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Spring Meetings Preview

Financial Crisis Prevention, Management Will Be Focus of Ministers' Discussions

The Asian financial crisis—its causes and effects and how the international monetary system might be strengthened to prevent, manage, and resolve future crises—will be a main topic on the agenda when the Interim Committee of the Board of Governors on the International Monetary System (the Interim Committee) convenes in Washington on April 16 for its fiftieth meeting. The Interim Committee, which comprises finance ministers and central bank governors, is chaired by Philippe Maystadt, Deputy Prime Minister and Minister of Finance and Foreign Trade of Belgium. Also on the agenda are the liberalization of capital movements under an amendment of the IMF's Articles of Agreement, a proposed code of conduct on fiscal transparency, and issues concerning the Enhanced Structural Adjustment Facility (ESAF) and the Heavily Indebted Poor Countries (HIPC) Initiative.

The Interim Committee session will be followed by the fifty-seventh meeting of the Joint Bank and Fund Committee on the Transfer of Real Resources to Developing Countries (the Development Committee) on April 17. The Development Committee will be chaired by Driss Jettou, Moroccan Minister of Finance, Commerce, Industry, *(Please turn to the following page)*

Maystadt: Key lessons from the Asian crisis will be a main topic during the Interim Committee's discussions.

Los Angeles Remarks

Fischer Outlines IMF Policy Prescriptions to Minimize Impact of Asian Crisis

In a Forum Funds lecture at UCLA in Los Angeles on March 20, IMF First Deputy Managing Director Stanley Fischer reviewed the purposes for which the IMF was created and the causes of the crisis in Asia, as well as discussing possible changes in the "architecture" of the international monetary system to prevent future crises. This edited excerpt focuses on one aspect of his remarks: the IMF's response to the Asian crisis and the appropriateness of its policy recommendations.

Are IMF Programs Too Tough?

When the three Asian countries approached the IMF, the reserves of Thailand and Korea were perilously low, and the Indonesian rupiah was excessively depreciated. The first order of business was, and still is, to restore confidence in the currency. To achieve this, countries have to make it more attractive to hold domestic currency, which, in turn, requires increasing interest rates temporarily, even if higher interest costs complicate the situation of weak banks and corporations. This is a key lesson of the "tequila crisis" in Latin America in 1994–95, as well as from the more recent experience of Brazil, the Czech Republic, Hong Kong SAR, and Russia—all of which have fended off attacks on their currencies in recent months with a timely and forceful tightening of *(Continued on page 100)*

Agenda for Interim, Development Committees

(Continued from front page) and Handicrafts. As the first item on the agenda, the Development Committee will review progress on the implementation of recommendations contained in a report by the Committee's task force on multilateral development banks, entitled "Serving a Changing World." Other topics for discussion include an update on the implementation of the HIPC Initiative, resources for the World Bank's Multilateral Investment Guarantee Agency (MIGA), and implications of the Asian financial crisis.

Driss Jettou of Morocco will chair the Development Committee.

The spring meetings of the Interim and Development Committees will be preceded by meetings of the Ministers of the Group of 24 developing countries and the Group of Ten industrial countries. Also, on April 13, Michael Mussa, Economic Counsellor and Director of the IMF's Research Department, will brief the press on the staff's report on the *World Economic Outlook.*

World Economic Outlook and the Asia Crisis

The financial crisis in Asia—and its implications for the world economy—is likely to dominate discussions of the IMF's biannual survey of economic developments and prospects, the *World Economic Outlook*, a press version of which will be released at the briefing on April 13. The Interim Committee will review the staff's revised projections for growth and external balances in the economies most affected by the crisis, as well as the broader implications of the crisis for industrial, developing, and transition economies.

Speaking to journalists in Brussels on March 31, Maystadt said that U.S. fundamentals remained strong, according to the IMF, and prospects were favorable for Europe. But the outlook for Japan's economy was a "cause for concern," and the Interim Committee would possibly discuss which fiscal stance should be adopted that would have positive and durable effects on growth prospects. One conclusion that the Committee might reach, he said, was that there is a need to combine fiscal stimulus with continued financial sector reforms. The Asian crisis and its spillover effects, such as lower oil and other commodity prices, could, Maystadt added, cast a shadow over Africa's growth prospects.

An important item on the Interim Committee's agenda is how to strengthen the architecture of the international monetary system, with a view to preventing, managing, and resolving future crises. Issues to be considered include:

- the role of the IMF and other international institutions in strengthening the structures of international and domestic financial systems;
- transparency, including disclosure of data to the IMF and to the public, as well as the feasibility of making IMF advice public;
- the IMF's role in managing a crisis, including financial assistance, and the role of other official support; and
- involvement of the private sector in resolving crises.

Strengthening IMF Surveillance

IMF surveillance has two components: consultations with member countries, which focus on economic issues from a national viewpoint; and the World Economic Outlook exercise, which focuses on the regional or global impact of members' policies.

IMF surveillance over the macroeconomic policies of its members has an important role to play in helping to shield the global economy from financial turmoil. The Interim Committee will therefore consider the past performance of IMF surveillance and suggest ways to strengthen it.

During his press briefing on March 31, Maystadt said that the Asian crisis had revealed some deficiencies in IMF surveillance and crisis management. Examining how these gaps could be plugged would probably take up a large part of the Interim Committee's agenda, he said. He noted that the Interim Committee is likely to consider the following implications of the Asian crisis.

- The *timely availability of information*, which is critical for the effectiveness of surveillance and which means that efforts are needed to strengthen further the provision of data by members to the IMF and to the public.
- The *focus of surveillance*, which should extend beyond the core of short-term macroeconomic issues.
- *Policy interdependence and the risks of contagion,* which should be paid more explicit attention by IMF surveillance at the country level in the current environment of increased financial and trade flows between countries.
- The *importance of policy transparency*, which is underlined by the crucial role of credibility and the need to restore market confidence in Asia. In this connection, press information notices (PINs) have become

Photo Credits: Denio Zara and Padraic Hughes for the IMF.

an important vehicle for transmitting the IMF's assessment of members' policies to the public, but questions remain on how far the IMF should go in making public the explicit warnings it gives in confidence to member country authorities. Increased publicity for the IMF's views might, for instance, make it even more difficult for the IMF to calibrate its warnings.

• *Supportive peer pressure*, exercised through regional mechanisms, which benefits the effectiveness of IMF surveillance.

Capital Account Liberalization

One of the broad policy issues emerging from the Asian crisis is the appropriate speed with which the capital account should be liberalized in view of the potential for shifts in market sentiment. Successful capital account liberalization requires that certain preconditions be in place and that the process of liberalization be a gradual and orderly one. In the meantime, emerging market countries need to find ways to protect their economies against undesirable surges in short-term inflows. The Interim Committee will address these concerns as part of its discussion on the liberalization of capital movements under an amendment of the Articles of Agreement. This discussion will be held against the background of a recent Executive Board seminar and discussion (see *IMF Survey*, March 23, page 81).

At his press briefing, Maystadt said he expected the IMF to make further progress toward assuming a wider role in monitoring capital market liberalization—a goal that was laid down during last year's Annual Meetings. It was possible, Maystadt added, that a link could also be established between the opening up of capital markets and banking supervision.

Fiscal Code of Conduct

A clear consensus has emerged that good governance is of central importance to achieving macroeconomic stability and high-quality growth. The IMF can make a key contribution to the cause of good governance by promoting transparency in fiscal policy and management and, in fact, the IMF staff has already begun work on a manual of good practices in the area of fiscal transparency, following a recommendation by the Executive Board in October 1997. Work on the manual and an inventory of transparent practices will continue, with a view to identifying good practices in the area of fiscal transparency adopted by member countries.

The increased emphasis now being placed on the establishment of the highest possible standards in all countries, however, argues for the IMF to adopt a direct approach to improving transparency in general, and fiscal transparency in particular. To this end, the Interim Committee will consider adopting a proposed Code of Conduct on Fiscal Transparency prepared by the staff. The principles of fiscal transparency in such a code are designed to ensure that:

• roles and responsibilities in government are clear;

• comprehensive and timely fiscal information is provided to the public;

• budget preparation, execution, and reporting are undertaken in an open manner; and

• fiscal information is subjected to independent assurances of integrity.

