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Forces of Globalization Must Be Embraced

Globalization—the focus of the IMF's May 1997 World Economic Outlook *(see* IMF Survey*, May 12, 1997, page 149)—is a fundamental source not only of economic growth but also of structural change, presenting policymakers with both new opportunities and challenges. To address some of the issues raised by globalization, the IMF sponsored an Economic Forum on May 5 at IMF headquarters. Moderated by Graham Hacche of the IMF's Research Department, participants included Dani Rodrik of Harvard University, and Robert Wescott and Phillip Swagel of the IMF's Research Department. Issues considered included the contribution of globalization to convergence between the income levels of the developing and advanced economies, the effect of competition from the developing world on wages and employment in advanced economies, and the impact of globalization on domestic policies and institutions.*

Dani Rodrik (left), Graham Hacche, Robert Wescott, and Phillip Swagel at the Economic Forum on globalization.

Since the mid-1980s, the pace of globalization has quickened considerably. As the *World Economic Outlook* points out, world trade has increased nearly twice as fast as world GDP, financial markets in many countries have been liberalized rapidly, and capital flows have accelerated. A striking feature of this expansion is the heightened involvement of developing countries over the last decade. These *(Please turn to the following page)*

Priorities for Russian Reform

"The IMF wants to provide as much support as it can to enhance economic reform prospects in Russia," said John Odling-Smee, Director of the IMF's European II Department and moderator of a recent IMF Economic Forum at IMF headquarters on prospects for macroeconomic stability and structural reform in Russia. Further progress with macroeconomic stabilization and structural reform should be Russia's key reform goal, Odling-Smee said. As the political momentum in support of reform builds in Russia, the IMF's chief responsibility is to work with the authorities to help ensure that the emerging consensus is underpinned by strong economic logic. Other participants at the forum included Padma Desai of Columbia University, Charles Wyplosz of the University of Geneva, and IMF Executive Director for Russia Aleksei Mozhin. Among the key issues addressed were Russia's current fiscal crisis and the role the IMF might play in helping address this challenge; steps the Russian government might take to solve its increasingly serious arrears problem; the extent and impact of crime and corruption in Russian economic life; and Russia's new economic leadership and its prospects for success.

The Record to Date

Forum participants agreed that Russia's new economic team could help lay the groundwork for stable growth and successful structural reform. These prospects were buoyed by sharply reduced inflation, a freely traded and convertible ruble, the abolition of central planning, reduced trade barriers, and the continued spread of privatization initiatives throughout Russia. A critical challenge was to address and resolve the country's looming fiscal crisis.

According to Desai, the IMF deserved substantial credit for helping expand the *(Please turn to page 164)*

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countries have increased their share of world trade to 29 percent in 1995 from 23 percent in 1985. They have also deepened and diversified their trade linkages in response to major changes in trade and exchange regimes in the direction of more outward-looking and open policies.

Developing countries are also becoming increasingly integrated with the global financial system. Net private capital flows to developing countries, excluding the Asian newly industrialized economies, reached almost $200 billion in 1996—nearly a sixfold increase from the average annual inflow during 1983–89. Liberalized financial markets in both recipient and source countries have helped spur this growing capital market integration. Impressive growth performance and improved track records of macroeconomic stability on the part of many developing countries, and emerging market countries in particular, have also promoted capital market integration by making these markets more attractive to investors.

Integration Not Coupled with Income Convergence

Examining the effects of these developments on cross-country growth and income patterns, Robert Wescott noted that, in absolute terms, living standards in most developing countries, as measured by real per capita incomes, have risen substantially between 1965 and 1995. Even excluding the successful Asian newly industrialized economies, developing countries as a whole more than doubled their real per capita income over the past thirty years. This average gain, however, is no greater than that achieved by the advanced economies, implying that per capita income levels between the two groups have not converged. In fact, Asia is the only major region to have registered significant relative progress. Gaps between the Western Hemisphere, the Middle East, and Africa, and the advanced economies have widened since 1965, especially after the mid-1970s. Moreover, evidence suggests that within the international distribution of average per capita incomes, developing countries have become increasingly polarized into high- and low-income clusters. These regional developments in relative income performance seem to parallel the patterns of integration proxied by shares of world trade.

