IMF SURVEY

International Monetary Fund
VOLUME 27
NUMBER 5

March 9, 1998

Contents

Interview with Claudio Loser

Facing Asian Crisis, Latin America and Caribbean Demonstrate Resiliency, Potential for Growth

Loser: Latin American countries have shown they are willing to act quickly.

Claudio Loser, Director of the IMF Western Hemisphere Department since 1994, spoke with the IMF Survey *about recent developments in Latin America, the effects of the Asian crisis on the region, and the prospects for continued integration in the world economy and sustained growth and structural reform. Loser, an Argentine national, was Deputy Director in the Western Hemisphere Department before assuming his present position.*

IMF SURVEY: *During the past several months, the Asian crisis seems to have driven consideration of the economic condition of the Latin American countries off the front pages. How similar are the conditions that face the Asian countries now to those that faced Mexico in early 1995, and how are they dissimilar?*

LOSER: There are many similarities. For instance, in 1994, in Mexico and, to some extent, Argentina, you had a rapidly rising level of demand, an expansion of credit, widening current account deficits, and—to varying extents—tensions in the banking system. The situation in Asia was similar, except that in Asia there was an investment boom rather than a consumption boom, as was the case in Latin America. *(Please turn to the following page)*

IMF Actions Supported

Group of Seven Calls for Debate on Implications of Asian Crisis for Strengthening Monetary System

Finance ministers and central bank governors of the Group of Seven industrial countries met in London on February 21 for their regular winter meeting to review recent developments in the world economy and financial markets—in particular, the recent and ongoing turmoil in Asia. IMF Managing Director Michel Camdessus joined the Group of Seven—which comprises the United States, Japan, Germany, the United Kingdom, France, Italy, and Canada—for part of the discussions. In its communiqué, issued on February 21, the Group of Seven called for a debate on the implications of the Asian crisis for strengthening the international monetary system. It added that the impact of the Asian crisis on world economic growth would be manageable if the affected economies undertake tough reforms to make their markets more open and transparent. The Group of Seven also urged the IMF to develop a code of conduct on transparency in fiscal policy to help forestall future crises. (See page 69 for excerpts from the Group of Seven communiqué.)

U.K. Chancellor of the Exchequer Gordon Brown opened the meeting by calling for a "considered and wide-ranging debate on the causes and the lessons of recent events." An important item on the agenda was the role the IMF could play in helping to prevent crises like the Asian turmoil. Calling for the development of a code of conduct, the Group of Seven communiqué said that an early response to IMF advice is vital to prevent economic problems from turning into crises and spreading to other countries. Further action is also required, *(Continued on page 69)*

An early response to IMF advice is vital to prevent problems from turning into crises.

Latin America Shows Growth Potential

(Continued from front page) What are the differences? First, the contagion effect has been much greater in Asia. The crisis in Latin America ended up being confined mainly to Mexico and Argentina—with limited impact on other economies.

Second, when the crisis hit in Latin America, structural reforms had already been in place for some time. Although Latin America's performance had been very weak in the 1980s, for about ten years the authorities had been working hard at changing the structure of the state and reducing its size, privatizing, modifying the structure of incentives, and eliminating elements of discretionality. When the crisis hit in late 1994, the authorities were better prepared and more willing to move quickly.

Third, although the banking systems were weak in both Asia and Latin America, the impact was probably smaller in Latin America.

I would also note that the quality of the technical staff in Latin American countries—in the ministries and central banks—has improved and deepened markedly.

IMF SURVEY: *How completely have Mexico and Argentina and the other countries that were affected by the 1994 financial crisis recovered? Are there any lessons to be learned from the Mexican crisis that could be applied to the Asian crisis?*

LOSER: Overall, Latin America has recovered: 1997 was a banner year, with GDP growth of 5.2 percent—the highest in recent years for the region—and inflation at 12 percent, the lowest in 20 years and in dramatic contrast to the triple and quadruple levels in earlier years. These figures mainly reflect developments in Mexico, with 7 percent growth, and Argentina, with 8 percent, as well as the actions taken after 1995—strengthening of the banking system in Mexico and maintenance of a strong currency board in Argentina that respected the rules of the game.

The IMF has been actively involved in helping strengthen the region's banking systems.

These actions gave assurances to market participants that the authorities were serious about the measures they had introduced and that the reforms were here to stay. After 1994–95, economic activity recovered, exports picked up, and capital flows increased rapidly. In fact, during 1987–97, private flows to the region—not just to Mexico and Argentina—increased tenfold, mainly in the form of foreign direct investment. Another important feature of the recovery was that all the countries in Latin America had strong fiscal positions.

IMF SURVEY: *Are the countries in the region now well insulated from the contagion effects of the Asian crisis?*

LOSER: It is difficult to say that countries can be completely insulated from outside shocks, any more than they can be completely insulated from hurricanes or other unpredictable climatic disturbances. A more relevant question is how well prepared they are to absorb the shock and limit the damage. I can say that the Latin American countries have demonstrated great resiliency. They have shown they are willing to act quickly in the face of external shocks, and they have developed the institutional elements that have improved their capacity to respond to external shocks.

This does not mean that the countries in Latin America and the Caribbean have not been affected by the Asian crisis; far from it. In fact, the crisis has hit them on two fronts: through the financial markets and through the terms of trade. Since October 1997, stock markets have declined, while the spreads on foreign borrowing by the countries in the region—not only Latin America, but in the Caribbean as well—have increased sharply, thus limiting the availability and increasing the cost of financing.

Second, since the onset of the Asian crisis, oil prices have declined markedly, as have the prices of other commodities, such as metals and cereals. Since many countries in the region are commodity exporters, the fall in prices will have an adverse impact on most of them.

They are, however, in a stronger position than they were, say, ten years ago, since the ratio of debt to GDP is now 31 percent of GDP, down from 54 percent then. But they are still vulnerable because most of them are running current account deficits and they have large borrowing from commercial private sources.

IMF SURVEY: *The Mexican financial crisis and the ensuing "Tequila" effect exposed the fragility of much of the region's banking systems, among other structural weaknesses. Has this situation improved in the past few years? What role can the IMF play?*

LOSER: Latin America has a long experience with banking crises: Chile had a major banking crisis in 1982–83, which cost the economy about 30 percent of GDP. Argentina and Mexico had problems in the early 1980s, and Venezuela had a crisis five years ago.

Since the early 1990s, the IMF has been actively and constructively involved in helping to strengthen the bank-

Photo Credits: Padraic Hughes and Pedro Marquez for the IMF, pages 65, 67, 71, 73, and 75; Paul Hackett for Reuters, page 69; Carolina Jiménez for Reuters, page 72.

ing systems in the region. During 1995–96, the IMF worked closely with Mexico, which had to move very quickly after the crisis to put its house in order. We also gave advice to Argentina. Both the Stand-By Arrangement with Mexico and the Extended Fund Facility with Argentina contained essential provisions for bank restructuring and monitoring. As a result, the banking systems are getting stronger, although the work is not complete.

A lesson we have learned is that the problems of the banking systems do not stop and start with the banks. In many cases, a crisis has emerged not just because the banking system was weak but because the macroeconomic environment was not conducive to good decisions. Thus, a sound banking system needs to be supported by a stable and strong macroeconomic environment.

IMF SURVEY: *IMF Managing Director Michel Camdessus inaugurated his "second generation" of reform in Argentina last spring. He suggested that many countries in South America are now ready to undertake such reforms. How has the new emphasis affected your work and your relationship with the authorities?*
LOSER: Although the authorities of some of the countries were initially a little surprised at the change of emphasis, I think they have come to understand and accept that the second generation of reforms is now an integral part of IMF-supported programs. This trend does not simply reflect the IMF's unilateral interests, but is also a reflection of the concerns that the countries and the different constituencies within the countries—the nongovernmental organizations, the political bodies of the countries—have expressed. The IMF has moved in this direction, because there is an understanding at the economic and political level that these issues are important.