The proposed code of conduct sets out specific principles and practices that governments should implement to achieve these objectives. To the extent possible, these principles and practices will take into account the diversity across countries in fiscal management systems and in cultural, constitutional, and legal environments, as well as differences in the technical and administrative capacity to improve transparency.

The effectiveness of IMF surveillance benefits from supportive peer pressure.

ESAF and HIPC

The Interim Committee will also review developments in ESAF and in the HIPC Initiative, including implementation and financing.

In the past year, the Executive Boards of the IMF and the World Bank have agreed to provide exceptional assistance under the HIPC Initiative to five countries: Bolivia, Burkina Faso, Côte d'Ivoire, Guyana, and Uganda. Assuming good policy performance, HIPC assistance will reduce the net present value debt of these countries by a total of $1.5 billion. Within the next 12 months, the IMF and the World Bank will likely decide on assistance for several other countries.

The Committee will also discuss the recent external ESAF evaluation by a panel of outside experts convened by the IMF Executive Board (see *IMF Survey*, March 23, page 81). The external evaluation, which complemented an internal ESAF review, focused on the social impact of ESAF-supported adjustment, an assessment of external viability, and the national "ownership" of ESAF programs. Both reviews share the basic conclusion that the ESAF is a valuable means of helping poorer countries, but determined that there is room for improvement. The lessons provided by these studies will be used to strengthen the IMF's ability to foster sustained growth and external viability in poorer member countries through the ESAF. ■

The schedule of events for the spring meetings is available on the IMF's web site at www.imf.org/external/news.htm.

IMF Programs Seek First to Restore Confidence

(Continued from front page) interest rates, along with other supporting policy measures. Once confidence is restored, interest rates can return to more normal levels.

Why not operate with lower interest rates and a greater devaluation? This is a relevant trade-off, but there can be no question that the degree of devaluation in Asian crisis countries is excessive. Companies with substantial foreign currency debts—as so many companies in these countries have—stand to suffer far more from a steep slide in the value of their domestic currency than from a temporary rise in domestic interest rates. Moreover, when interest rate action is delayed, confidence continues to erode. Thus, the increase in interest rates needed to stabilize the situation is likely to be far larger than if decisive action had been taken at the outset. Indeed, the reluctance to tighten interest rates forcefully at the beginning has been an important factor in perpetuating the crisis.

From the viewpoint of the international system, the devaluations in Asia will lead to large current account surpluses in those countries, damaging the competitive positions of other countries and requiring them to run current account deficits. Although not by the intention of the authorities in the crisis countries, these are excessive competitive devaluations—not good for the system, not good for other countries. Indeed they are a way of spreading the crisis—precisely the type of devaluation the IMF has the obligation to seek to prevent.

On the question of the appropriate degree of fiscal tightening, the balance is a particularly fine one. At the outset of the crisis, countries needed to firm their fiscal positions, both to make room in their budgets for the future costs of financial restructuring and—depending on the balance of payments situation—to reduce the current account deficit. In calculating the amount of fiscal tightening needed to offset the costs of financial

Malaysia Unveils Package of Economic Measures

On March 24, Malaysian Deputy Prime Minister Anwar Ibrahim unveiled a package of economic measures, followed by an announcement on March 25 by Bank Negara Governor Ahmad Don on monetary and financial sector policies. Welcoming these announcements, IMF Managing Director Michel Camdessus issued the following statement.

This package, which builds on previously introduced measures, takes a welcome comprehensive approach to Malaysia's economic and financial situation, and is set within a realistic macroeconomic framework. It will allow growth to remain positive in 1998, even as substantial external current account adjustment is achieved, and will keep inflationary pressures under strict control.

While Malaysia has been seriously affected by regional developments, it has avoided the most severe market pressures and economic difficulties experienced by some other Asian countries. This is because Malaysia has followed over a long period a prudent approach to external exposure, the fiscal position has had considerable strength, and the supervisory and regulatory framework for the financial sector has been relatively well developed. In addition, policies have been successful in significantly reducing poverty to low levels.

Nevertheless, under the current market conditions, it has become increasingly clear that these fundamentals needed strengthening to ensure orderly adjustment of the domestic economy.

The centerpiece of the new package is a series of pre-emptive actions to strengthen the financial sector and address emerging problems in financial institutions. Thus, the finance company sector is to be quickly consolidated into a much smaller number of core finance companies, and a strategy for recapitalizing individual banking institutions is to be set in train. Deputy Prime Minister Anwar has given assurances that the strategies adopted will be transparent, and that the potential use of government resources will be subject to safeguards.

Deputy Prime Minister Anwar has appropriately also proposed to rebalance macroeconomic policies. Fiscal policy will maintain Malaysia's strong record by targeting a surplus in 1998, despite the economic slowdown. Credit and monetary growth is to be reduced significantly, and a more active interest rate policy will be directed at stabilizing the foreign exchange market and restraining inflation. The budget will include increased spending to strengthen the social safety net.

Deputy Prime Minister Anwar has reaffirmed the government's commitment to improve transparency and to the steady implementation of structural reforms in a number of areas, consistent with maintaining the social consensus. With their full implementation, the reforms will deepen the market orientation of Malaysia's economy, improve corporate governance, and set the stage for a return to more rapid growth over the medium term.

Finally, Malaysia's economic package will also reinforce the efforts of other countries that are strengthening their own economic policies, thereby contributing to broader regional stability.

sector restructuring, the programs include the expected interest costs of the intervention, not the capital costs. Among the three Asian crisis programs, the current account deficit was large only in Thailand, which had been running a deficit of about 8 percent of GDP.

The amount of fiscal adjustment in Indonesia was 1 percent of GDP; in Korea it was 1.5 percent of GDP; and in Thailand—reflecting its large current account deficit—the initial adjustment was 3 percent of GDP. After these initial adjustments, if the economic situation in the country weakened more than expected, as it has in the three Asian crisis countries, the IMF has generally agreed with the country to let the deficit widen somewhat—that is, to let automatic stabilizers operate. However, the level of the fiscal deficit cannot be a matter of indifference, particularly since a country in crisis typically has only limited access to borrowing and the alternative of printing money would be potentially disastrous in these circumstances. Nor does the IMF need to persuade Asian countries of the virtues of fiscal prudence. Indeed, in two of the crisis countries, the government has insisted on a tighter fiscal policy than the IMF had suggested.

Monetary policy has to be kept tight to restore confidence in the currency, and fiscal policy was tightened appropriately but not excessively at the start of each program, with automatic stabilizers subsequently being allowed to do their work. That is as it should be. These policies are showing increasing signs of success in Thailand and Korea, and interest rates could begin to come down if market confidence and the currencies continue to strengthen.

Structural Policies

However, macroeconomic adjustment is not the main element in the programs of Indonesia, Korea, and Thailand; financial sector restructuring and other structural reforms lie at the heart of each program. The problems they deal with—weak financial institutions, inadequate bank regulation and supervision, and the complicated and nontransparent relations among governments, banks, and corporations—lie at the heart of the economic crisis in each country.

It would not serve any lasting purpose for the IMF to lend to these countries unless these problems were addressed. Nor would it be in the countries' interest to leave the structural and governance issues aside: markets have remained skeptical where reform efforts are perceived to be incomplete or half-hearted, and market confidence has not returned.

The IMF has been accused of encouraging countries to move too quickly on banking sector restructuring: we have been urged to support regulatory forbearance, leaving the solution of the banking sector problems for later. This would only have perpetuated these countries' economic problems, as experience in Japan has shown. The best course is to recapitalize or close insolvent banks, protect small depositors, require shareholders to take their losses, and take steps to improve banking regulation and supervision.

Critics have suggested three criteria the IMF should apply in deciding whether to ask for the inclusion of any particular measure in a program.

• First, is the measure really needed to restore the country's access to the international capital markets? The answer in the case of the Asian programs is yes.

• Second, is this a technical matter that does not interfere unnecessarily with the proper jurisdiction of a sovereign government? The answer here is complicated, because we have no accepted definitions of what is technical or what is improper interference. Banking sector reform is a highly technical issue, far more than the size of the budget deficit. Is trade liberalization—long a part of IMF and World Bank programs—any less an intrusion on a sovereign government than banking sector reform? Also why are the programs supported by the IMF in the transition economies, including Russia—which are far more detailed, far more structural, and in many countries as controversial as in Asia—acceptable, but those in Asia are not?