To put themselves on a path of convergence with the advanced economies, developing countries must align their policies with the forces of globalization. They must embrace the reforms needed to do so, liberalizing markets and pursuing disciplined macroeconomic policies, said Wescott. Citing a study of the relationship between policies and income growth in 110 developing countries during 1985–95—a period when the global integration process was in full swing—Wescott noted that policies and income growth performance are highly correlated. A key lesson is that no one policy is sufficient by itself but that sound policies in several areas are necessary to support fast growth.

Trade Sparks Some Concerns

By enabling a greater international division of labor and a more efficient allocation of savings, globalization raises productivity and living standards, while broader access to foreign products allows consumers to enjoy a wider range of goods and services at lower cost. Globalization can also allow a country to mobilize a larger volume of financial savings, as investors have access to a wider range of financial instruments in various markets. Nevertheless, globalization has sparked some concerns. For example, it is often asserted that the increasing integration of developing and transition countries into the global economy has contributed to declining relative wages and employment of less-skilled workers in advanced economies. Indeed, increased globalization throughout the 1980s and 1990s has coincided with a period of increased labor market "anxiety" in the advanced economies, said Phillip Swagel. In the United States, this anxiety has manifested itself in falling wages for unskilled workers relative to wages of skilled workers, and in Europe, through record high unemployment rates, particularly for unskilled workers.

The way in which globalization may affect wages in advanced countries is through low-cost imports. Import competition from unskilled-labor-intensive products tends to lower the prices of such products, reducing profitability of their production relative to skilled-labor-intensive products and inducing firms to shift production toward the latter. Trade flows can thus give rise to countrywide shifts in factor demands. With fixed supplies of factors, this leads to changes in factor prices and, in particular, to a relative decline in the earnings of unskilled labor.

The question then is whether prices of import-competing, low-skilled-labor-intensive goods have fallen relative to prices of high-skilled-labor-intensive goods. Data show that imports have, in fact, not reduced the relative prices of goods produced by unskilled labor, indicating that trade has had little effect on wages and employment in advanced economies, according to Swagel. Although the impact of trade on wages cannot be discounted completely, with trade accounting for an estimated 10 to 20 percent of the increase in wage dispersion in the industrial countries during the 1980s and 1990s, it appears that this increased inequality results largely from a shift toward high-tech industries requiring high-skilled workers and by advances in production technology that favor skilled labor.

Concerns have also been expressed in a number of advanced economies that outflows of capital—particu-

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larly foreign direct investment, the exporting of jobs, and outsourcing by domestic firms—have lowered domestic wages and employment. Evidence, although limited, indicates that employment tends to rise or fall together in the parent company and subsidiaries, according to Swagel. As such, firms do not appear to have substituted foreign for domestic workers on a large scale. Although globalization may adversely affect some industries, Swagel suggested that the appropriate policy response would be to address the underlying structural rigidities that prevent labor markets from adjusting to technological change or external competition rather than attempting to limit globalization itself. In this respect, he emphasized the critical importance of education and training and also the need for well-targeted and cost-effective social safety nets to assist those displaced.

Dani Rodrik said that globalization has made it both more difficult and more necessary for governments to provide social insurance. The welfare state has been under attack for two decades, and while the increasing mobility of capital has rendered an important segment of the tax base footloose, the need for social insurance has not diminished. If anything, it has become greater as a consequence of increased global integration, which has fundamentally transformed the employment relationship: reduced barriers to trade and investment accentuate the asymmetry between groups that can cross international borders and those that cannot. As such, globalization makes the demand for the services of individuals more elastic; the fact that workers can be more easily substituted for each other across national boundaries undermines what, according to Rodrik, many conceive to be a postwar social contract between workers and employers, under which the former would receive a steady increase in wages and benefits in return for labor peace.