The issues we have emphasized include governance, the structure of the state and the structure of expenditure—for example, improving protection of the poor and enhancing human capital through health and education. I don't recall having had any difficulty in recent years negotiating a program because we have emphasized these subjects. There is also what I would call a deepening of the first generation of reforms, which includes stepping up privatization and banking system reform and improving the structure of incentives affecting private initiative. Of course, we still emphasize the central aspect of our activities, which is macroeconomic and structural reform.

IMF SURVEY: *A related issue is transparency. Has the new "openness" enhanced or hampered operations? How many countries in your region subscribe to the Special Data Dissemination Standard (SDDS) or are planning to subscribe to the General Data Dissemination System (GDDS)?*
LOSER: Seven countries from the Western Hemisphere region subscribe to the SDDS—Argentina, Canada, Chile, Colombia, Mexico, Peru, and the United States—and four more are planning to subscribe. The GDDS is still at an early stage, but at least ten countries are interested in participating.

This suggests that there is a consensus on the part of most of the countries that these initiatives are important—particularly when it was pointed out after the

Loser: The emphasis on second-generation reform is a reflection of the concerns that the countries have expressed.

Mexican financial crisis that the lack of transparency had affected the behavior of the markets and had aggravated the situation. Mexico and Argentina, in particular, have enthusiastically embraced these initiatives and have benefited from them.

IMF SURVEY: *How will the new initiative for capital account liberalization affect the countries in the region? What is the current thinking about some measure of capital controls?*
LOSER: With 32 countries in Latin America and the Caribbean, there are bound to be different experiences, although there is certainly a strong preference for open capital accounts, as witnessed by the experience of Argentina, Bolivia, Mexico, Peru, and Venezuela. It has also been the case that controls—either on inflows or outflows—have been ineffective at best, if not useless, because such restrictions tend to be easily and quickly circumvented. Nevertheless, in the case of certain countries—Colombia and Chile, for example—the authorities have successfully introduced or maintained certain capital controls on inflows. They have worked well, in the sense that capital has come in at a somewhat slower pace.

We take a pragmatic view, with a clear preference for as open a system as possible. Any limitations that exist should be seen as temporary.

IMF SURVEY: *Despite much progress in recent years, income disparities and poverty continue to be important social issues. Are these disparities widening or narrowing in Western Hemisphere countries?*

LOSER: Let me start by saying that the disparity between the rich and the poor in the region remains significant. It is much greater than in Asia, which, over the last 20 or 30 years, has been able to reduce income disparities, probably by concentrating on improving human capital more than in the Western Hemisphere. Nevertheless, we have seen some progress. One major improvement has been the reduction of inflation, which has eliminated the region's major regressive tax. Also, in general, the proportion of the population below the poverty line has declined.

It is essential that the United States and Canada continue to encourage open trade.

That said, a lot of work remains to be done. It is our duty, in our negotiations with the authorities, to incorporate relevant suggestions and advice into the programs we agree to support—for example, safety nets for the most exposed segments of the population, changes in the pattern of government spending from unproductive expenditure to spending on education and health, and other institutional reforms that improve prospects for economic opportunity advancement.

IMF SURVEY: *What measures might the United States and Canada take to alleviate the concerns of Latin American countries?*

LOSER: The United States is undertaking a major initiative in trying to find a consensus for the integration of the whole continent through the creation of what we call the "Free Trade Agreement of the Americas." Latin America and the Caribbean tend to trade much more with North America than with other countries, and the United States and Canada have a clear understanding of the importance of maintaining strong trading relations with the rest of the continent. I feel it is absolutely essential that the United States and Canada continue to encourage open trade and discourage any reversion to unilateral protectionism.

IMF SURVEY: *Bearing in mind the usual pitfalls associated with predicting the future, what do you think lies ahead for the Western Hemisphere?*

LOSER: I think the region has tremendous potential for growth. It has a winning combination—natural and human resources and the right policy attitude. By "right policy attitude," I mean that the authorities are willing to devise policy aimed at creating an environment for sustained growth, greater domestic savings, and increased investment. In the past, Latin America has been fairly successful in dealing with macroeconomic imbalances. The region now faces the challenge of achieving sustained growth through structural change and second-generation reforms—that is, creating the economic and social conditions that make sustained growth possible over the medium term. ■

IMF Executive Board Completes Second Review of Thailand's Economic Program

On March 4, IMF Managing Director Michel Camdessus announced that the IMF Executive Board had approved the second review of Thailand's economic program.

Camdessus said: "I am pleased to announce the IMF's Executive Board today approved the completion of the second review of Thailand's Stand-By credit with the IMF. The 34-month Stand-By credit, equivalent to SDR 2.9 billion (about $3.9 billion), was approved on August 20, 1997 (see Press Release No. 97/37, *IMF Survey*, September 17, 1997). In approving the release of the next disbursement of SDR 200 million, or about $270 million, Executive Directors strongly commended the Thai authorities for resolutely implementing the economic program in very difficult circumstances and noted that this approach was increasingly being reflected in improved market sentiment. At the same time, Directors supported key modifications to policy targets aimed at alleviating the impact of the sharp economic downturn and strengthening the currency.

"The key modifications of the program are:

- more flexible use of interest rate policy to support the exchange rate;
- a modification in the fiscal target from a surplus of 1 percent of GDP to a deficit of 2 percent of GDP (in recognition of the adverse effect of the recession on revenues and the need to raise spending on the social safety net);
- intensified efforts to recapitalize the banking system and fully restore public confidence in its financial health; and
- a broader program of legal and structural reforms to permit the financial restructuring of corporations and revitalize private sector activity.

"The IMF Board also noted that the shift of the external current account into surplus had helped to offset much of the weakness that had been evident in the capital account, so that there was sufficient financing to assure that key external objectives—exchange rate stability and the maintenance of adequate foreign exchange reserves—would be met. The IMF will continue to monitor the situation closely to ensure that the program remains properly funded at all times, including, if necessary, by the provision of additional financing," Camdessus said.

News Brief No. 98/5, March 4

(Continued from front page) according to the Group of Seven, to allow countries to take full advantage of global capital flows by opening their financial markets. In this context, the Group of Seven communiqué called for speedy amendment of the IMF's Articles of Agreement defining the IMF's role in capital account issues. In light of the IMF's central role in the international monetary system, the communiqué also urged early implementation of the IMF's quota increase.

The Group of Seven emphasized its support for the approach taken by the IMF and other international financial institutions—particularly the emphasis on structural reforms to reduce inappropriate government interference in the market economy, restructure financial systems, promote integrity and transparency, and fight corruption. The communiqué also stressed the importance of protecting social expenditure, including well-designed and affordable social safety nets, and commended the international financial institutions for supporting the work of the International Labor Organization in promoting core labor standards.

The Group of Seven communiqué urged Japan to continue to strengthen its financial system and to adopt regulatory reforms of the financial and other sectors, so as to increase openness. It noted that, in the view of the IMF, "there is now a strong case for fiscal stimulus to support economic activity in Japan during 1998."

For the future, the Group of Seven said it planned to focus on issues related to strengthening the international monetary system. The communiqué cited several areas on which the Group of Seven's initial efforts will focus:

Group of Seven meeting of finance ministers and bank governors in London, February 21. From left are Paul Martin of Canada, Theo Waigel of Germany, Robert Rubin of the United States, Gordon Brown of the United Kingdom, Dominique Strauss-Kahn of France, Hikaru Matsunaga of Japan, and Carlo Ciampi of Italy.