• Third, would the IMF think it appropriate to ask for similar changes if these policies were practiced in the major industrial economies of Europe? The answer here is a straightforward yes—an answer that should gain credence by examining the Russian reform program supported by the IMF and the World Bank.

Omitted from this set of criteria, however, is the most important question that should be asked: does this program address the underlying causes of the crisis? There is neither point nor excuse for the international community to provide financial assistance to a country unless that country takes measures to prevent future such crises. That is the fundamental reason why structural measures are included in IMF-supported programs. Of course, many of these measures take a long time to implement, and many of them are in the purview of the World Bank.

Structural reforms are crucial to address the underlying causes of the crisis.

Moral Hazard

The charge that by coming to the assistance of countries in crisis the IMF creates moral hazard has been heard from all points of the political compass. The argument has two parts: first, that officials in member countries may take excessive risks because they know the IMF will bail them out if they get into serious trouble; and, second, that because the IMF will come to the rescue, investors do not appraise risks accurately and are too willing to lend to countries with weak economies.

It would be far-fetched to think that policymakers embarking on a risky course of action do so because the IMF safety net will save them if things go badly. All the evidence is that countries do their best to avoid going to the IMF. Nor have individual policymakers whose countries end up in trouble generally survived politically. IMF conditionality provides the right incentives for policymakers to do the right thing—indeed, these incentives have been evident in the pre-emptive actions taken by some countries during the present crisis. These incentives may even be too strong, and I agree with critics who say it would generally be better if countries were willing to come to the IMF sooner rather than later. But countries should not have too easy access to the IMF: it should not be the lender of first resort—that is the role of the private markets.

The thornier issues arise on the side of investors. Economists tend to point to the problems of moral hazard and the inappropriate appraisal of risks; others are more concerned that some investors who should have paid a penalty—typically they refer to the banks—may be bailed out by IMF lending. These are two sides of the same coin: if investors are bailed out inappropriately, then they will be less careful in the future than they should be.

First, the facts. Most investors in the Asian crisis countries—equity investors and many of those who have lent to corporations and banks—have taken very heavy losses. Many firms and financial institutions in these countries will unfortunately go bankrupt, and their foreign and domestic lenders will share in the losses.

Some short-term creditors, notably those lending in the interbank market, were protected for a while, in that policies aimed to ensure that these credits would continue to be rolled over. In the case of Korea, where bank exposure is largest, the creditor banks have now been bailed in—with the operation to roll over and lengthen their loans successfully completed. Further, fourth-quarter earnings reports indicate that, overall, the Asian crisis has been costly for foreign commercial banks.

None of this is to deny the problem of moral hazard. It exists, and we need to find better ways of dealing with it. But surely investors will not conclude from this crisis that they need not worry about the risks of their lending because the IMF will come to their rescue. Investors have been hit hard. They should have been, for they lent unwisely. But the question remains: if it was not mainly moral hazard that led to the unwise lending that underlies the Asian crisis, what was it?

The answer is irrational exuberance. Financial crises based on swings in investor confidence—on irrational exuberance and irrational depression—far predate the creation of the IMF. We have to do everything we can to provide the information and incentives that will encourage rational investor behavior. We need to find better ways to bail in the private sector more systematically. But we cannot build a system on the assumption that crises will not happen. We need in the system the capacity to respond to crises that would otherwise force countries to take measures unduly "destructive of national or international prosperity."

Role of IMF

The IMF is part of that system of response. When the IMF lends in a crisis, it helps moderate the recession that the country inevitably faces. That means that the residents of that country, its corporations, and some of the lenders to that country do better than they otherwise would have. That is not in any meaningful sense a bailout, provided lending of this type can be sustained in future crises. If properly designed to avoid as far as possible creating the wrong incentives for the private sector, it represents rational lending—not grants or handouts—in conditions when markets appear to have overreacted.

To ensure that lending of this type can be sustained in future crises, we have to be sure that the required size of IMF loans does not keep rising. This means that in seeking to improve the architecture of the international system, we will have to find ways of discouraging unwise private lending—that is, to help ensure that risk is properly priced and to limit the required scale of official lending, in part by finding ways of sharing the burden between the official and private sectors.

The alternative proposed by those who would abolish the IMF is to leave countries and their creditors to sort out the country's inability to service its debts. That sounds simple but has rarely been so in practice. That is one reason that the IMF assisted the Asian crisis countries to avoid defaults or debt moratoria. In the absence of an accepted bankruptcy procedure, past workouts have been protracted and countries involved have been denied market access for a long time, at a significant cost to growth. By contrast, in the Mexican crisis of 1994–95, market access was lost for only a few months. Mexico returned within a year to impressive growth, assisted by its ability to tap the international capital markets. Similarly, in the present Asian crisis, it is quite likely that both Korea and Thailand will be back to the international markets within a few months.

The second reason the IMF tried to help countries avoid a standstill was the fear of contagion. We believed, and continue to believe, that a standstill in one country, at a time when markets were highly sensitive, would have spread to other countries and possibly other continents.

Of course, we cannot know what would have happened had there been no official lending in the Asian crisis. But we do know that the crisis has been contained, and it is reasonable to believe that, deep and unfortunate as the crises in individual countries have been, growth in those economies can resume soon. ■

The full text of Stanley Fischer's remarks is available on the IMF's web site at www.imf.org/external/news/htm.

World Bank Study Projects Near-Term Drop in Private Financial Flows to Developing Countries

For emerging markets with access to private capital flows, 1997 was a "roller coaster" year. The World Bank's *Global Development Finance 1998*—a two-volume study that replaces and expands the Bank's *World Debt Tables*—notes that private capital flows increased slightly in 1997 to a record $256 billion. The major story, however, was the fluctuation of flows within the year triggered by the spreading crisis in Asia. For the first three quarters of 1997, private financial flows to developing countries grew strongly, continuing a decade-long trend. These flows fell off sharply in the fourth quarter, reflecting the growing dimensions of the crisis in Asia and a sharp change in investor sentiment toward emerging markets in general. The report envisages a downturn in private capital flows over the near term—a slowing of flows through bond and equity markets partially offset by higher foreign direct investment. The study projects a reversal in this decline over the medium term if countries—particularly those affected by the Asian crisis—successfully implement needed reforms and market confidence is restored.

Private Capital Markets in 1997

A favorable global economic climate, liquid international capital markets, and the continued strong performance of several major borrowers helped boost overall financial flows to $256 billion in 1997 from $247 billion in 1996. But it was not the early or overall performance for which the year would be remembered. Market access for developing countries, which started to deteriorate in July with the onset of the crisis in Thailand, worsened late in the year as the Asian financial turmoil spread. The decline in bond issues and loan commitments that characterized Asia in the third quarter extended to most major borrowers in the fourth quarter—forming what the Bank report terms a "general retreat from new investments in emerging markets." Stock markets followed suit in many countries and loan spreads widened—though still well below the spreads seen after the Mexican crisis in 1995. Secondary markets, whose spreads narrowed dramatically between early 1995 and mid-1997, widened markedly in late 1997 as the upheaval in currency and financial markets deepened.

Foreign direct investment, which formed nearly half of all capital flows to developing countries in 1997, rose to $120 billion—a record high—but this represented only a slight increase over its 1996 level ($119 billion). Declining flows to two large East Asian recipients—China and Indonesia—were offset by increased flows to Latin America, notably Brazil. Among the most striking changes in the composition of foreign direct investment flows has been a rapid rise in the amount going to service sectors in developing countries. The report credits strong growth in domestic markets, improved communication technologies, greater privatization of infrastructure, and more widely available investment insurance with spurring service sector investment and helping to free up public resources for greater investments in meeting social needs.

