaps countries that have been enemies for centuries. Yet, in a matter of weeks and under strong pressures, they produce high-quality work before disbanding to form yet new teams. This productive human interaction is the foundation of the IMF's success in its wider role.

I recall with special warmth the idealism of the first generation of IMF staff. Many of them lived with the memory of the depression years and the inability of governments to deal cooperatively with their problems. Even more remembered the suffering of World War II, to which earlier failures in economic policymaking had contributed. To that generation of staff, the links between the dry technical matters of economic analysis, on the one hand, and broader human aspirations for peace and prosperity, on the other, were always evident. They knew full well that a failure to get a member country's economic policy right had far more than just economic consequences. After

more than fifty years in which global conflict has been avoided, and in which material prosperity has been achieved in large parts of the world, it is easy to forget these things. But we would do so only at humanity's peril.

Who can doubt today that long-term peace and prosperity in Western Europe or North America will depend on neighboring regions also enjoying lasting prosperity, or that the future of an open multilateral trading system depends on new participants—for example, in East Asia—being welcomed as partners in a positive sum game rather than as rivals in a zero sum game? There is legitimate concern in some quarters about the potential for renewed international conflicts. But are such conflicts inevitable if sound domestic policies and free movement of goods, capital, and people promote an increasing and equitably distributed global prosperity? These sound policies, however, do not come about unless policymakers pay full attention

to the nuts and bolts issues of money supply, budget deficits, trade policies, exchange rates, and so on—which are the daily preoccupation of the IMF. Thus, by attending to these things, one is helping humanity achieve the higher goals for which it has always striven.

It is because of the goals this institution serves and the personal friendships I have made here that my overwhelming feeling today is one of gratitude for the opportunity of having been associated with the IMF.



**Outgoing Deputy Managing Director Narvekar**

## IMF Adopts Decision on New Arrangements to Borrow

*Following is the text of Press Release No. 97/5, issued on January 27.*

The Executive Board of the IMF adopted a decision on New Arrangements to Borrow (NAB). The decision follows agreement by the 25 potential participants in the NAB on the terms and conditions in which they will be prepared to make loans to the IMF when supplementary resources are needed to forestall or cope with an impairment of the international monetary system, or to deal with an exceptional situation that poses a threat to the stability of the system. The amount of the resources available to the IMF under the NAB will be up to SDR 34 billion (about \$47 billion).

The NAB will enter into force when it has been adhered to by potential participants with credit arrangements amounting to no less than SDR 28.9 billion (about \$40 billion), including the five members or institutions with the largest credit arrangements. The decision will be in effect for five years and may be renewed.

The participants in the NAB are Australia, Austria, Belgium, Canada, Denmark, the Deutsche Bundesbank, Finland, France, the Hong Kong Monetary Authority, Italy, Japan, Korea, Kuwait, Luxembourg, Malaysia, the Netherlands, Norway, Saudi Arabia, Singapore, Spain, the Sveriges Riksbank, the Swiss National Bank, Thailand, the United Kingdom, and the United States. A member or an institution that is not currently a potential participant in the NAB may be accepted as a participant at the time of renewal, if the IMF and participants representing 80 percent of the total credit arrangements agree to the request. New participants may be accepted at other times by way of an amendment to the NAB adopted by a decision of the IMF and with the concurrence of participants representing 85 percent of total credit arrangements.

### Background

In June 1995, the Group of Seven summit meeting in Halifax, Canada, called on the Group of Ten (G-10) and other countries with the financial capacity to support the international monetary system to develop financing arrangements with the aim of doubling as soon as possible the amount of currency available under the GAB. Following a review of the GAB by the IMF's Executive Board in July 1995, and meetings of the G-10 and other countries, the IMF's Interim Committee, meeting in Washington, D.C., in September 1996, requested potential participants in the new arrangements, and the Executive Board to complete the remaining work promptly.



**Peter Costello, Treasurer of Australia, will be the first NAB chair, a position that will rotate among NAB participants.**

### Relationship with the GAB

The NAB does not replace the General Arrangements to Borrow (GAB), which will remain in force. However, the NAB will be the facility of first and principal recourse in the event of a need to provide supplementary resources to the IMF. The amount available under the GAB will remain unchanged at SDR 17 billion (about \$24 billion) and SDR 1.5 billion (about \$2 billion) under the associated agreement with Saudi Arabia. As mentioned

before, the amount available under the NAB will be up to SDR 34 billion, which will also be the maximum combined amount available under the GAB. The participants in the GAB and the amounts of the credit arrangements (in billions of SDRs) are the United States (4.3), the Deutsche Bundesbank (2.4), Japan (2.1), France (1.7), the United Kingdom (1.7), Italy (1.1), the Swiss National Bank (1.0), Canada (0.9), the Netherlands (0.9), Belgium (0.6), and the Sveriges Riksbank (0.4). The size of the credit arrangement with Saudi Arabia in association with the GAB is SDR 1.5 billion.