- alleviating the debt burden of the poorer developing countries;
- promoting more efficient functioning of global markets;
- improving transparency and disclosure;
- strengthening financial systems;
- defining the role of the international community; and
- promoting appropriate burden sharing by the private sector.

London Communiqué

Group of Seven Agrees on Basis for Recovery; Supports Emphasis on Structural Reform

Following are excerpts from the Group of Seven Communiqué, issued on February 21, in London.

We discussed recent developments in our own countries, which have, on the whole, been positive. In the United States, the United Kingdom, and Canada, where growth has been strong, domestic inflationary pressures have been weaker than past experience would have suggested. Their authorities will continue to monitor developments closely and act if necessary to maintain conditions for noninflationary growth.

In Germany, France, and Italy, growth has generally continued to pick up. We welcome its greater balance, but economic activity still remains below potential. While this recovery will help to create new jobs, reducing unemployment to acceptable levels in these countries on a sustainable basis will require implementing further significant structural reforms especially in the labor market but also elsewhere in the economy.

In Japan, activity is low, and the outlook is weak. Recovery will require continued action to strengthen the financial system and regulatory reforms of the financial and other sectors, so as to increase openness. We welcomed the progress so far on the "big bang" reforms of the financial system. In the view of the IMF, there is now a strong case for fiscal stimulus to support activity during 1998.

In the context of surveillance, we reviewed recent developments toward European Economic and Monetary Union and discussed its implications for the Group of Seven economies.

We discussed developments in our exchange and financial markets. We reiterated that exchange rates should reflect economic fundamentals and that excess volatility and significant deviations from fundamentals are undesirable. We emphasized that it is important to avoid excessive depreciation where this could exacerbate large external

imbalances. We agreed to monitor developments in exchange markets and to cooperate as appropriate.

Improved employability will play an important part in ensuring the widest inclusion of our citizens in all our countries' prosperity, and improving prosperity overall.

Developments in Asia

We reviewed the serious economic and financial problems in some Asian countries. We agreed that the basis for recovery can best be established through the adoption and vigorous pursuit of significant and far-reaching reforms by the affected countries, with temporary financial assistance where necessary, led by the IMF and other financial institutions, with the private sector playing an essential role.

We emphasized our support for the approach taken by the international financial institutions, in particular the emphasis on structural reforms to reduce inappropriate government interference in the market economy, restructure financial systems, promote integrity and transparency, and fight corruption in order to lay the basis for economic recovery. We recognized the importance of protecting, as far as possible, humanitarian expenditure, including well-designed and affordable social safety nets, and the international financial institutions' support for the work of the International Labor Organization in promoting core labor standards. We welcome the creation by the IMF of the new Supplemental Reserve Facility for the provision of finance at premium interest rates, where appropriate.

We believe that where countries pursue the necessary reforms, the prospects of a return of confidence to global investors and a resumption of vigorous growth in the medium term are good. As long as affected Asian countries follow through with reform, and the rest of the world responds appropriately, the overall effect of the Asian crisis on world growth in 1998 should be manageable.

Lessons for the Future

We discussed the wider implications of the Asian crisis. One clear lesson to date is that emerging and transition countries that strengthen their economic policies help avoid the consequences of contagion. While the actions of the international financial community and the affected Asian governments should bring about recovery, there will be lessons to be learned by countries, international financial institutions, private financial institutions, and others who participate in the world financial system. We need to ensure the continued smooth and effective functioning of an open world financial market, which is of great benefit to all. In the interest of the longer-term proper functioning of the financial markets, it is essential for the private sector to play its role in resolving crises.

We look forward to a profound and broad-ranging debate over the coming months on the causes and lessons of recent events in Asia and their implications for strengthening the international monetary system. We believe that it is important to consult widely, making full use of a number of forthcoming international fora that permit discussion with representatives of emerging market economies. The meetings of the Interim and Development Committees in April [at the IMF] provide

Group of Eight Advocates "Practical Steps" to Promote Jobs and Employment

At a meeting on employment issues in London on February 22, labor and finance ministers from the Group of Eight—comprising the Group of Seven and Russia—agreed that each county should take "practical steps as appropriate" to promote job creation and tackle unemployment. In a statement issued on February 22, the Group of Eight also called for stable macroeconomic policies, coupled with government initiatives, to encourage investment in industry, infrastructure, skills, and new technology. Recognizing that economic growth and stability are prerequisites for maintaining and expanding employment, the Group of Eight welcomed the response of the international community to the crisis in Asia and the IMF's leading role in supporting essential policy reforms and providing temporary financial assistance where necessary.

In its communiqué on jobs, the Group of Eight recommended that at their economic summit scheduled for May 1998 in Birmingham, England, heads of state of the Group of Eight adopt seven principles to generate jobs and tackle unemployment:

- implementing sound macroeconomic policies conducive to sustained noninflationary growth and employment;
- implementing structural reforms in the labor market to boost job growth, remove tax and regulatory barriers, and promote adaptable, efficient, and equitable working arrangements;
- creating an economic climate favorable to small and medium-sized enterprises;
- enhancing employment, education, and training opportunities to prevent long-term unemployment;
- reforming the tax and benefit system to foster growth and encourage the unemployed to seek work, while protecting vulnerable groups;
- enabling people to learn throughout their working lives and improve their employability; and
- promoting equal opportunities and combating discrimination.

opportunities to carry this work forward. We will provide a progress report for the meeting of our Heads of State or Government at the Birmingham Summit in May. The areas on which our initial efforts will focus are as follows.

• *Poorer developing countries.* We agreed that the turbulence affecting some emerging markets in Asia should not distract attention from the problems facing poorer developing countries. We reviewed the Group of Seven work put in train by the Denver Summit [June 20–22, 1997; see *IMF Survey*, July 7, 1997, page 204] on the key difficulties in African countries. We also discussed the progress of the HIPC Initiative [joint IMF-World Bank initiative to assist heavily indebted poor countries], which will relieve the poorest countries of the unsustainable burden of past debts and thereby improve their development prospects. We welcome the relief already agreed for Bolivia, Burkina Faso, Guyana, and Uganda and hope for final decisions to be reached very soon on Mozambique and Côte d'Ivoire. We look forward to determined and speedy extension of debt relief to more countries, in line with the terms of the initiative. We call on all eligible countries to embark on the process as soon as possible, and to take steps to ensure that all can be in the process by the year 2000. We will also seek to support the initiative by working to ensure that future official credits to these countries are used productively.

• *Measures to promote more efficient functioning of global markets.* We need to consider ways of strengthening the international financial system's infrastructure, including the appropriate supervision and regulation of financial markets to ensure adequate soundness of banks and other financial institutions. Work is already under way within our own institutions and among the international regulators' bodies to increase cross-border cooperation between regulators of internationally active conglomerates and to improve information exchange.

• *Measures to improve transparency and disclosure.* This is also essential to the efficient functioning of global markets. We look for improvements in the timeliness, accuracy, and coverage of national statistical reporting; in the transparency of public policymaking; and in the private sector in corporate governance and disclosure. We look forward to the IMF strengthening and expanding its data dissemination standards. We also look forward to the IMF making proposals soon for a code of conduct on transparency in fiscal policy as agreed in Hong Kong last year, and will look for further ways to ensure transparency. We also stressed the importance of transparency and accountability of the IMF arrangements.