The late-year tumult also interrupted what had been a remarkable deepening in developing country financial markets. Before the crisis, these markets had been growing increasingly more sophisticated—featuring, among other developments, a growing currency diversification in bond issues, a variety of new instruments to attract investors, and an expanded use of financial

Net Long-Term Resource Flows to Developing Countries
(billion U.S. dollars)

Type of Flow	1990	1991	1992	1993	1994	1995	1996	1997[1]
All developing countries	98.3	116.3	143.9	208.1	206.2	243.1	281.6	300.3
Official development finance	56.4	62.7	53.8	53.6	45.5	54.0	34.7	44.2
Grants	29.2	35.1	30.5	28.4	32.7	32.6	29.2	25.1
Loans	27.2	27.6	23.3	25.1	12.9	21.4	5.4	19.2
Bilateral	11.6	13.3	11.1	10.0	2.5	10.0	–7.2	1.8
Multilateral	15.6	14.4	12.2	15.2	10.4	11.3	12.6	17.4
Total private flows	41.9	53.6	90.1	154.6	160.6	189.1	246.9	256.0
Debt flows	15.0	13.5	33.8	44.0	41.1	55.1	82.2	103.2
Commercial bank loans	3.8	3.4	13.1	2.8	8.9	29.3	34.2	41.1
Bonds	0.1	7.4	8.3	31.8	27.5	23.8	45.7	53.8
Other	11.1	2.7	12.4	9.4	4.7	2.0	2.3	8.3
Foreign direct investment	23.7	32.9	45.3	65.6	86.9	101.5	119.0	120.4
Portfolio equity flows	3.2	7.2	11.0	45.0	32.6	32.5	45.8	32.5

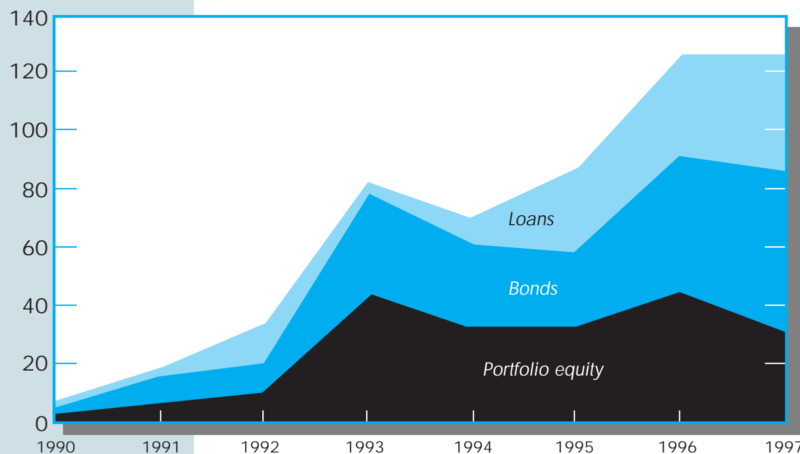
Note: Developing countries are defined as low- and middle-income countries with 1995 per capita incomes of less than $765 (low) and $9,385 (middle).

[1]Preliminary.

Data: *Global Development Finance 1998*

The next issue of the *IMF Survey* will be published on April 27, 1998, and will include complete coverage of the Interim and Development Committee meetings.

and equity derivatives. The Bank study cautions that while innovation has made these markets more attractive and enhanced their ability to hedge against risks, it carries with it a potential down side, particularly when derivatives and other innovations are introduced without adequate regulatory safeguards being in place. Balancing financial reforms and financial innovation will remain a key challenge for policymakers in emerging market countries, according to the report.



Data: World Bank Debator Reporting System

Outlook for 1998

Over the near term, the anticipated decline in private capital flows to developing countries will result from changes in both the supply of and the demand for financing. The market's shaken confidence has already affected fourth quarter flows to emerging market countries. In the short term, this is expected to be compounded by a drop in the demand for funds as countries dealing with currency devaluations and the need to reduce external deficits tighten fiscal and monetary policies. If strong adjustment programs are implemented and market confidence is restored relatively quickly, however, the downturn in flows is expected to be moderate.

The overall trend for international capital flows is likely to remain broadly favorable in 1998, with interest rates staying low and growth in world output and trade continuing strong. Countries with solid fundamentals may quickly regain full market access—as was the case after the Mexican crisis—but this is contingent, the Bank study stresses, upon the concerted efforts of the international community, strong reforms in developing countries (particularly those most immediately affected by the crisis), and restoration of market confidence. If any of these falter, the global economy could see a deeper and more widespread crisis of confidence that could induce a "generalized sharp fall in private capital flows to developing countries."

Copies of the two-volume *Global Development Finance 1998* are available in paper for $300; copies of the first volume only, *Analysis and Summary Tables*, are $40. CD-ROM and diskette formats are also available in single-user and network versions. For more information about these versions or to order, please contact the World Bank, P.O. Box 960, Herndon, VA 20172-0960; telephone: (703) 661-1501; fax: (703) 661-1580; or e-mail: books@worldbank.org.

Origins of the Asian Crisis

What went wrong in Asia? *Global Development Finance 1998* emphasizes that, unlike the Mexican crisis of 1994 or the debt crisis of the 1980s, this crisis had private sector—not public sector—origins, and it occurred "despite a benign international environment, with low international interest rates and solid global growth in output and exports." Asian economies had compiled a notable macroeconomic track record and had long been committed to prudent fiscal policies. The weak link proved to be elsewhere—primarily in the financial sector.

The World Bank report cites distorted incentives, lax regulations, poorly managed financial liberalization, and inadequate disclosure and supervision for a financial environment that ultimately encouraged excessive risk taking and resulted in particularly dangerous maturity and currency mismatches in its borrowing. Large capital inflows exacerbated these problems and fueled domestic demand that, in conjunction with the appreciation of the dollar against the yen, prompted an appreciation of local currencies and set the stage for the crisis.

But vulnerabilities within the Asian economies are, by themselves, an incomplete explanation, the report argues, for the breadth and depth of the crisis. "A self-fulfilling loss of market confidence played an important role" in creating a self-perpetuating crisis, it concludes. Stronger local currencies increased the value of liabilities denominated in those currencies, lowered stock prices, and increased demand for foreign currencies to cover open positions. Greater demand for foreign currencies further depreciated local currencies. Both healthy and insolvent firms suffered as a lack of transparency prevented investors from distinguishing between them, and all struggled to deal with the impact of the currency depreciation on dollar-denominated debt, higher interest rates (to defend currencies), contracted credit, and increased uncertainty and economic downturn.

Globalization, Market Integration Spotlight Key Role of Payment Systems

Accelerated globalization has underscored the importance of a sound financial sector and sparked new interest in payment systems. Omotunde E. G. Johnson, principal author of the IMF's new study, Payment Systems, Monetary Policy, and the Role of the Central Bank, *discusses why payment systems matter increasingly to those concerned about financial sector stability.*

IMF SURVEY: *Why should central banks and others worry about the quality of payment systems?*

JOHNSON: One expert stated that central banks should concern themselves with three very important issues: payment systems, payment systems, and payment systems. That's an exaggeration, perhaps, but a good payment system is vital.

Money, as the medium of exchange, is one of the most important things in a market economy. What we use to make payments and how we make payments are basic issues. The IMF has concerned itself with banking soundness and monetary operations, but payment systems have often been left to hard-core central bankers. We felt we had to educate ourselves on payment systems issues, and we wrote the book initially to give the IMF's Executive Board a feel for what the issues are and why the IMF should be concerned about payment systems.

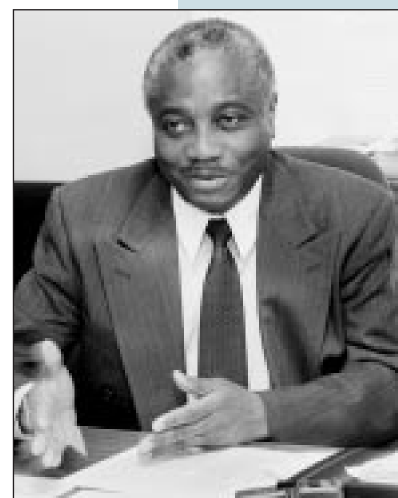
IMF SURVEY: *What is the study's focus?*

JOHNSON: We try to describe payment systems and explain why they have become important to policymakers over the past two decades or so. We emphasize risk, efficiency, and monetary policy. Most important, we stress that transactions have become extremely large relative to GDP and risks have become correspondingly high.

We also review what countries are actually doing. The book surveys practicalities as well as principles. The leaders in the design and operation of payment systems are, of course, the industrial countries. But we also examine the experience and the particular needs of developing and transition countries. A previous IMF book, *The Payment System: Design, Management, and Supervision,* provided a primer on the basics of payment systems; our book summarizes some of these basics but moves on to somewhat more difficult issues as well as reviews a lot of country experience.