### Activation

The credit arrangements under the NAB may be activated for the benefit of an IMF member that is a participant in the NAB (or whose institution is a participant), or for the benefit of a member that is not a participant, under circumstances similar to those contemplated in the GAB, except that activation of the GAB for the benefit of a nonparticipant requires the additional condition that, after consultation, the Managing Director considers that the IMF faces an inadequacy of resources.

### NAB Meetings

Potential participants have agreed to meet once a year at the time of the Annual Meetings of the IMF to discuss, among other matters pertaining to the NAB, macroeconomic and financial market developments, especially those that could have an impact on the stability of the financial system and lead to a possible need for the IMF to seek supplementary resources. The chairmanship of the NAB grouping will rotate annually in the English alphabetical order of the participants. IMF headquarters staff, under the direction of the chair, will provide secretariat support for the group.

*The full text of the decisions on the NAB and the transferability of claims is being posted on the IMF web site at [www.imf.org](http://www.imf.org) under "news," and is available by mail on request.*

# Dealing with Japan's Fiscal Challenges

**J**apan's long-term fiscal viability has been undermined by rising budget deficits and future spending pressures associated with an aging population, according to a recent IMF Working Paper, *Japan's Medium- and Long-Term Fiscal Challenges*, by Kenji Okamura of the IMF's Asia and Pacific Department. In the absence of policy adjustments, deficits will worsen for a number of reasons, including higher government transfers to the public pension plan, rising medical costs, increases in public investment, and a growing debt-service burden. After calculating the present value of the fiscal gap between expenditures and revenues, Okamura concludes that a return to long-run fiscal sustainability in Japan will require a balanced mix of spending cuts and targeted tax increases.

## Demographics Heighten Fiscal Pressures

Ballooning public debt is hardly unique to Japan, according to the May 1996 IMF *World Economic Outlook*. Over the past two decades, higher levels of government debt in most industrial countries have boosted real interest rates, retarded the accumulation of private capital, and limited gains in living standards in most industrial countries. As populations age, growing pension and health care costs can be expected to further aggravate budgetary pressures throughout North America, Asia, and Europe.

Among the major industrial countries, however, Japan is expected to experience the most rapid increase in the number of elderly in the total population and correspondingly larger demands on that country's already strained pension, medical, and health insurance systems, according to the

IMF study. The country's old-age dependency ratio (defined as the ratio of the population aged 65 and over to the population aged 15–64) is projected to jump to almost 45 percent by 2020, from 20 percent in the early 1990s, while growth of the working population is expected to turn negative.

The major effect of a rapidly aging population on Japan's fiscal position is expected to show up in increases in pension benefits, combined with jumps in medical and health insurance payments, says Okamura. These demographic shifts carry with them longer-term implications for Japan's potential output growth, which on current projections could drop to 1 percent by 2015 from the current level of 2.4 percent annually.

The greatest impact of population aging on Japan's fiscal position can be directly traced to a rise in pension benefits. For this reason, the Japanese government's 1994 pension plan, which aims to reform pension finance, constitutes a serious effort to address the country's long-term fiscal challenge. The government's effort to control these outlays, however, may still prove inadequate in the face of expected rises in social security transfer payments for pensions and medical care. To prevent a debt explosion, the IMF study recommends significant fiscal measures—equivalent to approximately 4 percent of Japan's GDP—that would both reduce spending and raise government revenues over the next decade.

## Fiscal Adjustment Is Critical

Tight restrictions on government expenditures that incorporate targeted reductions in selected programs should be the main pillar of future consolidation in Japan, says Okamura. Consideration should also be given to se-

lected revenue-enhancement measures, according to the study. Such steps might include:

- A rise in patient co-payments for medical insurance premiums to 80 percent from the current rate of 70 percent, for example, could have reduced mandated government transfers by  $\frac{1}{2}$  of 1 percent of GDP in 1995. As the share of medical payments to GDP rises over time, savings from this measure could reach 1 percent of GDP in 2020, when overall medical payments are expected to reach 10 percent of GDP.
- Cuts in Japan's ten-year public investment plan. The current plan calls for ¥630 trillion of public investment between 1995 and 2004, an outlay that would raise the country's public investment to more than 8 percent of GDP from the current level of 7 percent. Both these levels, notes the study, are much higher than the Group of Seven average of 3 percent. Moreover, there is already widespread concern about possible inefficiencies in public investment. A downward revision of the investment plan that would simply hold capital expenditures constant at current levels of