• *Strengthening financial systems.* Further action to strengthen financial systems and their operation, at both the national and international level, is needed to allow countries to take full advantage of global capital flows by opening their financial markets. A capital account amendment to the IMF Articles should be implemented quickly to define the IMF role in capital account issues and to help countries to implement reforms with appropriate sequencing, taking account of the strength of financial systems.

• *Role of the international community.* An early response by countries to the IMF's advice is vital. Countries' prompt and appropriate actions—supported by the international financial institutions—are essential to prevent economic problems from turning into crises and to prevent contagion to other countries. Any international financial support must be consistent with the longer-term proper functioning of financial markets. The institutions need access to all relevant economic data. In the light of the central role of the IMF, we urge early implementation of the IMF quota increase and the ratification of the New Arrangements to Borrow.

• *Steps to promote appropriate burden sharing by the private sector.* Private sector borrowers and lenders need to face and act on appropriate incentives so as to ensure that they share both the profits and losses appropriately. With hindsight it is clear that the private sector's judgment has been inadequate in a number of instances. We encourage positive consideration of new mechanisms to ensure an orderly involvement of the private sector in the resolution of financial crises. ■

Camdessus Meets with Asian Labor Leaders

On February 25, IMF Managing Director Michel Camdessus held a working lunch with senior officials of the World Confederation of Labor (WCL) and national labor leaders from Indonesia, the Philippines, and Thailand to discuss the Asian crisis and IMF-supported adjustment programs. Participants in the luncheon included Willy Thys, Secretary General of the WCL; Willy Peirens, Vice President of the WCL; Ronald Janssen of the WCL; Isidro Antonio Asper of the Federation of Free Workers (Philippines); André Miramis, BATU Indonesia (SPSI); Panul Thailuan, National Congress of Thai Labor; and Rekson Silabon (SBSI, Indonesia). The luncheon was organized by Willy Kiekens, an IMF Executive Director.

In the photograph, Camdessus (left) talks with André Miramis, Panul Thailuan, and Willy Thys.

Caracas Declaration

Group of 24 Focuses on Lessons of Asian Crisis For Developing Countries

Meeting in extraordinary session in Caracas, Venezuela, on February 7–9, the Ministers of the Intergovernmental Group of 24, representing the developing countries, focused on the implications of the intensifying integration and participation of developing countries in the global economy. The Group of 24, which is chaired by Antonio Casas González, Governor of the Central Bank of Venezuela, emphasized the need for global cooperation to preserve the stability of the international and economic and financial system—particularly in the wake of the Asian financial crisis. Addressing the meeting on February 7, IMF Managing Director Michel Camdessus said, "The task before us is very simple: to keep this crisis from becoming a catastrophe of global proportions." [The full text of Camdessus's speech is available on the IMF's web site at the following address: http://www.imf.org/external/news.htm.]

IMF Director Michel Camdessus (right) shakes hands with Venezuelan President Rafael Caldera, accompanied by Antonio Casas González, Chairman of the Group of 24 and Governor of the Central Bank of Venezuela.

In the Caracas Declaration, issued on February 9, the Group of 24 agreed to:

• promote an orderly and cautious approach to the liberalization of capital accounts under IMF auspices;

• explore global arrangements for the purpose of securing appropriate sharing of the cost of crisis resolution;

• support efforts to strengthen and coordinate the work of agencies for financial market surveillance and supervision and to pursue discussions in respect of international arrangements for supervision and regulation of financial markets and institutions;

• further the effort to seek permanent and creative solutions to the debt problems and development financing needs of the poorest countries;

• support an expanded role for the SDR in the international monetary system; and

• support national and international efforts to further develop and disseminate comprehensive and timely economic and financial information.

The Caracas Declaration also called for the establishment of a task force comprising industrial and developing countries that would conduct a review of issues of concern:

• the capacities of the international monetary and development finance institutions to respond in a timely and effective manner to crises induced by large-scale capital movements and the appropriateness of the conditions prescribed by these institutions to deal with such crises;

• equitable sharing of the costs of post-crisis financial stabilization between private creditors, borrowers, and governments;

• more effective surveillance of the policies of major industrialized countries affecting key international monetary and financial variables, including capital flows;

• modalities for building domestic social safety nets as integral elements of stabilization and adjustment programs to protect the most vulnerable elements of the population; and

• increased representation and participation of developing countries in the decision-making organs of the international community.

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
February 23	4.27	4.27	4.68
March 2	4.32	4.32	4.73

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

IMF SURVEY

Trade Liberalization Increasingly Seen as Crucial Ingredient for Sustained Growth

While there is a broad agreement on the economic benefits of free trade, trade reform has not always engendered broad-based support. A February 19 IMF Economic Forum on "Trade Liberalization: How Should the Agenda Read?" explored unilateral, regional, and multilateral approaches to trade reform and the economic benefits, as well as the social consequences, of liberalization. The panel, moderated by Jack Boorman, Director of the IMF's Policy Development and Review Department, included Robert Sharer, Chief of the Trade Policy Division in the IMF's Policy Development and Review Department; Arvind Panagariya, Professor of Economics and Co-Director, Center for International Economics, University of Maryland; Clemens Boonekamp, Counsellor in the Trade Policies Review Division of the World Trade Organization (WTO), Geneva; and Bill Brett, General Secretary of the U.K. Institution of Professionals, Managers and Specialists, and Vice-Chair of the Governing Body of the International Labor Organization (ILO).

Clemens Boonekamp (left), Robert Sharer, Jack Boorman, Bill Brett, and Arvind Panagariya at the Economic Forum on trade liberalization.

Case for Unilateral Liberalization

Why should countries pursue unilateral trade liberalization? A broadening and deepening of unilateral trade liberalization is increasingly being seen as a crucial ingredient for sustained high-quality growth, said Robert Sharer, reflecting the findings of a recent IMF study, *Trade Liberalization in IMF-Supported Programs*. Countries that unilaterally reduced trade restrictions and adopted open, outward-looking trade policies have reaped substantial rewards. By steadily reducing nontariff barriers on imports and eliminating controls on exports and lowering and unifying tariff rates—and sustaining this process over the medium term—countries such as Chile, Colombia, New Zealand, and Singapore have dramatically improved their trade and growth performance. Benefits are also being seen for countries, such as Uganda and Ghana, that have started down this road.

An open trade regime expands trade and investment opportunities and allows countries to specialize in, and export, products in which they have a comparative advantage. Resource allocation improves and growth prospects are enhanced. Governance and transparency can also be strengthened by creating a level playing field. But if the benefits of liberalization and the experience of countries with open trade regimes are so clear, why do many countries maintain restrictive regimes? Several aspects of trade reform bolster protectionist sentiment. These include political economy factors in which the asymmetry between clear losers and potential gainers often tilts the balance against reform; short-term adjustment costs; concerns that greater competition through trade could lead to a "race to the bottom" as countries adopt ever lower labor and environmental standards; and fiscal concerns—which Sharer felt are often overstated—that trade reform will reduce government revenue.

Trade protectionism is a blunt instrument of trade policy, however, and is equivalent to "throwing out the baby with the bath water," Sharer argued. Openness to international competition raises living standards, brings about higher wages, and improves working conditions and labor and environmental standards. He cited key lessons from successful trade reforms:

• Far-reaching trade reform is a medium- to long-term process, and "ownership" by the government and the population is critically important for its success.

• Trade reform should be part of a coherent package of structural and macroeconomic policy reform often bolstered by an IMF-supported program.

• Trade liberalization objectives should be publicly announced at an early stage, allowing economic agents to adjust quickly and thus reducing adjustment costs.

• Effective reform requires specific medium-term plans with intermediate steps.

• Fiscal considerations—for example, including revenue-positive elements and measures to improve tax administration—must be addressed.

