IMF SURVEY

International Monetary Fund
VOLUME 26
NUMBER 6

MARCH 24, 1997

Contents

81
IMF Conditionality

81
Structural Reform In Botswana

83
Current Account Sustainability

86
Inflation in Transition Economies

88
Economic Developments In Nigeria

91
Selected IMF Rates

92
From the Executive Board

93
Table of IMF Arrangements

94
Members' Use of IMF Credit

95
Financial Integration In Asia

IMF Conditionality Can Signal Policy Credibility to Markets

IMF conditionality—the remedial policy measures that member countries agree to take in conjunction with the use of IMF financing—has evolved over time. The IMF and its full membership have long held an interest in seeing conditionality used to ensure that imbalances are corrected and the IMF's resources recycled. The sentiments of borrowing members have been more mixed and are often shaped by the degree to which they internalize the benefits that conditionality promotes.

Access to international capital markets has placed a whole new emphasis on credible domestic policies and predictable government actions and has brought about a new perspective on IMF conditionality. In *Conditionality as an Instrument of Borrower Credibility*—a new IMF Paper on Policy Analysis and Assessment—Pierre Dhonte reviews the evolution of conditionality and looks at the implications, for member countries and for the IMF, of this new attention to policy credibility and predictable government actions.

Evolution of Conditionality

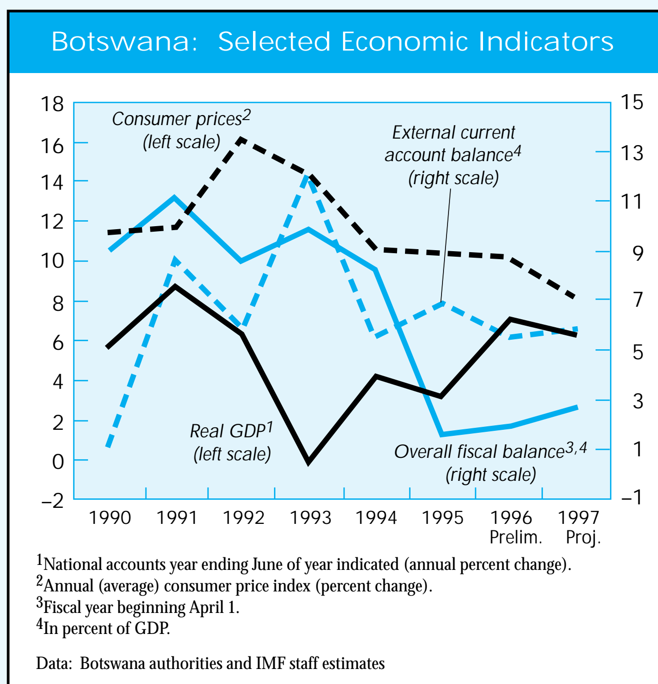
The IMF provides financing to give confidence to borrowing members that they can rely on cooperative policies to redress imbalances. In the early days of IMF financing, resources were lent under the umbrella of a widely accepted set of rules. "Transitory balance of payments needs were to be remedied by adjustment," Dhonte notes, "with contingent financing provided as a backup to weather the storm. Appropriate corrective measures were key." Financing reassured the member, while conditionality reassured the IMF that constructive measures would be pursued and its resources repaid.

In the 1970s, after the collapse of the par value system, industrial countries turned to the capital markets for their financing needs. *(Please turn to the following page)*

Effective Macro Management, Structural Reforms Are Hallmarks of Botswana Economy

Botswana's stable democratic system, pursuit of sound macroeconomic policies, and harnessing of its substantial mineral resources have helped transform this sub-Saharan African country from one of the poorest in the 1960s and 1970s to a middle-income country in the 1990s. Broad-based real GDP growth averaged 16 percent in the 1970s and 11 percent in the 1980s, underpinned by abundant diamond resources (diamonds account for about 30 percent of GDP, 70 percent of exports, and more than 45 percent of government revenue). These resources were managed so as to avoid the "Dutch disease" syndrome that has afflicted many mineral-rich countries.

Botswana's exceptional economic performance has been buttressed by sustained fiscal surpluses since fiscal 1983/84 (fiscal year beginning April 1). *(Continued on page 89)*



[1]National accounts year ending June of year indicated (annual percent change).
[2]Annual (average) consumer price index (percent change).
[3]Fiscal year beginning April 1.
[4]In percent of GDP.

Data: Botswana authorities and IMF staff estimates

Developing countries—many with diverse economic philosophies and development strategies—could also call on abundant bank lending. Market credibility was not yet an issue. Those that turned to the IMF, however, often came to perceive conditionality as being imposed on them.

The debt bubble burst in 1982, effectively changing this dynamic. The IMF's financing came to be seen as catalytic, suggesting that its conditionality gave confidence not only to the IMF but also to other creditors that appropriate corrective steps were being taken. Two developments in the 1990s, Dhonte says, further altered perceptions of the IMF's conditionality:

• A growing consensus on the effectiveness of market economies and on the necessary underpinnings of growth—macroeconomic stability, low inflation, liberal trade and exchange regimes, and effective legal and regulatory frameworks—predisposed borrowing countries to look more favorably upon these same elements when they came in the form of IMF conditionality.

By endorsing IMF conditionality, borrowing countries establish credibility and predictability.

• The extraordinary growth in capital flows—principally in the form of direct investment—made domestic and foreign markets key players in development strategies. Intrinsically skeptical about authorities' intentions, these markets believed many countries—whether for sovereignty or other reasons—were likely to resist "rules-based, market-oriented approaches, and [could] not be trusted to implement them predictably," according to Dhonte. Unease over the predictability of government policies and the resulting wariness prompted investors to postpone investments and gave governments a strong incentive to view IMF conditionality as a means to respond to investor concern.

Investor anxiety is reduced when restraints are placed on government's discretionary powers—that is, when rules pertain, and they are fixed, transparent, and enforced. Institutions, procedures, or international agreements can function as credible restraints on a government's discretionary authority and can help assuage investor concern over possible policy reversals. These restraints can take the form of independent central banks, a cash budget, or a currency board, or they can rest on outside support; for example, in the shape of multilateral trade agreements or commitments to international institutions.

Governments can strengthen market perceptions of their predictability by invoking such restraints. This is what conditionality can offer, Dhonte argues. "As an externally enforced restriction that limits the members' policy options to those that have been agreed with the IMF, it not only serves to protect the IMF's financial integrity, but also, critically, helps establish the credibility of the chosen policy options vis-à-vis market participants." This arrangement does not bind governments to fixed policies, but it does transparently link the process of formulating policies to established ultimate objectives.

Implications for IMF

Clearly, endorsing IMF conditionality is a means by which borrowing countries establish the credibility and predictability of their policies. Dhonte cites the increased demand for "precautionary" IMF arrangements—which allow members to agree on the requirements for IMF financing without actually making use of these resources—as evidence of increasing interest in IMF conditionality and notes evidence that demand for IMF programs may be inversely related to policy credibility.

The new uses to which conditionality is put make new demands on the IMF as well. In conjunction with the World Bank, the IMF is expected to provide assurances that members are making progress toward the structural and other reforms needed to achieve and sustain growth. The IMF must also credibly assess members' financing needs and mobilize these resources. In this task, one IMF audience is a broad array of aid agencies and other forums for concerted action, such as the Paris Club of official creditors. These agencies and forums value effort as well as achievement and have repeatedly demonstrated—through reschedulings and refinancings—their appreciation of the incremental nature of progress in policy reform. Within this context, the IMF assesses the feasibility of policy adjustments and secures a reasonable degree of country commitment.

Private investors are a more demanding audience—responding not to effort but to achievement. Markets want to be reassured, according to Dhonte, that the risk of policy reversal has been removed and that the country's capacity to respond to shocks has been established. This can take considerable time, and the market may be won over only grudgingly, as Latin America's experience after the 1982 debt crisis attests. Markets want proof not only of the technical merit of policies but also of the authorities' will to sustain them. IMF financing vouches for this will, and conditionality helps countries signal their determination to act predictably, in accordance with prior commitments.

Markets clearly respond to such signals. In Latin America, the IMF was instrumental in stimulating a change of policies that ultimately renewed investor confidence in the region. The apparent rationality of the market—the degree to which solid fundamentals are reflected in stronger credit ratings—also reassures countries that steps taken to strengthen their fundamentals will be translated into greater attractiveness to

investors. Even in Africa, where credit ratings are very low on average, there is evidence that good performance is in time reflected in improved credit ratings.