Globalization can also lead to conflicts within and between nations over domestic norms and social institutions that embody them, said Rodrik, and trade becomes contentious when it undermines the norms implicit in domestic practices. He noted that many residents of advanced countries are uncomfortable with the weakening of domestic institutions through the forces of trade when, for example, child labor in Honduras displaces workers in South Carolina or when pension benefits in Europe are reduced to meet the requirements of the Maastricht treaty. The challenge therefore is how to minimize the tension between globalization and the pressures for socialization of risk. If such tensions go unaddressed, the danger is that the domestic consensus in favor of open markets will ultimately erode and trigger a generalized resurgence of protectionism. A serious retreat into protectionism would, concluded Rodrik, only hurt the many groups that benefit from trade. ■

Globalization Calls for Extending IMF's Role

The rapid globalization of capital flows and the concurrent development and growing importance of emerging market economies were key themes that emerged from the spring meetings of the IMF's key policy advisory committee, the Interim Committee of the IMF's Board of Governors. A major challenge facing the global financial community, according to Charles Dallara, Managing Director of the Washington-based Institute of International Finance (IIF), is "how to sustain, broaden, and deepen private flows to these economies." In a letter to IMF Managing Director Michel Camdessus and Interim Committee Chairman Philippe Maystadt prior to the Interim Committee meeting, Dallara suggested actions that the international financial community—markets, national governments, and international financial institutions—could take to address this challenge. Speaking a week later at the Spring Membership Meeting of the IIF, IMF First Deputy Managing Director Stanley Fischer spelled out the actions the IMF is taking to adapt its role to meet the requirements of the increasingly globalized financial markets.

Recent Developments in Emerging Markets

In 1996, according to Dallara, private flows to emerging markets amounted to $255 billion—a more than fourfold increase over 1990. Nearly half of these flows were in the form of equities. Asian economies were the leading recipients, garnering about $131 billion in net flows. As a consequence of these flows, the financial position of emerging market economies has strengthened considerably.

Dallara attributed the impressive growth of private flows to emerging markets to several positive trends:

- growth and reform in emerging market economies;
- greater transparency, especially the publication of better and more timely data;
- financial market integration;
- corporate globalization; and
- portfolio diversification.

Although these trends augur well for the continued expansion of private flows to emerging market economies, Dallara cited several risks that could jeopardize their sustainability, including uneven country performance, a slackening of reforms, the diminishing influence of multilateral institutions, and injudicious lending.

The continued expansion of capital flows can also have potentially harmful effects on emerging market economies. Strong inflows can weaken external competitiveness and put pressure on monetary policy. They can also create the illusion that macroeconomic discipline can be relaxed and, in some cases, weaken politi-

cal support for reforms, and they can undercut efforts to boost domestic saving. All players in the international financial community have a role in minimizing these risks, according to Dallara. For the advanced countries, sound, coordinated policies are essential for a healthy world economy and to support exports for emerging market economies.

Policymakers in emerging market economies can guard against the reversal of capital flows and the pitfalls of strong flows by:

• countering upward exchange rate pressure by reducing underlying fiscal imbalances, following pragmatic exchange rate policies, and liberalizing capital flows;

• sustaining disciplined policies and deepening structural reforms even when markets do not seem to require them in the short run;

• increasing transparency through the timely release of data; and

• strengthening and deepening financial systems.

Market participants—asset managers, investors, and lenders—also have a vested interest in enhancing stability and need to monitor and analyze risks assiduously.

Finally, the multilateral institutions—the IMF and the development banks—can help sustain private flows by continuing to adapt their roles in a rapidly changing world.

Role of the Multinationals

Despite the generally good prospects for sustained capital flows to emerging market economies, many downside risks remain, according to Stanley Fischer. Some of these risks are specific to individual countries, and discriminating investors should be able to deal with them. Other risks are more generalized and have systemic implications—for example, the risk that capital flows to emerging markets may be significantly affected by conditions in advanced country capital and money markets. These risks require the attention of the international community. Several initiatives are already under way or in prospect.