Regional Agreements

Despite the perceived benefits of unilateral trade liberalization, regional liberalization—commonly known as preferential trading agreements (PTAs), such as NAFTA—is proliferating. While there is some degree of openness, said Arvind Panagariya, PTAs are essentially discriminatory—offering reduced tariffs to some partner countries while retaining them for the rest. He said he was increasingly skeptical of preferential liberalization on three counts.

First, when a high-tariff country, such as Mexico, forms a PTA with a low-tariff country, such as the United States, the high-tariff country gives a much greater tariff preference than it receives. The outcome is a net tariff-revenue transfer from Mexico to U.S. exporters. Panagariya estimated these transfers currently amount to $3.25 billion—approximately 1 percent of Mexico's GDP.

Second, PTAs divert trade from more efficient countries (outside the PTA) to less efficient union partners. Recent studies on European Union expansion and MERCOSUR show evidence of trade diversion.

Third, PTAs have slowed down and, in many cases, reversed unilateral liberalization in developing member countries. For instance, Mexico raised tariffs on outside countries after the peso crisis, and MERCOSUR recently raised its common external tariff by 3 percent.

Finally, multiple free trade agreements fragment the world trading system by creating a "spaghetti bowl" of tariffs—imposing different trade restrictions on different trading partners—and resulting in efficiency and transparency losses.

What can be done to minimize the damage of regional arrangements? Panagariya suggested WTO members place a moratorium on new PTAs except those already in advanced stages of negotiation. At a minimum, it would help arrest the process if big PTAs are put on hold. Second, WTO rules could be altered to require a country entering into a free trade arrangement to bind its external tariffs to applied rates. Last, future regional arrangements could adopt the Asia Pacific Economic Cooperation forum as a model; this forum encourages liberalization exclusively on a most-favored-nation basis.

Multilateral Negotiations

While there are clear and real advantages to unilateral trade liberalization, Clemens Boonekamp said, it is difficult to persuade governments to pursue this route. The advantages, though widespread and diverse, can be difficult to identify in advance. However, the short-term adjustment costs—are very visible. Here is where the multilateral system shows its strength, Boonekamp explained. The multilateral system—through negotiations among a large group of countries—offers governments the "political cover to do what is in the general well-being of their populations." Also, unlike unilateral liberalization, it brings a certainty into the system about the openness of the trade regime; that is, governments make lasting commitments that the liberalization they undertake multilaterally will not be withdrawn.

The multilateral system is thus a simple and efficient way to conduct trade on agreed rules. One contract signed by 131 members cuts through the need to have multiple contracts, different rules of origin, and different tariff structures. The system that is in place—the WTO—is based on three principles, according to Boonekamp: nondiscrimination, predictability and stability, and transparency. Each has at its root a sound economic rationale. He cited the 500 pages of rules and schedules of commitments that countries have made, though he admitted that in some cases—such as in regional agreements—these rules are not as "ironclad" as they should be.

How can one ensure the system works? Boonekamp listed the means the WTO has in place. These comprise a legal mechanism of dispute settlement wherein a country can be taken to task for not abiding by its obligations. There is also an economic surveillance mechanism—trade policy reviews—that monitors the extent to which members' trade policies conform to the broad objectives of the multilateral system. This multilateral system will guide the global trading system, it is hoped, into a far more liberal stance than it has even now, he concluded.

Links Between Trade and Labor

Trade liberalization is an accepted fact of life, according to Bill Brett, but it does give rise to many social issues, such as labor standards. The most trenchant example is the effect of the East Asian crisis on labor—not just in East Asia, but also in Europe and the United States. Trade liberalization is not an end in itself but a means to maximize welfare for all. If one accepts that argument, Brett said, then countries cannot ignore labor issues in formulating trade policy. Indeed, labor is a trade-related issue.

Yet, this link between trade and core labor standards has been ignored, Brett argued. Even the ILO and the WTO have done nothing other than exchange "fine words and declarations on core labor standards." The outcomes have been long on rhetoric but short on substantive actions. Perhaps more baffling, said Brett, is that while the IMF and the World Bank play a considerable part in encouraging trade liberalization, there is virtually no collaboration with the ILO on labor-related issues. In many developing countries, Brett pointed out, the IMF and the World Bank would be "rated zero" by labor union members on the beneficial effects of structural adjustment. This view, he felt, is both unfair and factually incorrect, but if the multilateral institutions expect to make a headway on trade liberalization, they must address the social dimensions of adjustment.

In his concluding remarks, Jack Boorman, referring to Brett's remarks, pointed out that the IMF has begun collaborating at senior levels with the ILO. However, the issue cannot be put to rest, Boorman said, noting that the agenda is a real and important one, and much more work is needed to ensure that labor is an important player in economic policymaking. ■

Gita Bhatt
IMF External Relations Department

Copies of *Trade Liberalization in IMF-Supported Programs,* prepared by a staff team led by Robert Sharer, are available for $25.00 (academic rate: $20.00) from IMF Publication Services. See page 77 for ordering information.

Reforming Pension Systems in the Baltics, Russia, and Other Countries of the Former Soviet Union

One of the most serious problems the Baltics, Russia, and other former Soviet Union countries face in their transition to market economies is the reform of the public welfare systems inherited from the Soviet period, which were designed to provide "cradle-to-grave" protection to the population. Attempts to reform the existing systems have been modest so far, and public welfare spending continues to absorb a large share of public financial resources in these countries. Despite their increasing fiscal burden, these pension systems have become crude social safety nets, providing small amounts of benefits to a large section of the population. The need for reform is most dramatic in public pension systems, which account for the bulk of total social security spending. In a recent study, Pension Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union, *Marta de Castello Branco reviews current pension systems, past attempts to deal with the financial pressures on them, and options for further reform. Castello Branco spoke with the* IMF Survey *about her study.*

IMF SURVEY: *What types of pension systems are currently in place in these countries? How do they differ from systems in other countries?*

CASTELLO BRANCO: The present public pension systems are run on a pay-as-you-go (PAYG) basis, with pension benefits financed by current payroll contributions, in some cases supplemented by budget transfers. They are essentially like the pension systems of many industrial countries, although countries in this group have much lower per capita incomes and levels of economic development. Unlike in most industrial countries, public pensions in these countries are not complemented by private pension schemes.

To understand their initial position and reform options, it is useful to group existing pension systems into three broad categories, comprising the German, the Swiss, and the Chilean "models."

• The German model is dominated by a large mandatory publicly managed PAYG pension scheme, which currently provides an average wage earner with a full contribution record of 45 years with a pension benefit equivalent to about 70 percent of average net wage earnings. Owing to the wide coverage and high income replacement rates of the public scheme, private pension provision has traditionally played a relatively small role.

• The Swiss model is based on a sizable mandatory publicly managed PAYG pension scheme, supplemented by an almost equally large mandatory private scheme. The public scheme has a wide coverage, a significant redistributive component, and promises an average wage earner a pension benefit equivalent to about 40 percent of average wages. The fully funded private pension scheme is designed to provide a pension benefit equivalent to about 30–40 percent of a contributor's wage.

• The Chilean model, dominated by a large mandatory privately managed pension scheme, is supplemented by a relatively small public scheme, essentially designed to provide poverty relief.

IMF SURVEY: *What are the specific shortcomings of pension systems in the Baltics, Russia, and other countries of the former Soviet Union?*

Castello Branco: High and rising ratios of pensioners to contributors threaten the short-term sustainability of pension systems.