How does IMF conditionality, then, meet the market's thirst for greater predictability and the interest of member countries in satisfying this requirement? Dhonte stresses that it is important for member countries with IMF-supported adjustment programs not only to change policies but also to change the way policies are made. Five points are key:

- Capacity building must assume equal importance with policy design. Capacity building is a crucial ingredient in achieving predictable policymaking. Dhonte notes that building up national expertise in the course of program negotiations and implementation, strengthening budgetary controls, and structuring better economic information networks help bring about a change of culture and secure a country's sense of "ownership" over its adjustment efforts.
- The scope of the required reforms needs to include a strengthening of the entire civil administration, particularly the judiciary. A strong civil service is necessary to the establishment of the rule of law, which is a key element in predictability. "In this specific sense," says Dhonte, "'good governance' is an integral component of IMF programs."
- Conditionality must remain realistic and firm because it is of little use otherwise. A rule of law is in place only when it is binding; conditionality must provide an effective system of incentives and disincentives for its enforcement.
- It all takes time and effort. Adjustment programs not only change policies, they constrain policymaking discretion. Efforts to curb discretionary authority—for example, establishing transparent fiscal accounts or implementing effective budgetary control—will be resented and resisted. The difficulties inherent in establishing a truly high-quality civil service or an independent and effective judiciary make sweeping reforms a slow process.
- The role of the initial, sometimes lengthy, program negotiations is essential. It is the IMF's participation in these negotiations—and awareness of the authorities' commitment to a program's goals—that allows it to support a program even though the country may still have limited market credibility.

Finally, in evaluating adjustment programs, Dhonte cautions that it is important to ask the right questions. Given the lengthy time frame and complex nature of the reforms that are undertaken, it is more pertinent for evaluators to ask whether progress is being made in building capacity and in formulating and implementing policy than in attempting to measure improvements in the ultimate objective—sustainable growth. ■

Copies of IMF Paper on Policy Analysis and Assessment 97/2, *Conditionality as an Instrument of Borrower Credibility*, by Pierre Dhonte, 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 The full text is also available on the IMF's web site (http://www.imf.org).

When Are Current Account Imbalances Sustainable?

From the late 1970s to early 1980s and again in the early 1990s, the lion's share of total international capital flows went to the developing countries of East Asia and Latin America. Many of these countries ran large and persistent current account deficits financed by these inflows. As the Mexican financial crisis in late 1994 demonstrated, however, abrupt reversals in international capital flows can cause serious problems for economies with large external imbalances.

The relationship between protracted current account deficits and external crises—such as an exchange rate collapse—has spurred interest in the question of what determines whether current account deficits are sustainable. An IMF Working Paper, *Current Account Sustainability: Selected East Asian and Latin American Experiences*, by Gian Maria Milesi-Ferretti and Assaf Razin, examines episodes of large and protracted current account imbalances during the early 1980s and the early 1990s in three East Asian developing countries (Korea, Malaysia, and Thailand) and in three Latin American developing countries (Chile, Colombia, and Mexico). Of the ten episodes examined, three ended in an external crisis. The authors find that the likelihood of a protracted current account imbalance resulting in an external crisis depends in large part on key macroeconomic and structural features of the economy—in particular, the level of savings and investment, the degree of openness, the level and flexibility of the exchange rate, and the health of the financial system.

Measures of Sustainability

Two pertinent questions that need to be addressed in evaluating the macroeconomic and external implications of persistent current account deficits are: Is the debtor country solvent, and is its current account imbalance sustainable?

Solvency. If a country has the ability to generate sufficient trade surpluses in the future to repay existing

debt, then it meets the solvency criterion. This, however, may not be the most appropriate criterion for evaluating the viability of external imbalances, because it takes for granted the country's willingness to pay its creditors and the willingness of foreign investors to lend to the country on current terms.

Sustainability. The authors therefore propose the broader notion of sustainability, which explicitly takes into account willingness to pay and willingness to lend. For a country that has positive net external liabilities and is running persistent trade and current account deficits, a "turning point" from deficits to surpluses will eventually be necessary to maintain solvency and sustainability. An important measure of sustainability is whether this turning point can be achieved smoothly and without disruptions in economic activity, or whether it is forced upon the economy by events, such as a sudden reversal of capital flows. If the trade account turns smoothly from deficit to surplus (that is, without drastic changes in consumption and economic activity) without the authorities having to change the current policy stance substantially, the deficit is likely sustainable. If, however, the turning point ultimately requires a drastic policy shift (such as a sudden tightening) and is accompanied by severe macroeconomic distress in the form of sharp drops in consumption and economic activity, the deficit is not sustainable.

Comparing Country Experiences

During both the early 1980s and the early 1990s, the East Asian countries in the sample had higher levels of savings and investment and a higher degree of openness than the Latin American countries. The East Asian countries also had a considerably lower ratio of debt to exports and recorded substantially larger increases in national savings and domestic investment.

Imbalances in the 1980s. All the countries reviewed were subject to a substantial worsening in external conditions, including large terms of trade shocks, a considerable increase in world interest rates, and reduced demand owing to the world recession of 1981–83. In addition, all six countries experienced a sustained real exchange appreciation.

In Malaysia, Thailand, Colombia, and Mexico the current account deficits were also associated with large fiscal imbalances. The policy adjustment undertaken therefore involved both a large fiscal consolidation and a nominal depreciation of the exchange rate. The resulting real depreciation, together with an output slowdown, temporarily raised the ratio of external debt to GDP. In Malaysia and Thailand, however, where the authorities took pre-emptive action and therefore avoided a crisis, the real depreciation also spurred export growth, reducing the current account deficit. As a result, the external debt-to-GDP ratio started to decline.

Imbalances in the 1990s. The experience during the early 1990s differed considerably from the early 1980s. On the external side, short-term interest rates were low and economic activity in the industrial countries was weak. At the same time, the improvement in the economies of many developing countries that had implemented market-oriented reforms and macroeconomic stabilization policies attracted a new wave of capital inflows, much of it in the form of portfolio and foreign direct investment. On the policy side, macroeconomic conditions were generally more stable in the 1990s than in the 1980s; none of the six countries experienced sustained fiscal imbalances; and current account imbalances mainly represented a gap between private savings and private investment.

Capital Account Developments. In all the countries under review, the capital account was more open and

Macroeconomic Indicators

	Chile 1979–81 (1982–83)	Colombia 1980–84 (1985–88)	Colombia 1992–95	Mexico 1977–81 (1982–83)	Mexico 1991–94 (1995)	Korea 1977–82 (1983–88)	Malaysia 1979–84 (1985–86)	Malaysia 1991–95	Thailand 1979–84 (1985–86)	Thailand 1991–95
Current account balance	–9.1 (7.6)	–5.1 (0.5)	–3.4	–5.0 (0.3)	–6.7 (–0.3)	–5.4 (2.6)	–8.2 (–1.1)	–5.7	–6.1 (–1.7)	–6.7
Saving	7.4 (5.9)	14.6 (20.5)	16.4	18.7 (22.0)	15.7 (17.9)	25.6 (31.6)	26.6 (25.7)	30.0	22.5 (26.9)	34.0
Exports	19.7 (21.3)	12.6 (18.1)	18.3	10.6 (17.2)	12.7 (24.0)	32.5 (36.9)	53.2 (55.6)	82.4	23.0 (27.8)	36.6
Real effective exchange rate	124.1 (118.5)	135.5 (80.2)	77.6	126.4 (103.5)	113.9 (76.0)	103.6 (92.2)	117.9 (111.8)	83.5	115.5 (95.0)	88.5
Fiscal balance	2.1 (–3.3)	–3.5 (–1.0)	–0.8	–8.0 (–11.2)	0.4 (0.0)	–2.8 (0.0)	–14.5 (–8.9)	–1.5	–4.3 (–2.8)	3.2
Gross external debt	48.2 (89.5)	40.8 (43.3)	28.9	31.4 (62.7)	35.5 (65.1)	50.0 (19.6)	55.2 (78.9)	35.1	35.9 (35.1)	42.6

Note: Current account balance, saving, exports, and fiscal balance are average ratios of GDP during the period. The real effective exchange rates are period averages (REER: average 1970–95=100). Gross external debt figures are ratios to GDP and refer to the last year of the period. Figures in parentheses reflect the succeeding adjustment period.

Data: IMF, Working Paper 96/110, *Current Account Sustainability: Selected East Asian and Latin American Experiences*

the financial system considerably more liberalized in the 1990s than a decade earlier, although the degree of liberalization differed across countries. The composition of capital flows also changed dramatically between the early 1980s and early 1990s. During the earlier period, all the sample countries relied heavily on commercial bank lending in the form of syndicated loans as well as on borrowing from official creditors. In contrast, during the 1990s, inflows were dominated by private capital, a sizable proportion of which took the form of foreign direct investment.