The book looks at country initiatives and emphasizes that they are taking these steps to address systemic risk, strengthen monetary policy, and increase efficiency. We also examine the increased cooperation among countries. The countries of the European Union, for example, have been devising a program to link electronically real-time gross settlement systems of the different countries. Developing countries are also increasingly cooperating—usually to save foreign exchange. We also review the experience of the Interstate Bank, which was seriously discussed by countries of the former Soviet Union but did not reach fruition.

We highlight the role of large-value systems, which settle large or time-critical payments, because they have important implications for the system. These payments may equal the GDP of a country every four or five days. We focus on these because of the risks involved and because central banks have taken a particular interest in these transactions.



Johnson: Transactions have become very large, and risks have become correspondingly high.

There are also various issues related to the design of payment systems. Should, for example, the central banks give intraday credit? Suppose a payment comes in and there is no money, how should the system queue obligations? And if obligations are queued, should these be ordered on the basis of first in-first out, relative importance, or some algorithm? You have to worry about all of this, as well as about fees and whether or not to have full-cost pricing for services provided by the central bank.

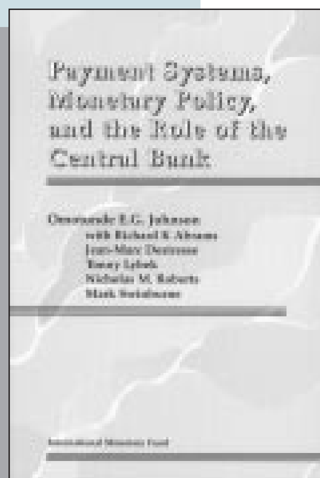
We did an overview of the payment system in seven countries—industrial countries like Australia, France, and the United States, a middle-income country like Thailand, transition economies like Poland and Russia, and then a low-income country like Zambia. And we also examined the large-value systems of 21 countries—some of which have net payment systems, some of which have gross payment systems, and some of which have both types.

IMF SURVEY: *What is the distinction between net and gross systems?*

JOHNSON: Net simply means that transactions go on during the day but it is not until the end of the day—or at some other deferred settlement period—that obligations are netted across each other. What is transferred as payments will be the net. For example, if I owe you 10 and you owe someone else 20 and that person owes me, then we net it all. At the end of the day only one person may need to pay anything to one or both of the others. In a gross system, you settle for each transaction. It's like going to the store and buying goods.

Systems that started in the private sector, like CHIPS—the United States' Clearinghouse Interbank Payments System—tend to use a net system. When the

private sector starts a large-value payment system, they tend to opt for netting systems because they will need fewer reserves and can save on explicit liquidity. When central banks own and manage a system, they tend to opt for gross systems because of the systemic risk involved in netting systems. If we are sending payments to each other and we are waiting until the end of the day, we are left exposed. When we net off at the end of the day to settle obligations, we may find someone is unable to pay.



Because they are concerned about risk and are often called upon to save a system if there is a problem, central banks have also become very interested in netting systems. They know netting system participants might take on unduly large risks and the central banks might then have to bail out these systems. The U.S. Federal Reserve, for example, encouraged CHIPS to put ceilings and caps on their exposure. These caps mean, for example, that banks agree to limit their exposure to a certain percent of capital.

Netting systems have also protected themselves by developing a pool of resources. Traditionally, if someone was unable to settle, rather than unravel everything, they could, for instance, simply remove the payment of that person and then do the clearing again. Today, netting systems tend to rely on some sort of pooling of resources and loss-sharing arrangements. They contribute to a pool of collateral, so that if someone fails, they share the loss. Net systems are becoming rare for large-value payments. Central banks have come to dominate the ownership of large-value systems. As countries create large-value payment systems, they tend to give ownership and management responsibilities to central banks.

Another point our book stresses is that while central banks can own, manage, and take leadership in payment systems, they should consult users in designing these systems. We encourage the establishment of national payment councils to provide forums to discuss payment system issues. We encourage countries to be very clear in their own minds about why they want to build a system and what features they want to have, as well as ensuring that it all makes economic sense.

IMF Survey: *Why do globalization and the increased integration of capital markets make payment issues more critical?*
Johnson: Speed becomes important, and risk control becomes important. Interbank money markets, securities markets, and currency markets are all being linked with domestic payment systems. That is a lot of money. And globalization means that crises can now be easily transferred from one country to another.

One thing happening is that countries are talking more and more to each other about legal and other issues in their payment systems. If the laws are weak here and strong there, private persons might decide to exploit these differences. It's similar to tax evasion, and you don't want to encourage it. Coordination will increase the similarities between legal systems and lead to the development of common standards and document standardization. All of this helps speed up and simplify transactions.

Also, with monetary policy and monetary operations becoming more market oriented, you are making more use of indirect monetary instruments. To do this, you need to rely on financial markets a lot. You want the financial markets to be well functioning and integrated, with fairly sophisticated managers. Efficient payment systems facilitate the integration of financial markets and efficiency of liquidity management. The sheer volume of transactions and the increasing degree of sophistication of transactions put stress on payment systems. This forces people to think about speed and reliability and risks.

IMF Survey: *Did you draw on external expertise in putting together this book?*
Johnson: Outside experts drafted two chapters, and we sent our drafts to central banks for their comments. The appendix, which deals with the large-value systems of 21 countries, was carefully reviewed by the respective central banks. We did the bulk of the work here, but we had a lot of help from outside and are extremely grateful for it.

IMF Survey: *What issues remain on payment systems?*
Johnson: The book lists a number of issues, including measurement of systemic risks, optimal pricing for credit risks in central bank lending, effects of fees and caps on daylight overdrafts, optimality of queuing arrangements, and effect of payment system development and arrangements on demand for international liquidity. But this list only gives a flavor of what needs to be looked at. An enormous amount of work still must be done, even whether there appears to be broad agreement on a point. In the use of full-cost pricing, for example, knotty questions remain about how full costs are to be determined and whether the policy should be phased in or implemented immediately.

I suspect we will not do another book soon, but these issues will be addressed in larger contexts—for example, within financial system soundness issues. I personally remain very interested in this whole subject. The mix of micro and macroeconomics is fascinating. ■

Copies of *Payment Systems, Monetary Policy, and the Role of the Central Bank*, by Omotunde E.G. Johnson with Richard K. Abrams, Jean-Marc Destresse, Tonny Lybek, Nicholas M. Roberts, and Mark Swinburne, are available for $25.00 from IMF Publication Services. See Page 109 for ordering information.

Following are excerpts from recent IMF press releases. The full texts are 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).

Côte d'Ivoire: Debt Reduction Under HIPC

The IMF and the World Bank have agreed to support a debt-reduction package for Côte d'Ivoire under the Initiative for Heavily Indebted Poor Countries (HIPC). The total assistance to be provided to Côte d'Ivoire by all of its external creditors will reduce the country's external debt burden by $345 million in net present value terms. This is estimated to translate into debt-service relief over time of close to $800 million. The IMF and the World Bank will provide assistance with a net present value of $22.5 million and $91 million, respectively. The completion point for the delivery of the debt-reduction package will be March 2001.

Delivery of the debt-reduction package from the IMF and the World Bank is subject to confirmation from Côte d'Ivoire's other creditors that they will provide their share and the satisfactory implementation of reforms agreed by the government. The World Bank will provide its contribution in the form of IDA grants—as opposed to the normal credits—of $314 million tied to specific adjustment operations through the completion point as part of its lending program to Côte d'Ivoire over the next three years. The IMF will provide its assistance at the completion point in the form of a grant into an escrow account to be used to pay debt-service falling due to the IMF. The debt relief provided under the HIPC Initiative will free budgetary resources for increased expenditure on primary health and education, rural development, and poverty alleviation.

The HIPC debt-relief package is in support of Côte d'Ivoire's wide-ranging economic and structural reforms that aim at keeping the economy on a path of sustained growth, ensuring financial viability, reducing poverty, and substantially improving the living standards of the population. To this end, the key policy components of the authorities' reform strategy include further fiscal consolidation to reduce the dependence on external assistance and increase public saving, with a more efficient use of scarce public resources; a deepening of structural reforms that promote private sector development and investment—including foreign direct and portfolio investment—and foster continuing diversification and transformation of the Ivoirien economy; and the pursuit of an ambitious social development agenda designed to reduce poverty, especially through well-targeted and efficient public spending on education and health.