CASTELLO BRANCO: Large-scale PAYG systems can have a number of problems. They can result in serious labor market distortions—especially at lower levels of economic development—as they undermine incentives to work and pay taxes. Also, it has been argued that PAYG pension schemes reduce incentives for private saving and capital accumulation and are often associated with relatively narrow equity markets. Despite their redistributive nature, evidence from industrial countries suggests that these systems tend to be regressive. Moreover, they do not promote an equitable distribution of benefits and costs across and within generations. Finally, since pension funds worldwide are showing signs of financial stress, the future size of public pension benefits and contribution rates has become uncertain.

In the countries under review, these shortcomings are compounded by certain specific circumstances of the transition process. On the revenue side, contribution collections have been negatively affected by low tax compliance and shrinking contribution bases. The high contribution rates and low tax enforcement capabilities typical of these countries have encouraged evasion and the development of underground activities. On the benefit side, the incentives for early retirement have led to a marked increase in the number of beneficiaries relative to the number of contributors. In sum, the sustainability of pension systems in these countries is threatened in the short run by narrow contribution bases, low compliance, and early retirement, which in turn translate into high and rising ratios of pensioners to contributors.

Looking ahead, the key challenge in the long run is whether these pension systems will be sustainable in face of rapidly aging populations. Given the diverse demographic structures in these countries, demographic change is likely to affect individual countries at varying speeds, although populations are aging rapidly across all countries.

IMF SURVEY: *What measures have policymakers in these countries taken to address these shortcomings and to what extent have they succeeded?*

CASTELLO BRANCO: Faced with increasing financial stresses on their pension funds, policymakers typically reacted by adopting a muddling-through approach during the transition period. Most countries severely compressed benefits—but not the number of beneficiaries—and, as a result, are failing to provide adequate social protection. In addition, they raised contribution rates, significantly discouraging compliance. Some countries have resorted to the accumulation of pension arrears. Others have increased budgetary transfers to bridge the gap between contributions and benefits. More recently, several countries have started to take measures to correct some of the distortions in their PAYG system. They have amended legislation in order to change the benefit structure and eligibility criteria, introducing, for example, gradual increases in the retirement age and reductions in benefits for working pensioners and in the eligibility for privileged early retirement. Policymakers have also been increasing efforts to improve the targeting of benefits and to strengthen tax collection. On the whole, however, these countries have taken only modest steps so far in reversing the increasing trend in the ratio of pensioners to contributors.

IMF SURVEY: *What explains this relatively modest success?*

CASTELLO BRANCO: Reforming pension systems in transition economies is in many ways a more difficult task than in industrial and developing countries. There are serious economic and political constraints to reform, including the fragile situation of the public finances, large competing expenditure needs, lack of developed financial markets and regulatory frameworks, and the need to provide minimum protection to pensioners who may not live to enjoy the eventual benefits from the transition but still expect governments to honor their inherited "social contract." Nonetheless, efforts to embark on systemic reform are gaining momentum as it becomes more obvious that the fiscal sustainability of the pension funds is at best precarious.

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:

Togo, No. 98/7, February 19
Chile, No. 98/8, February 20
Argentina, No. 98/9, February 23
Barbados, No. 98/10, February 25
Belgium, No. 98/11, March 3

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

IMF SURVEY: *What are some options for further reform and what key long-run challenges do policymakers face?*

CASTELLO BRANCO: One possible reform approach is to reduce expenditures and increase revenues without changing the basic structure of the PAYG system. This piecemeal reform option would be achieved through reforming the benefit structure, reducing the ratio of pensioners to contributors, and increasing tax collection. Several countries have started in that direction. Another broad approach is to change the systems altogether, which typically involves downsizing and restructuring the existing public pension schemes and developing privately managed pension plans. Two countries—Kazakhstan and Latvia—have chosen this option. However, they have adopted different approaches and different timetables to implement systemic reform. While Kazakhstan's reform aims at replicating the Chilean pension system in one go—dominated by mandatory, privately managed, funded pension schemes—Latvia has chosen to adopt gradually a system that provides a balanced mix between PAYG and funded systems, resembling the Swiss pension model.

As they embark on systemic reform, policymakers in these countries will have to address two key reform issues. First, they have to decide on the relative roles that public and private pension provision will play in the new system. This will depend on individual circumstances and—most important—on the redistribution objectives of each country. In view of the deterioration in income distribution during the transition period and the lack of an efficient and sound financial infrastructure for the successful operation of private pension funds, a relatively large redistributive public pension scheme may be necessary, at least for the time being, in most of these countries. Another key issue on the reform agenda is the speed of the transition to the final pension system. Again, this will depend on the specific circumstances of each country, including its demographic structure and trends, the degree of financial market development, and the adequacy of the tax system and the regulatory framework. The decision about how quickly to implement systemic reforms will also need to take into account the fiscal costs involved in moving to funded pensions systems.

The important point here is that there is no "ideal model" for pension reform. Regardless of the approach taken, however, it is crucial to downsize and restructure the existing PAYG public systems and to start developing private pension schemes to supplement the public system. ■

Copies of Working Paper 98/11, *Pension Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union,* by Marta de Castello Branco, are available for $7.00 each from IMF Publication Services. See page 77 for ordering information.

World Economic and Financial Surveys Series

Trade Liberalization in IMF-Supported Programs, IMF Staff ($25.00; academic price $20.00) (see page 73 of this issue).

Occasional Papers ($18.00; academic rate: $15.00)

No. 156: *The ESAF at Ten Years—Economic Adjustment and Reform in Low-Income Countries,* IMF Staff (see *IMF Survey*, February 23, page 63).

No. 158: *Transparency in Government Operations,* George Kopits and Jon Craig (see *IMF Survey,* February 23, page 55).

No. 159: *Hungary: Economic Policies for Sustainable Growth,* Carlo Cottarelli and others. A collection of studies focusing on economic developments in Hungary, particularly during 1995–97.

Working Papers ($7.00)

98/6: *How to Deal with Azerbaijan's Oil Boom? Policy Strategies in a Resource-Rich Transition Economy,* Christoph B. Rosenberg and Tapio O. Saavalainen. Describes a medium-term policy strategy for Azerbaijan, relating its prospects to the experience in the 1970s of Ecuador, Indonesia, and Nigeria.

98/7: *Income Inequality—Does Inflation Matter?*, Alěs Bulíř. Contributes to the income inequality literature that is based on the traditional Kuznets model.

98/8: *Currency Boards—The Ultimate Fix?,* Atish R. Ghosh and others. Compares the macroeconomic performance of countries with currency boards to those with other forms of pegged exchange rate regimes.

98/9: *Uncertainty, Flexible Exchange Rates, and Agglomeration,* Luca Antonio Ricci. Shows that exchange rate variability promotes agglomeration of economic activity.

98/10: *Open Regionalism in a World of Continental Trade Blocs*, Jeffrey Frankel and Shang-Jin Wei. In a world of continental blocs, open regionalism in which trade blocs undertake modest liberalization can usually produce Pareto improvement.

98/11: *Pension Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union (BRO)*, Marta de Castello Branco (see page 75 of this issue).

98/12: *French Public Finances: Modeling Long-Term Prospects and Reform Options,* Karl F. Habermeier and Fabrice Lenseigne. Uses stochastic simulations to examine the robustness of the results to changes in parameter values.

98/13: *Does the Introduction of Futures on Emerging Market Currencies Destabilize the Underlying Currencies?*, Christian Jochum and Laura Kodres. Presents empirical results examining the influence of the Mexican peso, the Brazilian real, and the Hungarian forint futures contracts on the respective spot markets.

98/14: *Generational Accounting for France,* Joaquim Levy and Ousmane Doré. Presents the first set of generational accounts for France, illustrating the impact on different generations of current policy settings.