Macroeconomic Indicators of Sustainability

During the early 1980s and the early 1990s, each of the six countries under review experienced episodes of protracted current account imbalances (see table, page 84). Of the ten episodes, three—Chile (1979–81) and Mexico (1977–81 and 1991–94)—resulted in a financial crisis. An examination of these episodes reveals important relationships between a number of macroeconomic indicators and external sustainability.

Ratio of Exports to GDP. To service debt and reduce external indebtedness, a country needs to rely on the production of traded goods as a source of foreign exchange. Countries with a large export sector can service external debts more easily, because debt service will absorb a lower fraction of total export proceeds. Among the sample countries, Korea, Malaysia, and Thailand—which adjusted successfully after experiencing large current imbalances—had a large export share and managed to increase exports substantially during the adjustment period. Thus, the authors conclude, large current account imbalances are less likely to lead to external crises when the economy has a large export base.

Real Exchange Rate. A persistent real exchange rate appreciation can be driven by "fundamental" factors, such as high productivity growth in the traded goods sector or favorable terms of trade shocks. In a fixed or managed regime, however, an appreciation could also reflect a fundamental inconsistency between the monetary policy stance and exchange rate policy, giving rise to overvaluation typically maintained by high domestic interest rates. A real exchange rate appreciation can also result from large capital inflows. In developing countries that have undertaken structural reforms, large capital inflows and a real exchange rate appreciation may reflect an increase in productivity and in the return to capital.

It is extremely difficult to evaluate to what degree a real appreciation reflects improved fundamentals rather than an overvaluation masking distortions in the economy. Nevertheless, the three crisis episodes reviewed were all characterized by a sustained real exchange rate appreciation in the period preceding the crisis. The evidence therefore suggests, say the authors, that large current account imbalances are more likely to result in a crisis when accompanied by a relatively appreciated level of the exchange rate.

Domestic Savings and Investment. High investment levels imply higher future growth through the buildup of a larger productive capacity. High savings and investment ratios can also be a signal to international investors of creditworthiness, implying a country's commitment to higher future output and raising its perceived ability to service and reduce external debt. In all three crisis episodes, savings were low in the affected countries, especially by middle-income developing country standards. In both Chile and Mexico during the second crisis (1991–94), the low rates were attributable to low private saving, rather than public sector imbalances. In contrast, Korea, Malaysia, and Thailand all had high saving and investment rates.

Fiscal Balance. The observed links between budget deficits and current account deficits—and, hence, between government budget solvency and current account sustainability—are especially strong in countries with underdeveloped or highly regulated financial markets. Nevertheless, as the pre-crisis fiscal surpluses prevailing in Chile (2.1 percent of GDP in 1979–81) and Mexico (0.4 percent of GDP in 1991–94) demonstrate, the absence of large fiscal imbalances does not imply that current account deficits will prove sustainable. The external crises did, however, entail large post-crisis costs for the government in the form of bailouts of banks and firms, as well as the budget's assumption of private external debt. Also, the large fiscal imbalances in Mexico (1977–81), Malaysia (1979–84), Colombia (1980–84), and Thailand (1979–84)—whether or not they culminated in an external crisis—did require a policy shift. In fact, the main element of the policy reversal in these countries was a substantial reduction of the fiscal deficit. In all four countries, the increase in public saving raised the overall saving rate and helped reduce external imbalances.

Sustaining Future Imbalances

The economies of East Asia reviewed in the IMF Working Paper are characterized by a higher degree of openness and higher levels of savings and investment than their Latin American counterparts. The track record of the East Asian countries over the last 25 years, the authors conclude, provides compelling evidence for why these macroeconomic and structural features can help an economy sustain protracted current account imbalances. ■

Copies of IMF Working Paper 96/110, *Current Account Sustainability: Selected East Asian and Latin American Experiences*, by Gian Maria Milesi-Ferretti and Assaf Razin, 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

Achieving Low Inflation In Transition Economies

A key issue for IMF-supported macroeconomic stabilization and reform programs in transition countries is whether the persistence of moderate inflation—levels of about 20–40 percent a year—results from the traditional causes of insufficiently tight financial policies and wage pressures or from conditions peculiar to transition economies: specifically, the sizable adjustment of relative prices necessary for transformation to a market-based economy. A new IMF paper on Policy Analysis and Assessment, entitled *Designing Disinflation Programs in Transition Economies: The Implications of Relative Price Adjustment*, by Sharmini Coorey, Mauro Mecagni, and Erik Offerdal, addresses this question through an examination of the inflation-fighting experiences of 21 transition economies (Eastern Europe, the Baltic states, and the other countries of the former Soviet Union) between 1990 and 1995. Based on the empirical evidence, the authors conclude that money growth, inertia, and wage pressures play a dominant role in explaining inflation in transition economies. Relative price variability appears to have a sizable impact during the initial liberalization period, but a small effect in the later stages of transition. The evidence also suggests, however, that significant relative price adjustments take place throughout the transition period, even well beyond comprehensive initial liberalization, and that money growth in the later stages of transition may reflect—depending on exchange rate policy—surges in capital inflows.

Money growth plays a dominant role in explaining inflation in transition economies.

Determinants of Inflation

Five key variables largely explain the stickiness of inflation in transition economies:

- monetary growth fueled by fiscal obligations, often reflecting delayed structural reforms;
- inflation inertia reflecting explicit or implicit wage indexation and the slow adjustment of inflation expectations;
- wage increases out of line with productivity gains;
- underlying pressures for an appreciation of the real exchange rate coupled with a policy of resisting nominal appreciation through official intervention in foreign exchange markets; and
- relative price adjustment combined with downward price rigidities.

Principal Findings

Key findings of the IMF study include the following: *Money growth* plays a dominant role in explaining inflation, contributing, on average, about one-third to one-half of inflation recorded in all three regions. Inflation is more responsive to broad money, including foreign currency deposits and domestic credit of the banking system, than to a monetary aggregate that excludes foreign currency deposits. The implication is that tighter monetary control could help lower inflation in the presence of wage and relative price shocks.

Inflation inertia—reflecting backward-indexation or backward-looking expectations in wage and price formation—is a more significant influence at moderate levels of inflation, suggesting that the output costs involved in lowering inflation tend to increase at these levels. Inertia, as measured by lagged inflation, appears to have contributed about one-fourth to one-third of the inflation in Eastern Europe and the Baltic states, but was insignificant in the high-inflation countries of the former Soviet Union.

Wage increases also appear to have a sizable effect on inflation accounting, on average, for about one-fifth to one-fourth of inflation in Eastern Europe and the countries of the former Soviet Union. Wage pressures do not appear to be a significant factor in the Baltic states.

Relative price variability, overall, has a statistically significant impact on inflation, although—more than in the case of the other explanatory variables—the size of the effect varies by region and over the sample period. Variability appears to have a larger impact (accounting for about one-fifth or one-sixth of inflation) early in the transition and, in the countries of the former Soviet Union, is associated with nominal wage shocks. The estimated contribution is generally small (less than one-twentieth) in the Baltic states and in the post-liberalization period in Eastern Europe. Relative price variability appears to be associated with downward price rigidity at moderate levels of inflation.

Relative prices continue to adjust and, hence, display a high degree of variability throughout the transition period, even in countries that have undertaken comprehensive initial price liberalization. The persistence of relative price variability might reflect the limited speed of structural reforms and the changing composition of output and demand associated with gradual movement toward a market economy; or the "cost-recovery hypothesis"—namely, that certain capital-intensive, nontradable prices, such as housing and utilities, must adjust more gradually than other prices. The cost-recovery hypothesis may provide an additional explanation for the steep real currency appreciation in transition economies.

Relative price adjustments arise from different sources. Sharp increases in relative price variance

(which are often concurrent with spikes in inflation) early in the transition frequently coincided with periods of intensive trade and price liberalization, wage and administered price increases, tax reform, and terms of trade shocks—at times accompanied by monetary accommodation. Following this initial sharp burst, variance typically declined, but remains high relative to market economies. The evidence also offers support for the cost-recovery hypothesis—particularly in countries in the later stages of transition.

Real appreciation is not estimated to have a significant impact on inflation, except for a small dampening effect (for a given rate of money growth) observed for Eastern Europe.