Despite rapid globalization of capital markets, capital controls remain widespread.

Financial Market Initiative. According to a 1996 IMF study—*Bank Soundness and Macroeconomic Policy* (see *IMF Survey*, February 24, page 60), 130 countries, including advanced economies, had experienced banking sector problems in the past several years. The growing realization that banking sector crises play an important role in the propagation of macroeconomic crises and that their resolution takes a heavy toll on fiscal resources has led to a major international effort to improve the quality of banking and financial systems in developing countries, according to Fischer. Among these are a report by the Group of Ten (G-10) deputies setting out a comprehensive strategy for dealing with financial sector problems (see page 158); and a paper by the Basle Committee on Banking Supervision that sets out 25 core principles that apply to bank supervision in emerging markets.

What the IMF Is Doing

The IMF is participating in the effort to enhance financial stability in emerging market economies and to strengthen the banking systems of all its members, both in collaboration with other institutions and through its own activities. Recently, the Managing Director of the IMF and the President of the World Bank issued a statement setting out the principles of their cooperation. The IMF, which will retain its macroeconomic focus, is paying increasing attention to the quality of banking systems in its surveillance and its technical assistance. In advising its members on banking standards, the IMF will use the Basle Committee's new core principles wherever possible. The World Bank will focus its lending and technical assistance on the microeconomic aspects of banking systems, supervision, and financial systems in general.

The IMF is also expanding its activities and its mandate into two major areas relevant to financial system stability: transparency and the capital account.

Transparency. Much of the IMF's analysis of economic developments in member countries is already widely available through its flagship publications, the biannual *World Economic Outlook* and the annual *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Fischer said. The IMF also publishes—with the consent of the country concerned—staff country reports, prepared as part of the annual consultation process the IMF holds with all its member countries (Article IV consultations).

The IMF has established a Special Data Dissemination Standard (SDDS) for member countries having, or seeking, access to world capital markets—to which 42 countries have subscribed. These countries provide comprehensive information about their data under the SDDS Dissemination Standards Bulletin Board (DSBB), which is available on the Internet (http://dsbb.imf.org). In addition, six countries have also established electronic hyperlinks from the DSBB to actual country data maintained on their own web sites (see *IMF Survey*, May 12, page 133). The IMF is also working on a General Data Dissemination System, which is both a data standard and a data system aimed at all other members.

Finally, the IMF Executive Board recently agreed to the publication of press information notices (PINs), based on the Executive Board's discussion of the coun-

try's Article IV consultation report (see *IMF Survey*, May 12, page 148).

The issue of how the IMF can better and more systematically share its assessments of individual countries' prospects with market participants is still a vexed one, according to Fischer, because the nature of the IMF's relations with its members inevitably limits the extent to which it can share such information. Although the PINs represent a major advance in making information about IMF consultations with member countries public, Fischer emphasized that they will only be issued with the consent of the country concerned. As an adviser to member countries, the IMF receives a great deal of confidential information, which

Stand-By, EFF, and ESAF Arrangements as of April 30

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-by arrangements			**3,764.48**	**2,481.07**
Argentina	April 12, 1996	January 11, 1998	720.00	321.00
Bulgaria	April 11, 1997	June 10, 1998	371.90	348.70
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
Papua New Guinea	July 14, 1995	December 15, 1997	71.48	36.14
Romania	April 22, 1997	May 21, 1998	301.50	241.20
Venezuela	July 12, 1996	July 11, 1997	975.65	625.65
Yemen	March 20, 1996	June 19, 1997	132.38	14.38
EFF arrangements			**10,183.93**	**6,574.56**
Algeria	May 22, 1995	May 21, 1998	1,169.28	422.08
Azerbaijan	December 20, 1996	December 19, 1999	58.50	49.14
Croatia	February 12, 1997	March 11, 2000	353.16	324.38
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	20.70
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			**4,048.28**	**1,675.74**
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	August 31, 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	83.25
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	3.68
Guyana	July 20, 1994	April 17, 1998	53.76	8.96
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	March 31, 1998	88.15	16.00
Lao P.D.R.	June 4, 1993	May 7, 1997	35.19	—
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	45.47
Madagascar	November 27, 1996	November 26, 1999	81.36	67.80
Malawi	October 18, 1995	October 17, 1998	45.81	22.91
Mali	April 10, 1996	April 9, 1999	62.01	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	January 12, 1998	130.79	17.84
Sierra Leone	March 28, 1994	December 31, 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	40.00
Total			**17,996.69**	**10,731.37**