IMF Staff Country Reports ($15.00)

97/119: Namibia—Recent Economic Developments
97/120: Pakistan—Recent Economic Developments
97/121: Portugal—Selected Issues
98/1: France—Selected Issues and Statistical Appendix
98/2: Ghana—Statistical Annex
98/3: New Zealand—Selected Issues and Statistical Tables
98/4: United Kingdom—Selected Issues
98/5: Tanzania—Statistical Appendix
98/6: Ethiopia—Statistical Appendix
98/7: Antigua and Barbuda—Recent Economic Developments
98/8: Kyrgyz Republic—Recent Economic Developments
98/9: Malaysia—Recent Economic Developments
98/10: Panama—Statistical Annex
98/11: St. Vincent and the Grenadines—Statistical Annex
98/12: Republic of Estonia—Selected Issues and Statistical Appendix
98/13: Guyana—Statistical Appendix
98/14: Mali—Statistical Annex
98/15: Paraguay—Selected Issues and Statistical Annex
98/16: Republic of Tajikistan—Recent Economic Developments

Pamphlets (free)

No. 51: *Debt Relief for Low-Income Countries: The HIPC Initiative,* Anthony R. Boote and Kamau Thugge. Revised December 1997

Other

IMF Committee on Balance of Payments Statistics, Annual Report 1997 (free)

Publications are available from Publication Services, Box XS800, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full text of the English edition of the *IMF Survey*, the *IMF Survey*'s annual *Supplement on the IMF*, *Finance & Development*, an updated *IMF Publications Catalog,* and daily SDR exchange rates of 45 currencies—please visit the IMF's web site (http://www.imf.org). The full texts of all Working Papers, Papers on Policy Analysis and Assessment, and Press Information Notices (PINs) are also available on the IMF's web site.

From the Executive Board

Following is an excerpt from a recent IMF press release. The full text is available on the IMF's web site (http://www.imf.org/external/news.htm) or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Cape Verde: Stand-By

The IMF approved a 14-month Stand-By credit for Cape Verde equivalent to SDR 2.1 million (about $2.8 million) to support the government's 1998 economic program. The authorities have indicated their intention not to draw on the credit.

Cape Verde: Selected Economic Indicators

	1995	1996	1997	1998	1999	2000
			(percent change)			
GDP at constant prices	4.7	3.0	3.0	4.0	4.0	4.0
Consumer prices (average)	8.4	5.9	8.9	3.5	3.0	3.0
			(percent of GDP)			
Overall fiscal balance	–15.1	–16.1	–15.1	–8.7	–4.9	0.5
External current account balance (excluding transfers)	–24.4	–17.4	–16.4	–15.7	–11.2	–7.8
			(months of imports)			
Gross international reserves	2.5	2.4	2.2	2.4	2.8	3.2

Data: Cape Verdean authorities and IMF staff estimates

1998/99 Program

The macroeconomic program envisages real GDP growth of 4 percent in 1998, compared with 3 percent in 1997, and an average inflation rate of 3.5 percent in 1998, compared with 8.9 percent in 1997. The external current account balance, excluding transfers, is targeted at a deficit of 15.7 percent of GDP in 1998, compared with a deficit of 16.4 percent in 1997.

The most important element of the program is a tightening of fiscal policy to reduce the overall fiscal deficit to 8.7 percent of GDP in 1998 from 15.1 percent in 1997.

The authorities of Cape Verde intend to maintain a pegged exchange rate, and thus monetary policy will be geared to balancing the private sector's credit needs against the reserve accumulation targets of the program.

Structural Reforms

Structural reforms entail an acceleration of the privatization program, as well as legislative and regulatory reform aimed at creating a favorable environment for private sector development.

Exports, particularly of services, are the key to sustainable growth in Cape Verde and are expected to continue to grow rapidly. In addition, the government intends to further liberalize the trade regime.

Addressing Social Costs

Cape Verde's objectives in the social area and in poverty alleviation are to be achieved through higher growth, lower inflation, and continued budgetary support of efforts to improve primary health and education. Job creation will depend on sustained economic growth brought about through firm implementation of structural reforms and fiscal objectives.

Cape Verde joined the IMF on November 20, 1978, and its quota is SDR 7.0 million (about $9.4 million). Cape Verde currently has no outstanding use of IMF financing.

Press Release No. 98/3, February 23

Favorable Experience

United Kingdom's Targeting Framework Is Expected to Improve Inflation Performance

For more than five years, the United Kingdom has relied on inflation targeting to set its monetary policy. Inflation targeting—which began in October 1992—has ushered in a period of moderate inflation. The officially targeted measure—retail price inflation (excluding mortgage interest)—stayed close to its 2½ percent target and reached the target in April 1997 (see top chart, page 79). Soon after taking office, the Labor government granted the Bank of England operational independence, while preserving key elements of the inflation-targeting framework and establishing additional elements of accountability. The result appears to be increased credibility for U.K. monetary policy, as evidenced by declining expected inflation and diminished spreads on bond yields.

Logic of Inflation Targeting

Under inflation targeting, the central bank sets a target for inflation and focuses monetary policy on achieving this target. The process is inherently forward-looking: monetary policy affects inflation only with a lag, which in the United Kingdom has been estimated at 18 months to two years, but may be even longer. As a result, inflation targeting can be seen as using the authorities' inflation forecast as an intermediate target: the authorities set monetary policy instruments so that inflation is predicted to be at its target—tightening if it is forecast above the target, easing if it is below.

The forward-looking nature of inflation targeting—unlike other forms of monetary targeting—makes it inherently nontransparent, thus creating a need for compensating institutional features to enhance the transparency of the policymaking process. The link between monetary policy and inflation is complex, prolonged, and uncertain. In contrast, with an exchange rate target, monetary policy is typically transmitted almost immediately to foreign exchange markets, and it is readily apparent when a target has been breached. With monetary aggregates as targets, the degree of transparency is somewhere in between: interest rates affect monetary aggregates with a relatively short lag, and these aggregates can be monitored on a monthly basis.

Given the fact that inflation targeting is inherently less transparent, it is particularly important that certain elements of it be stated clearly. These include the inflation targets, the horizon over which they will be met, and the basis on which the appropriate policy to achieve these targets is assessed. It is also essential to spell out the monetary authorities' reasoning with regard to the actions needed to achieve these objectives. Thus, in the United Kingdom, beginning in 1994, inflation targeting was accompanied by the publication of minutes of monthly monetary policy meetings and quarterly *Inflation Reports* presenting the Bank of England's analysis of inflation prospects.

Another consequence of the forward-looking nature of inflation targets is the need to develop institutional arrangements to strengthen accountability. This is essential because the usual method of holding the monetary authorities accountable ex post—comparing the outturn to the target—is not operative until a couple of years later. Accountability and transparency thus focused on the monthly meetings between the governor of the Bank of England and the chancellor. The governor would present his advice for changes in policy, while the chancellor would present the reasoning underlying his policy decision. Even with these transparency features, a significant challenge for inflation targeting has been how to communicate to the public the nature of the problem of forecasting under uncertainty, particularly when inflation is on target but forward-looking considerations call for a tightening.

The adversarial approach to transparency and accountability that was central to inflation targeting until May 1997 had both strengths and weaknesses. A strength was the framework's capacity to prompt an airing of arguments on both sides of the decision, thus promoting greater transparency. The main drawback was that it did not provide for the independence of the central bank, which could have helped insulate monetary policy decision making from short-run political manipulation, especially as political horizons shortened in the run-up to a general election. Another possible drawback was that the resulting emphasis on disagreement between policymakers could give confusing signals to the markets, undermining confidence in the price stability objective. The experience in the United Kingdom seems, to contradict the latter possibility, however, since there was no significant unfavorable market reaction on occasions when disagreement between the governor and chancellor was reported. The additional transparency—signified by the willingness to reveal such disagreements—may indeed have helped enhance credibility.