Substantial and protracted relative price variability and real appreciation are features of transition economies, but the limited direct impact on inflation estimated for these variables may reflect rapid monetary accommodation through foreign exchange inflows in these small, open economies (particularly in the Baltic states). Evidence from case studies suggests that money growth from such sources can be substantial at moderate inflation ranges.

Policy Consequences

The following policy consequences can be derived from the authors' empirical analysis of price adjustment effects on inflation performance in the 21 transition economies:

• Given the variation in the size of the impact of relative price variability on inflation across regions and time periods, the potential importance of such an effect has to be assessed in individual country cases. Relative price adjustment cannot be said to set a "floor" on inflation, provided there is a willingness to use monetary policy sufficiently aggressively. But sizable and continuous relative price changes add to the costs to growth of tightening monetary policy sufficiently to achieve low inflation, particularly at moderate levels of inflation where inertia and downward price rigidity play a greater role.

• The worsening of any given trade-off between inflation and output growth (at least at moderate inflation rates) suggests that for a given set of preferences between these objectives, policy-makers may choose to tolerate a higher level of inflation in the presence of substantial relative price adjustment. Against this must be set the risks, and opportunity costs, of remaining at moderate inflation levels. While rapid disinflation may be still optimal if the long-term benefits are sufficiently large relative to short-term costs, the presence of relative price shocks may tilt the balance in the direction of a more gradual, but sustained, reduction in inflation.

• In view of the potential short-term conflict between relative price adjustment and disinflation, programs need to guard against the risk that structural reforms and the adjustment of public service prices may be delayed in order to achieve low inflation targets.

Countries in Transition: Medium-Term Inflation Scenario
(annual percent change)

	1990	1991	1992	1993	1994	1995	1996	Average 1991–96	Average 1996–2001
Countries in transition	**34.6**	**95.8**	**681.2**	**614.3**	**264.8**	**128.0**	**41.3**	**265.9**	**9.5**
More advanced[1]	191.0	73.8	93.6	53.6	28.6	21.9	16.5	40.3	8.1
Less advanced[2]	5.9	102.5	1,088.8	1,100.6	463.2	203.9	54.7	419.4	10.2
Central and Eastern Europe[3]	133.8	98.9	114.8	79.2	46.2	25.8	20.6	53.6	8.4
Belarus, Russia, and Ukraine	5.5	91.8	1,259.7	1,293.7	427.2	234.9	55.4	456.5	9.9
Transcaucasus and Central Asia	5.0	110.9	1,001.9	1,243.6	1,610.7	258.7	68.9	587.4	12.3

[1]Albania, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, former Yugoslav Republic of Macedonia, Mongolia, Poland, Slovak Republic, and Slovenia.
[2]Armenia, Azerbaijan, Belarus, Bulgaria, Georgia, Kazakstan, Kyrgyz Republic, Moldova, Romania, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
[3]Excluding Belarus, Russia, and Ukraine.

Data: IMF, *World Economic Outlook*, October 1996, page 79.

• The significant impact of nominal wage pressures in both high and moderate inflation contexts indicates the need for vigilance in programs in the area of wage growth, particularly with regard to backward indexation, which would add to inertia.

• Regardless of the presence of relative price effects, controlling money growth—whatever its source—is essential for disinflation. This brings to the fore a dilemma for exchange rate policy: an exchange rate anchor may play an effective anchoring role in high-inflation contexts, but can also slow disinflation in transition economies with moderate inflation by permitting monetary accommodation of various nominal and relative price shocks. A money-based anchor could, in principle, help lower inflation in the latter circumstances, but the resulting nominal appreciation is likely to entail output costs unless accompanied by productivity-enhancing structural reforms.

• If an exchange rate strategy is chosen—and there may be good reasons for not abandoning such a strategy once it is in place—or if firm commitments cannot be obtained with regard to permitting nominal appreciation, inflation targets should reflect the likelihood that moderate inflation will persist. Although inflation may eventually decline as relative price adjustment is completed, other factors, such as inertia, may entail output costs at this later stage.

• If programs envisage a gradual reduction of inflation from moderate levels, increased exchange rate flexibility—through either a switch to a money-based anchor or a widening of an exchange rate band—may be needed. If a more rapid reduction of inflation to low levels is targeted, strong and credible commitments would be needed to limit the extent of foreign exchange intervention, thus controlling money growth and allowing nominal appreciation, particularly if ambitious structural reforms are also envisaged.

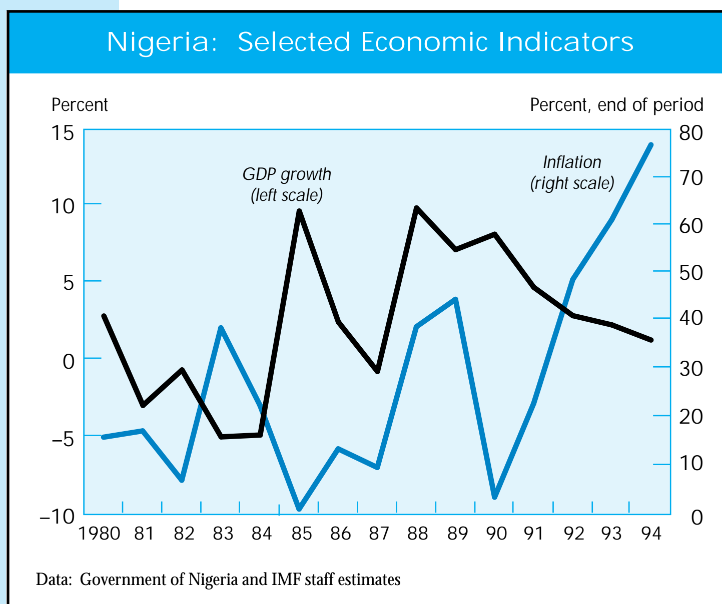
• Sterilization operations may need to be limited, since there may be a temptation to pursue the inflation target while resisting nominal appreciation by resorting to sterilization. This would be both a costly burden on already weak fiscal positions and of limited effectiveness if pressures for appreciation are persistent, as suggested by the cost-recovery hypothesis. ■

Designing Disinflation Programs in Transition Economies: The Implications of Relative Price Adjustment, by Sharmini Coorey, Mauro Mecagni, and Erik Offerdal, is No. 97/1 in the IMF's Papers on Policy Analysis and Assessment series. Copies are available for $7.00 from Publication Services, Box XS700, International Monetary Fund, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax (202) 623-7201; Internet: publications@imf.org The full text is also available on the IMF's web site (http://www.imf.org).

Nigeria's Economic Ills Linked to Inconsistent Policy Implementation

Nigeria's economic policy stance over the past two decades has been characterized by resistance to comprehensive structural adjustment. Much of the country's economic troubles—including debasement of its currency, high inflation, crippled domestic industry, high interest rates, high unemployment, and the spread of poverty—resulted from a combination of erratic macroeconomic policies, weak management of the country's rich natural resources, and inefficient public investments. For a brief period (1986–90), the government vigorously pursued a structural adjustment program, which brought about substantial economic growth and employment expansion. The program went off track by 1991, however, as the government abandoned its efforts to tighten financial policies in the face of mounting political pressures and the temporary surge in world oil prices. In 1995, the government initiated a partial deregulation of the economy, which yielded benefits on the inflation and exchange rate fronts. A new IMF Occasional Paper, *Nigeria: Experience with Structural Adjustment*, 1986–94, by Gary Moser, Scott Rogers, and Reinold van Til, analyzes the country's key economic policies and performance during 1980–94. It gives particular emphasis to the 1986–90 structural adjustment period.

Nigeria: Selected Economic Indicators



Data: Government of Nigeria and IMF staff estimates

Policy Errors in the 1970s and 1980s

During the 1970s, Nigeria evolved from a poor agricultural economy into a relatively rich, oil-dominated one. Misdirected policies during this period, however, left Nigeria vulnerable. The government concentrated public investment in costly, often inappropriate, infrastructure projects with questionable rates of return; promoted inward-looking industrial policies that bred an uncompetitive manufacturing sector; and neglected the agricultural sector. Despite a dramatic rise in oil revenue, the government also failed to strengthen public finances, and expansionary financial policies contributed to an acceleration of inflation. An appreciating real effective exchange rate that followed the surge in oil prices toward the end of 1973 eroded the competitiveness of the nonoil tradable goods sector.

During the early 1980s, the collapse of world oil prices, together with a sharp decline in petroleum output resulting from a lowering of Nigeria's quota in OPEC (Organization of Petroleum Exporting Countries), severely weakened the country's precarious external and fiscal positions, reflected in dwindling international reserves and collapse of the government's revenue base. The growing scarcity of foreign exchange hurt the import-sensitive manufacturing sector, and a steady appreciation of the real effective exchange rate depressed agricultural exports.