Côte d'Ivoire is the fifth country to benefit under the HIPC Initiative, raising the total debt relief committed under the Initiative to about $1.5 billion in net present value terms, or about $2.8 billion in debt service over time. Côte d'Ivoire is the second country to qualify under the fiscal/openness criteria that were established under the Initiative in April 1997 for highly open economies with a heavy fiscal burden of external debt despite strong efforts in mobilizing revenue. In the special case of a country with an open economy that is making a substantial effort to collect fiscal revenues, the net present value of debt-to-exports target may be set below 200 percent, with the target set so that the net present value of debt-to-fiscal revenues would be 280 percent at the completion point. Côte d'Ivoire's target was set at 141 percent of exports, compared to a projected ratio of 148 percent before assistance.

Press Release No. 98/6, March 19

Nicaragua: ESAF

The IMF has approved a three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF) for Nicaragua, in an amount equivalent to SDR 100.9 million (about $136 million), to support the government's economic program for 1998–2000. The first annual loan, equivalent to SDR 33.6 million (about $45 million), is available in two equal semiannual installments, the first of which will be made available March 25, 1998.

Medium-Term Strategy and 1998 Program

The objectives of the government's medium-term strategy for 1998–2000 are to move the economy toward sustainability of the public finances and the external sector, carry out structural reform, and promote economic growth in order to alleviate poverty and reduce unemployment. The fiscal program aims at increasing public savings by 6 percentage points of GDP during this period, and targets a small surplus in the combined public sector balance (after grants) by the year 2000. The basic macroeconomic objectives for 1998–2000 are to increase gross reserves to the equivalent of three months of imports, achieve a rate of real GDP growth of about 6 percent by the end of the program period, and bring down inflation to about 5 percent. Within this medium-term strategy, the 1998 program, supported by the first annual ESAF loan, seeks to increase gross reserves to the equivalent of 1.8 months of imports, achieve a real GDP growth rate of 4.8 percent, and limit inflation to 8.0 percent. To achieve these objectives, the government will pursue a fiscal policy designed to reduce the overall public sector deficit (before grants) to 9 percent of GDP from 9.7 percent in 1997.

Nicaragua: Selected Economic Indicators

	1996	1997[1]	1998[2]	1999[2]	2000[2]
			(percent change)		
Real GDP	4.5	5.0	4.8	5.3	5.7
Consumer prices (end of period)	12.1	7.3	8.0	6.5	5.0
			(percent of GDP)		
Overall fiscal balance (before grants)	–15.7	–9.7	–9.0	–5.1	–3.7
External current account balance (excluding official transfers)	–32.2	–26.8	–23.2	–19.3	–17.8
			(months of imports)		
Gross official international reserves	1.4	0.2	1.8	2.4	3.0

[1]Estimates.
[2]Program.

Data: Nicaraguan authorities and IMF staff estimates and projections

Structural Reforms

The authorities plan to continue with public sector reforms to improve services and efficiency. To improve governance and public accountability, the government is preparing

a comprehensive judicial reform designed to improve legal procedures and enhance enforcement of contracts and property rights.The authorities will complete the reform of the state banking sector and privatize public utilities, state oil distribution, and the services of the major ports.

Addressing Social Needs

The authorities' social strategy is based on investing in human capital, by improving health and education, including through investment in social infrastructure in the poorest regions by the Social Investment Fund.

Nicaragua joined the IMF on March 14, 1946, and its quota is SDR 96.1 million (about $129 million). Its outstanding use of IMF financing currently totals SDR 20 million (about $27 million).

Press Release No. 98/7, March 19

Ghana: ESAF

The IMF approved the second annual loan under the Enhanced Structural Adjustment Facility (ESAF), in an amount equivalent to SDR 82.2 million (about $110 million), to support Ghana's economic program in 1998. The loan has been augmented by SDR 27.4 million (about $37 million) at the authorities' request, by rephasing the remaining amount available under the three-year loan program (see Press Release No. 95/38, *IMF Survey*, July 17, 1995). The commitment period of the three-year ESAF arrangement has also been extended by one full year to June 29, 1999. The loan is available in two equal semiannual installments, the first of which can be drawn immediately.

Ghana: Selected Economic Indicators

	1995	1996	1997	1998[1]	1999[2]	2000[2]
			(percent change)			
Real GDP	4.5	5.2	3.0	5.6	5.8	5.8
Consumer prices (end of period)	70.8	32.7	20.8	11.0	5.5	5.0
			(percent of GDP)			
Overall budget balance	–6.7	–10.4	–8.6	–6.3	–4.0	–3.4
External current account balance (excluding official transfers)	–6.5	–8.3	–6.4	–7.3	–6.6	–5.4
			(months of imports)			
Gross official reserves	4.6	3.4	2.8	2.7	2.9	3.1

[1]Program.
[2]Projection.

Data: Ghanaian authorities and IMF staff estimates and projections

1998 Program

The government's overall objective is to secure a stable macroeconomic environment that supports economic growth led by the private sector, thereby creating jobs, increasing incomes, and reducing poverty. The key macroeconomic targets of the 1998 program are to achieve annual real GDP growth of 5.6 percent, or 2.5 percent on a per capita basis; to reduce annual inflation from 20.8 percent in 1997 to 11 percent by the end of 1998, and further halve it to 5.5 percent by the end of 1999; and to contain the current account deficit at 7.3 percent of GDP while maintaining gross official reserves at the equivalent of 2.7 months of imports. To achieve these objectives, the Ghanaian authorities plan to strengthen the fiscal adjustment effort launched in 1997.

Structural Reforms

Under the program, the government will pursue structural reforms to enhance incentives for saving, encourage private investment, and improve resource allocation.

Addressing Social Needs

The fiscal program provides for a medium-term expenditure framework to be completed by mid-1998 that focuses on the priority sectors of education, health, and roads. The 1998 budget reflects a favorable shift in the composition of domestic expenditures, excluding interest payments, toward health and education.

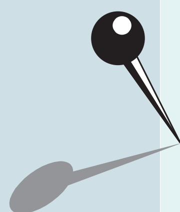
Ghana joined the IMF on September 20, 1957, and its quota is SDR 274.0 million (about $368 million). Its outstanding use of IMF financing currently totals SDR 249 million (about $334 million).

Press Release No. 98/8, March 23

Philippines: Stand-By Arrangement

The IMF approved a two-year stand-by credit for the Philippines equivalent to SDR 1.02 billion (about $1.4 billion) to support the government's economic program for 1998–99. The authorities have expressed their intention to treat the arrangement as precautionary and will draw on the credit only if necessary. The final review under the Extended Fund Facility, approved on June 24, 1994 (see Press Release 94/43, *IMF Survey*, July 25, 1994) was also completed.

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:

Guinea-Bissau, No. 98/20, March 26
Poland, No. 98/21, March 30
The Bahamas, No. 98/22, March 31
Morocco, No. 98/23, March 31
Mali, No. 98/24, April 1

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

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
March 23	4.25	4.25	4.55
March 30	4.30	4.30	4.60

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 107 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

1998–99 Program

The authorities' program addresses the dual goals of managing the current crisis while creating the conditions for sustained growth over the medium term, providing for an orderly adjustment to lower capital inflows in the wake of the crisis, and creating the conditions for an early return to sustained rapid growth. The main macroeconomic objectives for 1998 and 1999 are to contain the slowdown of real GNP growth to 3 percent in 1998 and 5 percent in 1999; limit inflation to 8 percent in 1998 and 6.0 percent in 1999; and reduce the current account deficit to 3.1 percent of GNP in 1998 and 2.7 percent in 1999, from 5.2 percent in 1997, with adjusted reserve cover rising to the equivalent of 1.9 months of imports in 1998 and 2.3 months in 1999.

To achieve these objectives, the consolidated public sector deficit will be limited to 0.9 percent of GNP in 1998 (compared with a projected deficit of 2.5 percent of GNP in the absence of corrective measures), followed by overall balance in 1999.