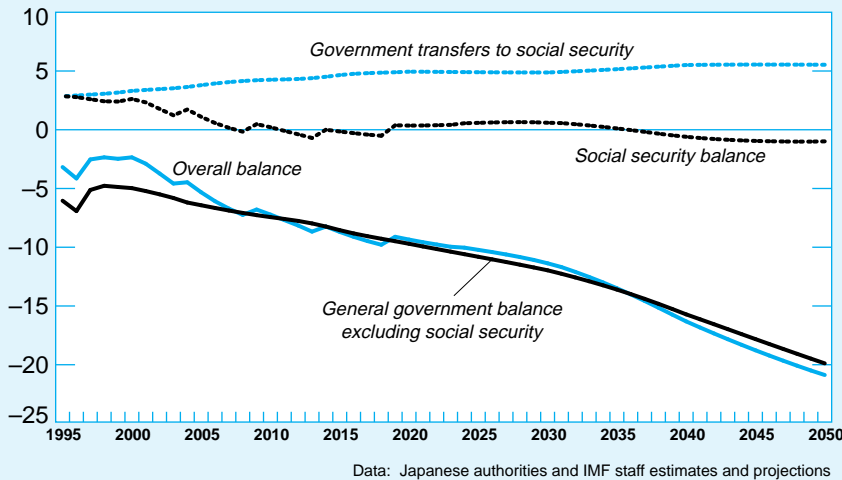
## Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
January 27	3.91	3.91	4.28
February 3	3.92	3.92	4.29

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 109.4 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

**Japan: Long-Term Projection of General Government Balance**  
(percent of GDP)



GDP could, however, result in a saving of 1 percent of GDP. Reaching this new target would require a reduction in planned capital expenditures to ¥580 trillion between 1995 and 2004. A more cost-efficient approach to investment might also encourage the government to liberalize its procurement policies.

- Increasing Japan's consumption tax rate beyond the existing 5 percent. Each percentage point increase in this rate would generate net tax revenue of about 1/2 of 1 percent of GDP. Another possibility might be to raise taxes on pension benefits that are currently lightly taxed. In principle, pension income is subject to withholding tax. In practice, however, generous deductions—by raising the tax threshold—have made pension income for most households virtually tax exempt, according to the IMF study. The revenue implications of higher taxes on pension benefits would accordingly be large. For instance, if a separate tax rate of 20 percent had been uniformly applied, it would have generated revenues in excess of 1 percent in 1996. If the above three measures were

adopted, Japan could achieve an overall saving equivalent to 4 percent of GDP, thereby placing that country's fiscal position back on a long-run sustainable track, according to the IMF study. Okamura recommends a hypothetical policy package incorporating an increase in the consumption tax rate to 7 percent; stricter taxation of pension benefits at an average rate of 10 percent; a reduction in outlays for the public investment plan to ¥580 trillion; and a compression of current expenditures, particularly medical care spending. Such ambitious front-loaded adjustment measures, concludes Okamura, would avoid the necessity of introducing more aggressive measures later and would minimize the risk of undermining investor confidence during the adjustment period.

Copies of IMF Working Paper 96/113, *Japan's Medium- and Long-Term Fiscal Challenges*, by Kenji Okamura, are available for \$7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax (202) 623-7201; Internet: publications@imf.org

**CONTENTS**

Volume 26, Number 3

**IMF Adopts New Arrangements To Borrow**  
Page 33

**Transition Economies Confront Social Issues**  
Page 34

**IMF Ready to Participate in Debt Initiative**  
Page 35

**Exchange Rates and APEC Trade And Investment**  
Page 37

**Growth in Thailand**  
Page 39

**Balance of Payments Statistics Yearbook, 1996**  
Page 40

**IMF Technical Assistance**  
Page 41

**Recent IMF Publications**  
Page 42

**From the Executive Board**  
Page 43

**Shigemitsu Sugisaki Is New IMF Deputy Managing Director**  
Page 44

**Outgoing Deputy Managing Director Narvekar Bids Farewell**  
Page 45

**Japan's Fiscal Challenges**  
Page 47

**Selected IMF Rates**  
Page 47



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