During 1981–85, subsequent governments undertook ill-fated efforts to stabilize the economy in the face

of the substantial decline in the terms of trade. Short-run fiscal stabilization measures and quantitative trade controls dominated the country's adjustment efforts, while underlying economic and financial conditions worsened. The negative impact of an overvalued exchange rate on oil and customs revenue, coupled with the depressing effect of increasingly complex import controls on the customs tax base, exacerbated the difficulties. Government intervention in key areas of the economy discouraged private sector activity and impeded the supply response essential to a sustained recovery.

In 1986, recognizing that short-run stabilization measures and increased regulation were inappropriate responses to deep-seated impediments to growth, Nigeria's economic policymakers embarked on a comprehensive structural adjustment program. Despite reversals and setbacks, the staff analysis shows that the structural adjustment program paid off. The authorities made significant progress in liberalizing the economy, specifically through reforming the exchange and trade system and freeing prices, which resulted in accelerated economic growth. Macroeconomic policy implementation remained erratic, however, and failed to bring inflation under control. The reversal and weakening of key policies since 1991 led to prolonged stagflation. Popular support for liberalization never took hold and adjustment fatigue set in, culminating in the official abandonment of the structural adjustment program in 1994.

In 1995, the government adopted a more limited policy shift. It moved to partially deregulate the economy by introducing a dual exchange rate system, liberalizing exchange controls, and restoring the role of the foreign exchange bureaus—along with stabilization measures centered on tightening fiscal policy. Gains were made in reducing demand pressures, which has resulted in a stabilization of the exchange rate.

Nigeria's experience confirms that inconsistent and unpredictable policies generate internal shocks that translate into extreme volatility in economic and financial variables. The country's sometimes positive experience with structural adjustment shows that sustainable reform requires continuity and coherence in fiscal, monetary, and exchange rate policies. It illustrates also that the scope of reform must be comprehensive, encompassing all major sectors of the economy (particularly the oil sector in Nigeria), and that the achievement of macroeconomic stability is essential for raising the productivity of human and physical capital. ■

Christine Hellemaa
IMF External Relations Department

Copies of IMF Occasional Paper 148, *Nigeria: Experience with Structural Adjustment, 1986-94*, by Gary Moser, Scott Rogers, and Reinold van Til, 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

Botswana Seeks Economic Diversification

(Continued from front page) The strength of its external position, as reflected in sizable current account surpluses, has contributed to the accumulation of substantial official reserves—estimated at more than $5 billion at the end of 1996, equivalent to 29 months of imports. Prudent financial policies have held inflation in check, while the maintenance of a competitive and stable exchange rate has stimulated nontraditional exports.

During 1992–94, Botswana had to contend with a serious economic recession brought about by the weakening international diamond market, the impact in 1991 of the worst droughts of the century, and the collapse of the construction sector in the wake of financial irregularities in 1992. The authorities responded to these challenges by tailoring their development strategy to emphasize economic diversification and liberalization, taking advantage of the potential for regional economic cooperation.

Development Strategy Through the Early 1990s

Through the early 1990s, Botswana pursued a development strategy that relied heavily on public investment in the diamond sector and an expansion of the public sector. Three diamond mines were opened between 1971 and 1982, boosting diamond exports to 15 million carats a year by 1992. As a result, GDP originating from the diamond sector grew on average by about 10 percent annually, and public expenditures reached 41 percent of GDP in 1992. Overall growth was strong and formal sector employment expanded at an annual average of nearly 8 percent. A well-developed infrastructure was put in place, and Botswana's social indicators improved substantially from the 1970s through the early 1990s. School enrollment, access to health care, and life expectancy at birth increased significantly and the fertility and crude death rates fell sharply. These achievements ranked Botswana high, within the sub-Saharan African region, on the United Nations Development Program's human development indexes.

Financial policies pursued during this period up to the early 1990s were generally prudent, yielding sub-

stantial budgetary and external account surpluses. These facilitated a steady accumulation of international reserves, accompanied by restrained external borrowing. Nonetheless, the authorities did not give sufficient scrutiny to the efficiency of public investment and the quality of recurrent expenditures during this period. Although Botswana did not embark upon major white elephant projects, it did adopt expenditure programs that entailed substantial concessional lending to public enterprises and the pursuit of self-sufficiency policies—notably, in crop production and power generation—that contributed to inefficiency.

Notwithstanding the impressive social and economic achievements to date, Botswana's economy has remained narrowly based as only limited diversification was achieved under the previous economic strategy. The government's efforts to encourage private sector growth were frustrated by the excessive public sector involvement in economic activities. As noted in the 1994 midterm review of the Seventh National Development Plan (1991/92–1996/97), "economic diversification—the thrust of the plan—proved difficult to achieve, in part, due to the failure to implement approved policies and an overambitious development program, and because diversification was *approached as* a long-term process." Furthermore, the economy's duality persisted, and limited progress was made in improving the plight of rural and low-income urban households.

The lack of diversification was acutely felt when the diamond market weakened and the economy entered a recession during 1992–94. Real GDP growth slowed to about 2 percent a year, employment in the formal sector declined, while unemployment—especially among school leavers and dislocated workers—rose as the manufacturing, mining, and construction sectors shed labor. The financial position of the central government weakened—the fiscal surplus narrowed to 1.9 percent of GDP in 1995/96 from 8.6 percent in 1991/92, owing largely to difficulties in slowing expenditure growth. At the same time, the country's external current account surplus fluctuated widely through 1994. As a consequence, doubts arose about the long-term viability of the prevailing economic development strategy, underscoring the urgency to emphasize diversification and private sector activity.

Botswana: Main Economic Indicators

	1990	1991	1992	1993	1994	1995	Prelim. 1996	Proj. 1997
				(annual percent change)				
Real GDP [1]	5.6	8.7	6.3	–0.1	4.1	3.1	7.0	6.3
of which:								
Mining GDP	–3.3	6.7	1.9	–4.6	5.0	5.0	8.9	5.7
Consumer prices (end of period)	12.0	12.6	16.5	12.7	9.8	10.8	9.6	8.0
Domestic credit (private sector)	43.0	37.4	34.4	11.7	18.0	–3.6	–3.9	19.8
				(percent of GDP)				
Central government [2]								
Revenue	46.1	52.4	49.9	52.1	50.5	36.7	38.2	42.2
Expenditure	37.1	41.2	41.4	42.2	42.2	35.1	36.4	39.5
Overall surplus (including grants)	9.0	11.2	8.6	9.9	8.3	1.6	1.9	2.7
External current account	1.1	8.6	5.9	12.1	5.5	6.9	5.6	5.9
				(percent of exports of goods and services)				
External debt	5.5	5.3	4.5	4.5	4.6	4.2	1.3	3.1
				(months of imports of goods and services)				
Gross international reserves	20.1	22.4	24.0	27.6	31.6	27.8	29.0	28.2

[1]National accounts year ending June 30 of the year indicated.
[2]Fiscal year beginning April 1 of the year indicated.
Data: Botswana authorities and IMF staff estimates

Government Shifts Policy Gears

The impetus for a policy shift came in response to several adverse developments, and it has gathered considerable momentum during the preparation of Botswana's Eighth National Development Plan (1997/98–2002/03). The policy change focuses mainly on stimulating private sector activity through:

- introducing institutional reforms;
- removing market impediments; and
- strengthening financial policies.

Botswana's intensified diversification effort targets the private export-oriented manufacturing sector, for which the authorities seek to provide stronger and more focused support. To this end, the authorities have reviewed and considerably improved existing policy frameworks and institutional arrangements. For example, tax and other incentives under the Industrial Development Policy and the Financial Assistance Policy (the latter provides grants to qualified firms) are more targeted to export manufacturing, while the Trade and Investment Promotion Agency has become autonomous and assumed a broader role. Moreover, under the Accelerated Land Servicing Program, fully serviced industrial plots and/or factory shells should be more readily available to investors. In 1995, Botswana joined the regional power grid, leading to a 10 percent reduction in electricity tariffs.