New Framework

The Labor government's decision to grant the Bank of England operational independence changed the requirements for accountability. Under the new rules, the Bank of England is responsible for implementing a monetary policy aimed at the inflation target. There are some qualifications: the Bank must "without prejudice to this objective, support the policy of the government, including its objectives for growth and employment"; exchange rate policy remains in the hands of the government (which even with a freely floating exchange rate, as at present, could limit the Bank's ability to use foreign exchange market intervention in the service of monetary policy); and the government reserves the right under extreme circumstances to override the Bank's monetary policy decisions. The inflation target itself is set by the government in each annual budget, with the expectation that it would be kept stable. Monetary policy decisions are made in monthly meetings of a Monetary Policy Committee chaired by the

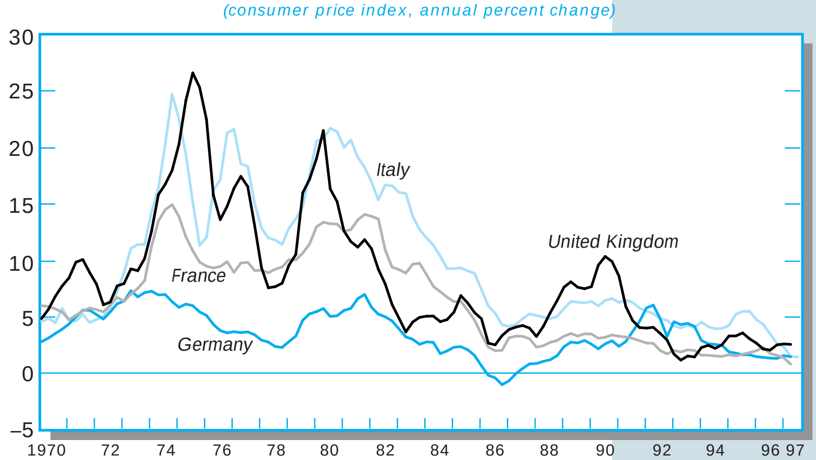
Retail Price Inflation

(annual percent change)

Data: U.K. Office for National Statistics; and Bank of England

Comparative Inflation Performance

(consumer price index, annual percent change)



Data: IMF, *International Financial Statistics*

IMFSURVEY

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 23 times a year, plus an annual *Supplement on the IMF* and an annual index. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Material from the *IMF Survey* may be reprinted, with due credit given. Address editorial correspondence to Current Publications Division, Room IS9-1300, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to imfsurvey@imf.org. The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged $79.00 annually. Apply for subscriptions to Publication Services, Box XS800, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430. Fax: (202) 623-7201; e-mail: publications@imf.org.

governor and consisting of five Bank of England senior staff members and four outside appointees.

The new monetary policy framework preserves some features of the pre-May 1997 framework but seeks to strengthen transparency and accountability consistent with the new assignment of responsibilities. The minutes of the monthly monetary policy meetings are still published, but they now present the views of the Monetary Policy Committee and report any internal differences of view; minutes of the January 1998 meeting were the first to report any differences. The Bank of England also continues to publish its *Inflation Report*, which no longer assesses the implications of policies pursued by the chancellor but presents the view of the Monetary Policy Committee.

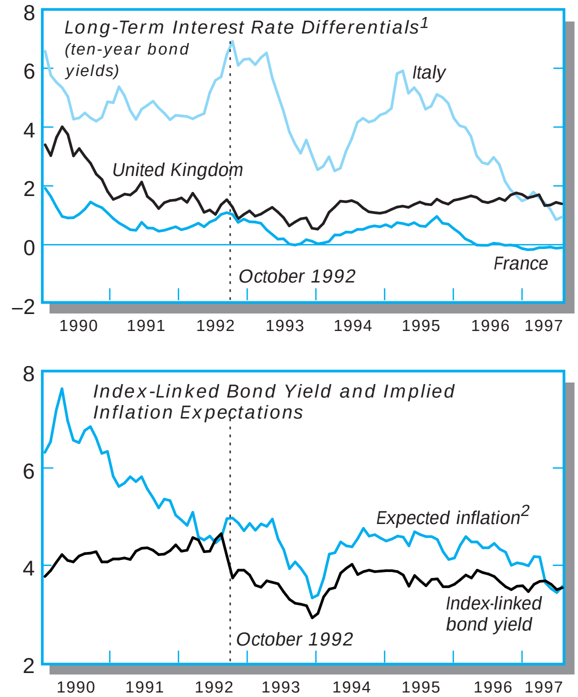
To these elements have been added strengthened ex post accountability to the chancellor. If inflation deviates from its target by more than 1 percentage point, the governor is required to write an open letter to the chancellor accounting for the deviation and stating what action is being taken to correct it. If inflation continues to be off-target three months later, another letter is required. This arrangement of open letters, while not contradicting the two-year horizon, has quite a different flavor, since with forward-looking policy, transient shocks to inflation would not necessarily warrant any corrective action and three months is likely to be far too early to assess the adequacy of any such action on the basis of the inflation outturn. The two-year horizon is not explicitly mentioned in the chancellor's remit to the Bank of England, although it has been re-emphasized in the Bank's public documents and is clearly understood and accepted by monetary policymakers.

Experience

The United Kingdom's experience with inflation targeting has been generally favorable: despite an easing of interest rates after sterling's exit from the ERM, inflation declined to close to the target. This decline must also be set against a trend of lower inflation elsewhere (see bottom chart, page 79) although it is unlikely that the United Kingdom would have shared in that trend if suitable monetary policies had not been in place. The decline of inflation during the earlier part of the inflation-targeting period appears to some extent to reflect the early 1990s recession, which was exacerbated by sterling's participation in the ERM. The logic of the two-year time horizon likewise implies that the inflation performance during the first two years of inflation targeting—the period during which inflation declined—should be attributed mainly to policies followed during the ERM period.

Although inflation targeting has delivered favorable performance, its introduction did not have a particularly warm reception in the markets. Expected inflation (measured as the differential between index-linked and

Indicators of Monetary Credibility
(percent)



[1]Against Germany.
[2]Difference in yields on 7.75 percent Treasury loans (2012–15) and 2.5 percent Treasury index-linked bonds (2016).

Data: U.K. Office for National Statistics; and IMF, Research Department

nonindexed bond yields) declined from the inception of inflation targeting through 1993, then rose sharply during 1994, and by April 1997 was still over 4 percentage points (see chart, page 80), indicating that the inflation targets had yet to gain credibility. At the same time, long-term interest rate differentials against Germany declined in the early months of inflation targeting, then rose in early 1994 (both movements partly reflecting global interest rate trends). The spread gradually widened during late 1994 through 1996 and was around 180 basis points in April 1997.

Since the May 6, 1997 decision to grant the Bank of England operational independence, inflation has stayed close to target, and market indicators have suggested substantial further gains in credibility. This has been reflected in long-term interest rates and differentials, although expected inflation implied by indexed bond yields suggests that credibility still needs to be consolidated. All in all, these indicators reflect the expectation that the new monetary framework, with an independent and accountable central bank, will deliver improved inflation performance over the longer term. ■

Timothy D. Lane
IMF European I Department

This article draws on material contained in Staff Country Report 98/4: *United Kingdom—Selected Issues*. Copies are available for $15.00 from IMF Publication Services. See page 77 for ordering information.