Structural Reforms

Comprehensive and proactive banking sector reforms are a central element of the authorities' strategy to contain the effects of the slowdown in growth, the peso depreciation, and higher interest rates. These reforms, which are already in course of implementation, comprise further increases in capital requirements: tightening provisioning requirements and strengthening regulatory oversight; reducing disincentives to peso intermediation; and adapting a resolution strategy for problem banks.

Addressing Social Needs

Poverty reduction in the Philippines has not proceeded as far as other countries in the region, although substantial inroads have been made in recent high-growth years. Measures to strengthen agriculture and improvements in education and health services, with a focus on primary education and the rural areas, are key to the government's strategy to reduce poverty.

Philippines: Selected Economic Indicators

	1995	1996	1997[1]	1998[2]	1999[2]
			(percent change)		
Real GNP growth	5.0	6.9	5.8	3.0	5.0
Consumer price index (end of period)	10.9	5.2	6.1	8.0	6.0
			(percent of GNP)		
National government balance	–1.3	–0.4	–0.9	–0.9	–0.1
Current account	–4.3	–4.5	–5.2	–3.1	–2.7
			(months of imports)		
International reserves (adjusted)[3]	2.2	2.8	1.7	1.9	2.3

[1]Actual.
[2]Program.
[3]Gross reserves less gold and securities pledged as collateral against short-term liabilities.

Data: Philippine authorities and IMF staff estimates

The Philippines joined the IMF on December 27, 1945. Its quota is SDR 633.4 million (about $851 million). Its outstanding use of IMF financing currently totals SDR 634 million (about $851 million).

Press Release No. 98/9, March 27

Recent IMF Publications

Staff Papers

Staff Papers, Vol. 45, No. 1 (March 1998) ($54.00 for four-issue volume; $27.00 academic rate)

Working Papers ($7.00)

98/30: *Islamic Banking: Issues in Prudential Regulations and Supervision*, Luca Errico and Mitra Farabaksh. Analyzes the implications of Islamic precepts on banks' structure and activities, focusing on banking supervision issues.

98/31: *Financial Infusion and Exiting from a Money Rule*, Mark Stone. Examines financial infusion, or an episode of large, upward, and permanent shifts in money demand prompted by successful macroeconomic stabilization.

98/32: *An Econometric Analysis of Countries' Repayment Performance to the International Monetary Fund*, Lynn Aylward and Rupert Thorne. Finds that the inclusion of IMF-specific financial variables and a small number of macroeconomic variables yields a highly significant econometric model of the probability of a country incurring IMF arrears.

98/33: *The Security Factor in the Political Economy of Development*, Martin C. McGuire. Analyzes both the productive and the unproductive side of security provision and shows that the balance depends on the nature of the political regime.

98/34: *Evaluation of Taxes and Revenues from the Energy Sector in the Baltics, Russia, and Other Former Soviet Union Countries*, Dale F. Gray. Examines the level and structure of fiscal revenues from the Baltics, Russia, and other former Soviet Union countries' energy sector and suggests reforms in energy tax policy.

98/35: *Should Public Pensions Be Funded?*, Richard Hemming. Outlines some of the arguments for and against the funding of public pensions, with a view to establishing whether there is an economic basis for judging funding to be superior to pay-as-you-go.

98/36: *Taxation and the Household Saving Rate: Evidence from OECD Countries*, Vito Tanzi and Howell H. Zee. Analyzes anew the relationship between taxation and the household saving rate.

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.

Transition Economies' Progress in Structural Reform Helps Determine Trade Patterns

During the Soviet period, trade of the economies of the Baltics, Russia, and other countries of the former Soviet Union was highly inward oriented. In a new Working Paper, *Opening Up and Geographic Diversification of Trade in the Transition Economies*, Oleh Havrylyshyn and Hassan Al-Atrash study the impact of the region's transition to a market-based system, beginning in 1990, on its trade patterns. They examine the extent to which a lifting of central planning restrictions on foreign trade has increased external trade relative to GDP and whether the degree of structural reform has affected the extent and speed of geographical trade reorientation.

Foreign trade statistics in the Baltics, Russia, and other countries of the former Soviet Union must be interpreted with great caution. The methodology of collecting and recording data changed markedly with the economic transformation and elimination of the large foreign trade organizations that relied on one currency and an administratively established exchange rate. Even after the dissolution of the U.S.S.R., the system of collecting statistics is still evolving. Furthermore, trade data for the U.S.S.R. were generally based on prices that deviated substantially and nonsystematically from world prices. A special 1989 study of the U.S.S.R. Statistics Committee partially corrects this pricing problem by recalculating trade using world prices. Nevertheless, analyzing this region's trade behavior is difficult.

Collapse and Recovery of Trade

Despite the strong caveats about data quality, there is little disagreement that intraregional exports in the countries under review dramatically declined at the start of the transition. Several factors explain this decline, including disintegration of intrarepublic trade links and of the interrepublic payments system, falls in incomes and demand throughout the region, substantial worsening in the terms of trade, and acute shortages of foreign exchange. The decline in trade with eastern Europe following the collapse of the Council for Mutual Economic Assistance also contributed to the decline in exports, but to a much smaller degree, as trade among the countries under review was more highly concentrated.

Since 1992, there has been a slow recovery in trade in all transition countries. In general, the advanced reformers have made significant progress in integrating their economies into the global trading system. As a result, the share of trade of Estonia, Latvia, and Lithuania—as well as Hungary, Poland, and the Czech and Slovak Republics—with the Baltics, Russia, and other countries of the former Soviet Union has fallen significantly in recent years. The advanced reformers were also successful in concluding trade agreements with major trading partners and regions, opening their exports to new markets. The slower reformers, on the other hand, have made more modest progress in shifting trade away from their earlier partners and toward the rest of the world. On the whole, however, trade in 1996 in these countries remains smaller than in 1990. According to the study, this reflects an increasing role of nontradable activities in recent years, the incomplete process of structural reform and resource allocation, as well as the still-lagging recovery of these economies.

Trade Openness

The most commonly used measure of trade openness is the ratio of exports and imports to GDP. The study suggests that (adjusting for size and per capita income) many countries, especially in central Europe, have economies that are as open as similar (in terms of size and per capita income) market economies. In this region, only Bulgaria, Romania, and, surprisingly, Poland show trade openness ratios below the cross-country norms. Nevertheless, for the countries that appear more open, none are as highly open as those in East Asia.

The results also suggest that most countries in the group comprising the Baltics, Russia, and countries of the former Soviet Union remain relatively closed compared to other economies of similar size and level of development. The main exceptions are the Baltics, Kazakhstan, Russia, and Ukraine. The results for Russia and Ukraine are somewhat surprising. Their trade openness ratios—at 23–28 percent—are as high or higher than for many much smaller transition economies. Indeed, the ratios are higher than or comparable to those of several medium-sized developing countries, though much smaller than those for industrial countries or more advanced emerging economies.

The study suggests that—notwithstanding methodological anomalies—the high trade openness ratios for Russia and Ukraine may stem from market participants' incomplete confidence in the countries' macroeconomic stability. This places a premium on external trading activities, which are a vehicle for capital flight and substitution into hard currencies. The study points out, however, that incomplete confidence would also result in much higher trading ratios for other countries in the region. Therefore, for Russia, the revival of natural resource exports may be part of the explanation. For Ukraine, it may be the continuation of strong trading links with other countries in the region. In addition, Russia and Ukraine were leaders in external and internal trade during the Soviet period and have been able to reestablish the old trading links earlier than other countries.

Geographical Trade Diversification

Although data problems complicate the analysis of trade direction shifts, orders of magnitude show that a diversification of exports to new markets outside the region did take place. In 1990, interrepublic trade accounted for well over 80 percent of all trade of each republic, except for Russia, where it amounted to about 65 percent. By 1996, the share of exports to the states of the former U.S.S.R. had declined to less than 60 percent, except for Belarus (75 percent), Georgia (66 percent), and Moldova (74 percent). Grouping countries by degree of reforms suggests that the advanced reformers have generally made the most progress in diversifying exports (see table). High-intermediate reformers—such as Estonia, Latvia, and Lithuania—reduced the share of exports to 48 percent in 1996 from around 94 percent in 1990. Low-intermediate and late reformers made much less progress, with the export share falling to 60 percent and 50 percent, respectively in 1996 from around 89 percent and 88 percent in 1990.