To foster efficient domestic markets after the major drought, Botswana has shifted from a policy of self-sufficiency in food to food security and eliminated crop subsidies in favor of regional trade and import parity crop pricing. The government has reduced cor-

porate and personal income tax rates to 25 percent (15 percent for manufacturing firms) from 35 percent, and it has lowered external tariffs and simplified their structure in the context of the Southern African Customs Union and the World Trade Organization. The authorities also liberalized external current account transactions. (In November 1995, Botswana accepted the obligations of the IMF's Article VIII, agreeing not to impose restrictions on payments and transfers for current international transactions.) Moreover, in the last few years, Botswana has liberalized most capital account transactions; most significantly, 70 percent of the portfolio of institutional investors (such as pension funds) can now be invested abroad, compared with 50 percent previously. As a result of the liberalization of the external sector, nontraditional exports have grown rapidly—averaging 30 percent a year during 1994–96—including vehicle assembly, textiles, and food processing, which have captured sizable export markets in South Africa.

The weakening of Botswana's public finances, as reflected in the sharp decline in the fiscal surplus in the early 1990s, prompted the authorities to reorient revenue and expenditure policies. Such reorientation was also seen as essential to move toward a more efficient but diminished role for the public sector. To reduce reliance on diamond revenue, the authorities have extended coverage of the sales tax to more goods and to services as a prelude to the introduction of a value-added tax; at the same time, tax administration is being improved with new hiring, expanded training, and computerization. On the expenditure side, public sector wage increases were limited to about 4 percent a year during 1994/95–1996/97, while lending to public enterprises has been increasingly restricted. There are ongoing reforms in the civil service to retrench nonperforming employees while providing more formal and on-the-job training to enhance productivity. Several government departments have been identified as candidates for privatization, and efforts are being made to contract out some government services. The budget for 1997/98, which projects a widening in the overall surplus to 4 percent of GDP, reflects considerable expenditure restraint.

A number of public enterprises—notably Air Botswana and Botswana Housing Corporation—have recently been restructured, while a significant portion of the activities of the Botswana Development Corporation and the Botswana Telecommunication Corporation have been privatized and operate increasingly on a commercial basis. These reforms and the reduced availability of government loans have led to important improvements in the financial performance of the public enterprise sector.

In the financial sector, since 1991, the monetary authorities have relied on sales of Bank of Botswana certificates and the bank rate as the main instruments of monetary policy. Measures to mop up excess liquidity in the economy have contributed to considerable moderation in the growth of domestic nongovernment credit and, since 1992, a declining trend in inflation. Other important reforms have included the passage of the new Banking Act (1995), the Botswana Stock Exchange Act (1995), and the new Bank of Botswana Act (1996). The new laws provide an updated legal framework that will facilitate financial sector development and financial intermediation.

Future Policy Directions

The Eighth National Development Plan, whose theme is "sustainable economic diversification," is expected to be submitted to Parliament in mid-1997. It is likely to reflect concerns about the continued high dependence on the diamond sector and efforts to exploit regional opportunities to foster a dynamic export-oriented private sector. As indicated in the 1997/98 budget speech by the Vice President and Minister of Finance and Development Planning, the plan commits the authorities to continue prudent macroeconomic policies and promote an environment conducive to economic diversification, employment creation, and poverty alleviation. The recent expansion of the Jwaneng diamond mine and the planned expansion of the Orapa mine by 2000 are expected to raise Botswana's production capacity by one-third to 24 million carats a year, promising bright prospects for this sector over the medium term. Nonetheless, the authorities remain firmly committed to executing the National Development Plan to provide a broader basis for growth, employment generation, and poverty alleviation. ■

Robin Kibuka and Charles Mordi
IMF African Department

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
March 10	3.96	3.96	4.33
March 17	3.98	3.98	4.35

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

El Salvador: Stand-By

The IMF approved a 14-month stand-by credit for El Salvador, equivalent to SDR 37.7 million (about $52 million), to support the government's 1997 economic program.

Since the end of the 12-year long civil war in 1990, and through 1995, economic growth in El Salvador averaged more than 6 percent a year, fostered by the implementation of economic reform and structural policies supported by consecutive IMF stand-by credits. Significant progress was made in reforming the tax system and the labor market and, recently, in privatization, as well as in the implementation of the peace accords in the context of strengthening the fiscal position. These achievements notwithstanding, there has been less success in reducing inflation to international levels.

Economic activity decelerated between mid-1995 and mid-1996 as a result of a burst in private consumption, the end of a construction boom, and the effect on external competitiveness of adverse external shocks. At the same time, inflation remained high—in part because of increases in the international prices of cereals and oil. As a result, the colón continued to appreciate in real effective terms, contributing to the erosion of external competitiveness. However, in the second half of 1996, there were signs of a turnaround: the pace of economic activity picked up, inflation decelerated, and external competitiveness improved.

El Salvador: Selected Economic Indicators

	1993	1994	1995	1996[1]	1997[2]
			(percent change)		
Real GDP	7.4	6.0	6.3	2.0–2.5	3.5–4.0
Consumer prices (end of period)	12.1	8.9	11.4	7.4	5–6
			(percent of GDP)		
Overall fiscal balance (excluding grants)	–3.6	–1.9	–0.9	–1.8	–1.4
External current account balance (excluding official transfers)	–4.4	–3.7	–5.1	–2.1	–2.8
			(months of imports)		
Gross international reserves	4.2	4.2	3.9	4.9	5.1

[1]Estimate.
[2]Program.

Data: Salvadoran authorities and IMF staff estimates

Medium-Term Strategy and the 1997 Program

The program for 1997 aims at strengthening public finances while accommodating larger outlays for infrastructure, maintaining an appropriate monetary policy, and continuing to advance structural reforms. It envisages a real GDP growth of about 4 percent in 1997, a reduction of the overall deficit of the nonfinancial public sector to 1.4 percent of GDP, a decline in inflation to 5–6 percent, and an increase in net international reserves to the equivalent of five months of imports.

To strengthen public finances in the context of modernizing the public sector and improving social expenditure, the authorities have stepped up efforts to contain current expenditure and increase tax collections. Along these lines, new positions will be offered only in priority sectors of the public administration, such as health and education. As a result of efforts made to improve tax collections, the tax ratio is expected to rise from 11.1 percent of GDP in 1996 to 11.8 percent of GDP in 1997, despite a reduction in import duties.

Structural Reforms

Following approval in September 1996 of the necessary legislation, the sale of 49 percent of the telephone company (ANTEL) and of the first of four electricity distribution companies is expected to be completed in the first half of 1997, with the other three companies to be sold by year's end. It is also expected that the telecommunications system will be fully privatized in two years.

The physical and financial implementation of the public investment program will be prioritized, monitored, and controlled through a unit of administration of public investment, under the Ministry of Finance. Legislation was also passed in December 1996 to reform the pension system and substitute the current pay-as-you-go system with privately administered individual accounts.

Addressing Social Needs

Social expenditure increased to 4.8 percent of GDP in 1996 from 3.5 percent in 1995 and will be maintained at that level in 1997, while military expenditure was contained at 1 percent of GDP in 1996 and will be reduced to 0.9 percent in 1997. The government attaches great importance to expanding and improving basic health and educational services as well as ensuring public safety in order to facilitate the development of the economy.

The Challenge Ahead

El Salvador's performance in the areas of public expenditure, monetary policy, and structural reform has been remarkable since the end of the civil war. However, a further tightening of fiscal policy and the continuing implementation of structural reforms to increase productivity are required to lay the basis for the recovery of private investment and growth. In addition, attainment of the inflation objective is fundamental to prevent loss of external competitiveness.

El Salvador joined the IMF on March 14, 1946, and its quota is SDR 125.6 million (about $174 million); it has no outstanding use of IMF credit.

Press Release No. 97/11, March 3

Croatia: EFF

IMF approved a three-year credit for Croatia equivalent to SDR 353.2 million (about $486 million) under the extended Fund facility (EFF) to support the government's medium-

Photo Credits: Hong Kong Monetary Authority, page 96.

term economic reform program for 1997–99. Of the total approved, credits equivalent to SDR 115 million (about $158 million) will be available to Croatia in 1997.

Croatia began the transition to a market economy with high and rising rates of inflation, economic disruption owing to the breakup of the former Socialist Federal Republic of Yugoslavia, and the unsettled regional security situation. In spite of difficult circumstances, Croatia began implementing a stabilization program in October 1993, which was supported by the IMF through a stand-by credit and the systemic transformation facility (STF). Fiscal and monetary control were broadly restored; and, fostered by the successful implementation of an exchange-rate-based approach to stabilization, inflation was brought down from over 1,000 percent to

Stand-By, EFF, and ESAF Arrangements as of February 28

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-by arrangements			**4,120.57**	**2,760.85**
Argentina	April 12, 1996	January 11, 1998	720.00	428.00
Bulgaria	July 19, 1996	March 18, 1998	400.00	320.00
Djibouti	April 15, 1996	June 14, 1997	4.60	1.73
Egypt	October 11, 1996	September 30, 1998	271.40	271.40
El Salvador	February 28, 1997	April 27, 1998	37.68	37.68
Estonia	July 29, 1996	August 28, 1997	13.95	13.95
Hungary	March 15, 1996	February 14, 1998	264.18	264.18
Latvia	May 24, 1996	August 23, 1997	30.00	30.00
Lesotho	September 23, 1996	September 22, 1997	7.17	7.17
Pakistan	December 13, 1995	September 30,1997	562.59	267.90
Panama	November 29, 1995	March 31, 1997	84.30	23.20
Papua New Guinea	July 14, 1995	December 15, 1997	71.48	36.14
Romania	May 11, 1994	April 24, 1997	320.50	226.23
Uruguay	March 1, 1996	March 31, 1997	100.00	100.00
Uzbekistan	December 18, 1995	March 17, 1997	124.70	59.25
Venezuela	July 12, 1996	July 11, 1997	975.65	625.65
Yemen	March 20, 1996	June 19, 1997	132.38	48.38
EFF arrangements			**9,830.77**	**6,359.96**
Algeria	May 22, 1995	May 21, 1998	1,169.28	506.48
Azerbaijan	December 20, 1996	December 19, 1999	58.50	53.82
Gabon	November 8, 1995	November 7, 1998	110.30	66.18
Jordan	February 9, 1996	February 8, 1999	238.04	127.74
Kazakstan	July 17, 1996	July 16, 1999	309.40	309.40
Lithuania	October 24, 1994	October 23, 1997	134.55	41.40
Moldova	May 20, 1996	May 19, 1999	135.00	112.50
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Philippines	June 24, 1994	June 23, 1997	474.50	438.00
Russia	March 26, 1996	March 25, 1999	6,901.00	4,564.74
ESAF arrangements			**3,993.72**	**1,695.21**
Armenia	February 14, 1996	February 13, 1999	101.25	67.50
Azerbaijan	December 20, 1996	December 19, 1999	93.60	73.12
Benin	August 28, 1996	August 27, 1999	27.18	22.65
Bolivia	December 19, 1994	December 18, 1997	100.96	33.65
Burkina Faso	June 14, 1996	June 13, 1999	39.78	26.52
Cambodia	May 6, 1994	May 5, 1997	84.00	42.00
Chad	September 1, 1995	August 31, 1998	49.56	24.78
Congo	June 28, 1996	June 27, 1999	69.48	55.58
Côte d'Ivoire	March 11, 1994	June 13, 1997	333.48	—
Ethiopia	October 11, 1996	October 10, 1999	88.47	73.73
Georgia	February 28, 1996	February 27, 1999	166.50	111.00
Ghana	June 30, 1995	June 29, 1998	164.40	109.60
Guinea	January 13, 1997	January 12, 2000	70.80	59.00
Guinea-Bissau	January 18, 1995	January 17, 1998	9.45	5.78
Guyana	July 20, 1994	July 19, 1997	53.76	17.92
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Honduras	July 24, 1992	July 24, 1997	47.46	13.56
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	July 20, 1994	July 19, 1997	88.15	32.25
Lao P.D.R.	June 4, 1993	May 7, 1997	35.19	—
Madagascar	November 27, 1996	November 26, 1999	81.36	67.80
Malawi	October 18, 1995	October 17, 1998	45.81	22.91
Mali	April 10, 1996	April 9, 1999	62.01	41.34
Mauritania	January 25, 1995	January 24, 1998	42.75	14.25
Mozambique	June 21, 1996	June 20, 1999	75.60	50.40
Nicaragua	June 24, 1994	June 23, 1997	120.12	100.10
Niger	June 12, 1996	June 11, 1999	57.96	38.64
Senegal	August 29, 1994	August 28, 1997	130.79	17.84
Sierra Leone	March 28, 1994	March 27, 1997	101.90	10.11
Tanzania	November 8, 1996	November 7, 1999	161.59	135.88
Togo	September 16, 1994	September 15, 1997	65.16	32.58
Uganda	September 6, 1994	November 17, 1997	120.51	23.43
Vietnam	November 11, 1994	November 10, 1997	362.40	120.80
Zambia	December 6, 1995	December 5, 1998	701.68	50.00
Total			**17,945.06**	**10,816.02**

Note: EFF = extended Fund facility.
ESAF = enhanced structural adjustment facility.
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

industrial country levels with essentially no loss in output. International reserves have increased to more comfortable levels, and rapid progress has been made in normalizing external relations. Structural reform, which had slowed in 1994 and 1995, was reinvigorated in 1996. New privatization and bankruptcy laws were passed, and key measures were taken to improve the functioning of the banking system and to develop financial markets. Some of these were taken as prior actions to the program that is being supported by the three-year extended arrangement.

Medium-Term Strategy and the 1997 Program

Two key policy challenges for Croatia are to consolidate the stabilization gains made so far, while providing for postwar reconstruction and social needs, and to rigorously implement structural reform that will foster an externally competitive market economy. The program relies on appropriately restrained monetary, credit, and government wage policies to keep financial discipline tight, while continuing with the stable exchange rate policy that has served Croatia well. The structural reform, reconstruction, and social needs will nevertheless impose substantial demands on fiscal resources in circumstances where the external current account deficit is large, but its size appears to be overestimated in the official statistics. Judgment and careful prioritizing will continue to be essential in designing and respecting budgetary limits that are consistent with a viable path for the balance of payments over the course of the program and beyond. Throughout the program, improved statistical systems are expected to improve economic monitoring and assessment, and Croatia has already subscribed to the special data dissemination standard (SDDS) of the IMF.

Consistent with the medium-term framework, the 1997 program targets real GDP growth of 5.5 percent, inflation of 3.5 percent, and an increase in reserve cover to almost three months of imported goods and nonfactor services. The deficit of the consolidated central government is to be limited to 3 percent of GDP. A deficit of this size supports substantial public investment in economic reforms and an adequate social safety net, while aiming to maintain prudent public sector debt dynamics and avoiding domestic bank financing of the deficit.

Croatia: Selected Economic Indicators

	1993	1994	1995	1996[1]	1997[2]
			(percent change)		
Real GDP growth	−3.7	0.8	1.5	5.0[1]	5.5
Consumer prices (period average)	1,517.5	97.6	2.0	3.5	3.5
			(percent of GDP)		
Overall fiscal balance (excluding grants)	−0.8	1.5	−1.0	−0.6	−3.1
External current account balance	0.9	0.7	−10.3	−7.2[1]	−6.9
			(months of imports)		
Gross official international reserves of goods and nonfactor services	1.1	1.7	2.3	2.6[1]	2.9

[1]Estimate.
[2]Program.

Data: Croatian authorities and IMF staff estimates

Structural Reforms

Building on Croatia's earlier strong actions, the program contains a rigorous agenda of structural reforms. These include actions on restructuring and privatizing large state-owned enterprises and banks, with a view toward improving corporate governance and breaking the intricate linkages between commercial banks and state-owned enterprises that have hampered the transition to fully market-based commercial relations; improving fiscal management and its institutions while scaling back the state's role in economic activity and reducing the tax burden; developing financial markets, which should also contribute to more efficient monetary control; and reducing trade distortions. Ongoing structural reform throughout the program is designed to promote improved productivity and profitability and thereby foster the increase in private saving needed to underpin adjustment in the external sector.

Addressing Social Needs

The government's program aims to provide for continuing postwar reconstruction needs as well as higher overall expenditures for capital and net lending more generally. It also targets an increase in expenditures for the social safety net. The bulk of the increase in social expenditures is war related, designed to help war invalids and participants, the families of war victims, and refugees from other republics of the former Socialist Federal Republic of Yugoslavia.

The Challenge Ahead

As prospects for regional peace have improved, there have also been mounting pressures resulting from expectations of higher living standards and social benefits. These pressures make it all the more important to be able to balance appropriately the many fiscal pressures that emerge, and maintain a prudent policy stance during the program. Though the large external current account deficit has been reduced, it has not been eliminated, and thus will present a continuous challenge.

Croatia joined the IMF on December 14, 1992, and its quota is SDR 261.6 million (about $360 million). Its outstanding use of IMF financing currently totals SDR 145 million (about $200 million).