The advanced reformers among the Baltics, Russia, and countries of the former Soviet Union have the highest share of trade to the European Union (EU), averaging around 45 percent for Estonia, Latvia, and Lithuania in 1996. These reformers, as well as other transition countries in central and eastern Europe also concluded trade agreements with major trading partners, which have helped open new markets. The share of trade to the EU for the late reformers, on the other hand, was still only about 10 percent in 1996. Some countries under review have increasingly redirected their trade not to industrial countries, but to neighboring developing countries. For example, the share of Azerbaijan's trade with the Middle East and Asia has increased from 15 percent in 1992 to over 30 percent in 1996. Similarly, the share of Turkmenistan's trade with the Middle East and Asia has increased from 1 percent in 1992 to 10 percent in 1996.

The study concludes that transition countries that have made the most progress in structural reforms have also gone farthest in diversifying their exports to new destinations. The actual global diversification of transition countries is dominated by diversification toward European markets. What would be the share of exports to the EU if progress in structural reforms were more ambitious? The study uses a model to simulate the effects of more ambitious structural reforms. Most striking in the results is the extent of potential diversification. Even for countries most advanced in reforms, such as Poland and the Czech Republic, one might still expect as much as an 8 percent to 10 percent increase in the level of exports to the EU to 65 percent or so of total exports. For those least advanced in reforms, one might expect more than a doubling—to levels of between 40 percent and 50 percent.

Implications for Policymakers

Many countries are still far from achieving the geographic pattern of trade that might be considered "natural"—that is, the pattern expected when a more fully functioning market economy is in place. This conclusion, along with those noted above, implies that:

• To the extent that expanding trade in new directions based on comparative advantage is an important element of successful restructuring and resource reallocation, much remains to be done in terms of liberalization and reform in some transition economies.

Share of Exports to the Baltics, Russia, and Countries of the Former Soviet Union and to Other Transition Economies

	1990	1992	1994	1996
Advanced reformers[1]	21.8	10.9	8.1	9.0
Czech Republic[2]	25.9	10.6	5.7	5.5
Hungary	20.2	13.1	10.2	9.4
Poland	15.3	9.2	9.3	13.9
Slovakia[2]	25.9	10.6	7.0	7.3
High-intermediate reformers[1]	70.7	28.6	34.2	33.7
Bulgaria	47.1	23.2	11.8	20.1
Estonia	94.3	...	44.0	39.0
Latvia	95.5	48.8	50.1	47.5
Lithuania	91.4	...	57.7	56.8
Romania	25.2	13.9	6.6	5.3
Low-intermediate reformers[1]	88.5	70.8	58.3	55.6
Armenia	97.0	...	...	...
Georgia	90.9	...	62.9	66.1
Kazakhstan	88.7	...	72.2	58.8
Kyrgyz Republic	97.3	74.9	59.1	...
Moldova	92.5	66.6	73.1	74.4
Russia	64.4	...	24.3	22.9
Late reformers[1]	87.6	51.9	43.1	44.9
Azerbaijan	91.9	50.7	44.3	50.2
Ukraine	81.8	53.1	38.4	43.1
Uzbekistan	89.1	...	46.6	41.5
Others[1]	88.9	69.4	45.3	59.9
Belarus	88.9	69.4	62.8	74.7
Tajikistan	81.9	...	22.4	45.1
Turkmenistan	95.9	...	50.8	...

[1]Average.
[2]Prior to 1993, Czechoslovakia.

Data: National authorities and IMF staff estimates; 1990 data used different pricing basis and are for indicative purposes.

• Greater access to EU markets—through association agreements or other arrangements—would give an added boost to reorientation of trade.

• A competitive exchange rate is important in achieving diversification of the new markets in Europe.

• For the transition economies of the former Soviet bloc relatively close to western Europe, the huge size and proximity of these markets implies a dominant share of exports will go to those markets in the longer term. ■

Copies of Working Paper 98/22, *Opening Up and Geographic Diversification of Trade in the Transition Economies*, by Oleh Havrylyshyn and Hassan Al-Atrash, are available for $7.00 each from IMF Publication Services. See ordering information on page 109.

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UNCTAD/ICC Survey

Multinationals Remain Confident in Asia As Destination for Investment

Leading multinational corporations continue to show confidence in Asia as a destination for foreign direct investment, according to a survey conducted in mid-February by the United Nations Conference on Trade and Development (UNCTAD) and the International Chamber of Commerce (ICC). Of the 500 multinational firms polled, 198 responded to the survey, and 62 percent of those will continue with their existing direct investment plans in Asia over the short and medium term, while 25 percent plan to increase direct investments. Over the longer term, almost all the firms questioned were positive, taking the view that direct investment prospects are either unchanged (81 percent) or have improved (13 percent).

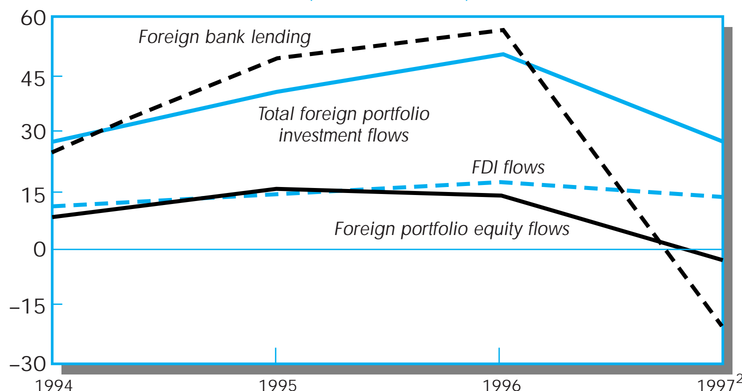
ICC Secretary General Maria Livanos Cattaui announced the results at a press conference on March 18 in New York, saying that the survey underlined a key distinction between the reactions of direct investors and those of portfolio investors and banks, whose decisions about international capital movements had been the center of attention during the Asian crisis. "Capital investments by portfolio investors focus on shorter term financial gains and tend to be volatile. In contrast, direct investors are mainly concerned with visible economic transactions, such as the establishment or expansion of plants, the operation of internationally integrated production systems, the international transfer of technology, and the distribution of intermediate and final products in world markets," Cattaui said, adding that the results are "a resounding vote of confidence in the economic fundamentals of east and southeast Asia and the region's long-term prospects."

Responses to the survey questions were consistent, both by main business sectors—primary, manufacturing, and services—and by home regions—Europe, North America, Japan, and developing Asia. According to UNCTAD Secretary-General Rubens Ricupero, "The results [of the survey] clearly show that multinational corporations are keenly interested in the region for direct investment. This augurs well for recovery in the region."

Survey Results

Statistics on foreign direct investment in the region support the survey's results. While portfolio equity investment and bank lending to affected countries have fallen sharply since the onset of the Asian crisis, foreign direct investment flows have remained close to pre-crisis levels. Net private foreign bank lending and foreign portfolio equity investment are estimated to have turned negative for the group of countries most affected by the crisis—Indonesia, Korea, Malaysia, Philippines, and Thailand—taken together (see chart). Foreign direct investment flows in 1997 to this group of countries as a group, however, have remained close to their 1996 levels. For developing east and southeast and south Asia as a whole, net flows are estimated to have increased from $77 billion in 1996 to $80 billion in 1997.

Foreign Bank Lending and Investment Flows[1]
(billion U.S. dollars)



[1]To Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand.
[2]Estimates.

Data: UNCTAD, based on UNCTAD's FDI/TNC database, data provided by the World Bank (portfolio flows data for 1994–96) and the Institute of International Finance

The survey recommends that the Asian countries consider policy measures to stimulate investment, including:

- Governments could make an extra effort to provide information about greenfield and joint venture investment opportunities, especially in priority activities.
- Countries might provide assistance to dynamic and innovative small and medium-sized enterprises whose role as potential partners in international networks and technology alliances would be enhanced.
- Asian countries could review their regulatory frameworks for foreign direct investment to make them as appropriate as possible in light of their development objectives.
- Where appropriate, Asian multinational corporations could adopt international accounting standards as soon as possible.
- Within the framework of regional integration arrangements and other forums for cooperation, Asian countries could formulate measures jointly to encourage foreign direct investment and its contributions to the economies of member countries.