Press Release No. 97/12, March 13

Members' Use of IMF Credit
(million SDRs)

	February 1997	Jan.– Feb. 1997	Jan.–Feb. 1996
General Resources Account	718.1	856.0	894.4
Stand-by arrangements	62.2	115.8	785.0
EFF arrangements	655.9	740.3	109.4
CCFF	0.0	0.0	0.0
SAF and ESAF arrangements	25.1	84.9	31.5
Total	**743.2**	**940.9**	**925.9**

Note: EFF = extended Fund facility.
CCFF = compensatory and contingency financing facility.
SAF = structural adjustment facility.
ESAF = enhanced structural adjustment facility.
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

Asia's Financial Integration Presents Challenges and Opportunities

The following is a summary of a March 7–8 conference, sponsored by the IMF and the Hong Kong Monetary Authority, on "Financial Integration in Asia and the Role of Hong Kong." The conference aimed to assess the implications of increasing integration of trade and financial markets for Asian policymakers, examine Hong Kong's role in the region, and identify policy issues for Hong Kong as it approaches the transfer of sovereignty to China. The conference was opened by Christopher Patten, Governor of Hong Kong, and brought together finance ministers, central bank governors, and senior officials from across Asia, as well as from Europe and North America, along with private sector representatives, academics, and representatives of international institutions.

Addressing the first session, IMF Managing Director Michel Camdessus stressed that the increasing regional integration within Asia was part of a broader process of globalization—through trade, financial flows, technology spillovers, and more rapid availability of information (see *IMF Survey*, March 10, page 68). While globalization has already had a major positive impact on Asia's role in the world economy, Camdessus said, its continuing benefits will not come automatically but will require good policies—especially stable macroeconomic policies, open trade regimes, and flexible product and factor markets supported by effective "exit" policies for noncompetitive industries. The quickening pace of financial innovation and integration also raises other challenges for Asia, said Camdessus; these include the development of a stronger financial infrastructure to handle the region's increasingly complex intermediation requirements and a regional policy dialogue to supplement strengthened surveillance and cooperation in a multilateral framework.

Hong Kong is a prime example of an economy that has already successfully managed a rapid structural transformation in an increasingly globalized economy, said Camdessus. This success owed to a strong policy framework—prudent budgetary principles, the free flow of trade and capital, and a well-justified and soundly supported exchange rate link to the U.S. dollar as the anchor and principal objective of monetary policy. This framework will continue, he added, after the transition of sovereignty. While transitions always present some degree of uncertainty, the Chinese, Hong Kong, and British authorities have shown great foresight and pragmatism in devising the "one country, two systems" approach that will help ensure that the transition runs smoothly and any uncertainty is minimized.

These themes were emphasized by other speakers at the conference. U.K. Chancellor Kenneth Clarke pointed to the critical role of open economic policies in the success of Asian economies. He also underscored Hong Kong's sound legal and economic framework, administered by a high-quality civil service. The strong assurances of Hong Kong's economic and financial autonomy, which lie at the heart of the Sino-British Joint Declaration, provided a sound basis for the future economic stability and prosperity of its people and for Hong Kong's continuing development as one of the world's key international financial centers.

> Globalization's benefits do not come automatically but require good policies.

Governor Dai Xianglong, of the People's Bank of China, noted that the Basic Law provides a legal guarantee for the maintenance of Hong Kong as an international financial center. The fundamental principles governing the monetary relationship between Hong Kong and mainland China, he said, could be summarized as two currencies, two monetary systems, and two mutually independent monetary authorities. In other words, the People's Bank of China and the Hong Kong Monetary Authority will perform their own functions of monetary management in their respective currency areas, independent of each other.

Deputy Prime Minister and Minister of Finance Anwar Ibrahim of Malaysia emphasized that, despite the pronouncements of some "prophets of doom," Hong Kong's future was not just assured but would even be enhanced by the transfer of sovereignty. The transfer would provide Hong Kong with new opportunities to integrate itself more closely with the booming economies of the region, including Southeast Asia. The Deputy Prime Minister also stressed that, since greater financial integration and increasing openness inevitably involved risks, regional cooperation would require more frank consultations and continuing dialogue to help avert potential crises before they occur.

Gerald Corrigan of Goldman Sachs observed that while some bumps in the road were inevitable, he was convinced that the transition of sovereignty could occur in a way that was good for Hong Kong, China, and the world. Corrigan emphasized that regionalism must be seen as a complement to, not a substitute for, globalism. Moreover, the vast quantities of cross-border financial flows—which are the visible symbols of financial interdependence—ultimately rest on that great intangible: public confidence. Maintaining this confidence, he said, will require good macroeconomic policies and strengthened supervisory oversight of financial institutions. Such oversight must be driven not by a

IMF SURVEY

David M. Cheney
Editor
Sara Kane · John Starrels
Senior Editors
Sheila Meehan
Assistant Editor
Sharon Metzger
Editorial Assistant
Lijun Li
Staff Assistant
Philip Torsani
Art Editor
Victor Barcelona
Graphic Artist

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 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 XS700, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430. Fax: (202) 623-7201. Internet: publications@imf.org

"black book" mentality of detailed rules, but by a firm yet flexible supervisory framework that does not punish well-managed institutions for others' mistakes.

Both Corrigan and Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, emphasized the need for stronger financial infrastructure, with special emphasis on national and regional payments, clearance, and settlement systems. Governor Lee of Korea also underscored the importance of enhanced financial cooperation in the region to help prevent financial crises and subsequent contagion. In this regard, he pointed to the regular forums of the Executive Meeting of East Asian and Pacific Central Banks, a group of 11 central banks, as a vehicle for practical cooperation on a wide range of issues.

IMF Managing Director Michel Camdessus (left); C.H. Tung, Chief Executive, Hong Kong Special Administrative Region; and Joseph C. K. Yam, Chief Executive, Hong Kong Monetary Authority, at the Hong Kong conference.

In another session, which focused on policy issues for Hong Kong arising from greater regional integration, Governor Soedradjad Djiwandono of Indonesia noted that Hong Kong's excellent financial infrastructure provided the basis for it to play a major role in the mutually beneficial development of other regional financial markets. Hong Kong should therefore continue to play a leadership role in fostering more cooperation in regional payments and settlement systems and the harmonization of prudential regulations, all of which would facilitate stronger financial linkages throughout the region. Rafael Hui, Secretary of Financial Services in Hong Kong, noted the dramatic evolution of Hong Kong's markets over the last few decades. Hong Kong was now the world's fifth largest banking center and foreign exchange market, seventh largest stock market (and the second in Asia), and eighth largest trading entity. Looking to the future, he said that Hong Kong's continued progress as a financial center would be centered on maximizing its advantages in location, time zone, infrastructure, experience, and financial expertise.

Hubert Neiss, Director of the IMF's Asia and Pacific Department, noted that no major new policies were required to fulfill Hong Kong's considerable further potential as a financial center and service economy. The exchange rate link with the U.S. dollar, for example, and the associated monetary policy framework—as well as conservative, rules-based fiscal policy—already provided a strong element of confidence. What was needed, therefore, was to maintain the policy course while strengthening the economy's adaptability to change. This required a continued emphasis on education and training to keep labor markets flexible and the promotion of competition in the nontraded services sector.

In the final session, David Borthwick, Deputy Secretary of the Australian Treasury, emphasized the interconnections between the policy challenges facing Asian economies in a world of globalized markets. One particularly important issue was the degree to which countries heavily dependent on capital inflows should be concerned about this dependence and their susceptibility to a reversal. In his view, experience showed that financial markets tend to give more leeway when there is a record of credible macroeconomic policy, national savings are high, and there is a focus on high quality direct investment.

Yukio Yoshimura, Deputy Director-General of Japan's International Finance Bureau in the Ministry of Finance, explained the purpose and approach behind the proposed wide-ranging "big bang" reforms of Japan's financial system. He noted that a major transformation of Tokyo's role as an international financial center could be expected as these reforms proceed—a transformation that, as Managing Director Camdessus also stressed, would offer enormous benefits to Asia and the world.

Hoe Ee Khor of the Monetary Authority of Singapore explained that further significant advances in Singapore's contribution to regional financial integration could also be expected. And David Goldsbrough, Senior Advisor in the IMF's Asia and Pacific Department, stressed the importance of more timely and accurate information flows in a world of highly integrated financial markets to reduce the risk of unwarranted contagion effects.

C.H. Tung, Chief Executive of the Hong Kong Special Administrative Region, closed the conference, expressing strong confidence that the continued autonomy of Hong Kong's institutions, under the principle of "one country, two systems," would make an enormous contribution to the future prosperity of the people of both Hong Kong and mainland China. ■

David Goldsbrough
IMF Asia and Pacific Department