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

Data: IMF Treasurer's Department

IMF arrangements are not contracts; they are decisions by which the IMF assures members of their ability to draw on IMF resources.

the member would be reluctant to reveal without the assurance that the information would remain confidential. The IMF's capacity to provide frank and useful advice would be significantly impaired if the organization were systematically making these assessments public. Nevertheless, Fischer said, the IMF will continue to explore ways of improving information flows.

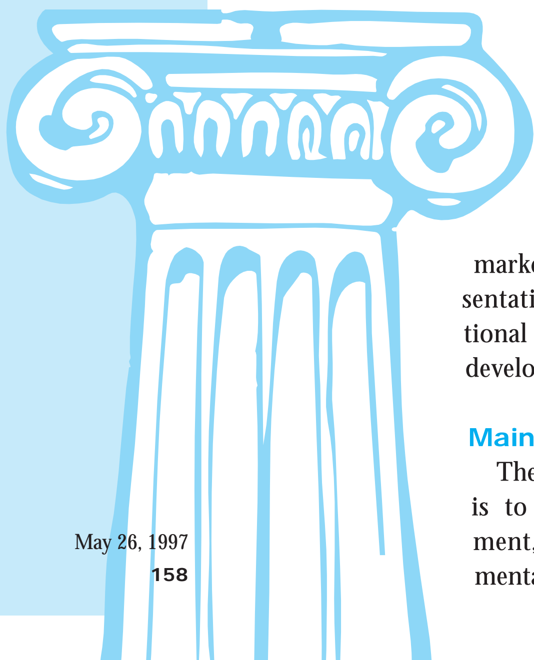
Capital Account. One of the IMF's most important initial challenges was to re-establish an international system of payments and restore the volume of international trade in goods and services that had been decimated by the Great Depression and World War II. Fifty years later, more than one-half of the IMF's member countries—including many of the transition economies—have agreed to keep their current account transactions free from restrictions that would hamper the free flow of goods and services. Despite the rapid globalization of capital markets, however, capital account liberalization lags behind, and capital controls are still widespread.

It is now clear, as noted by the G-10 in its communiqué issued during last month's spring meetings (see *IMF Survey*, May 12, page 141), that capital account liberalization should be pursued and that the IMF should have jurisdiction in this area. Taking the G-10's suggestion one step further, the IMF's Interim Committee agreed at its April meeting that the IMF's Articles of Agreement should be amended "to make the promotion of capital account liberalization a specific purpose of the IMF and to give the IMF appropriate jurisdiction over capital movements."

Taking on jurisdiction over capital movements will be a major step for the IMF and for the international economy, Fischer concluded. It will enable the institution to contribute to completing this "critical chapter in the creation of the global economy." ■

New Strategy Aims to Promote Financial Stability in Emerging Markets

Banking and financial crises can result in heightened macroeconomic instability, reduced economic growth, and a less efficient allocation of savings and investment. Recognizing these hazards and responding to an initiative at the Lyon Summit of the Group of Seven industrial countries in June 1996, a working party consisting of representatives of the Group of Ten (G-10) advanced countries and emerging market economies (see box, page 159) have developed a strategy for fostering financial stability in countries experiencing rapid economic growth and undergoing major changes in their financial systems. The strategy, set out in a report entitled "Financial Stability in Emerging Market Economies," was prepared under the chairmanship of Mario Draghi, Chairman of the Deputies of the G-10, in consultation with officials from other countries, market participants, and representatives of various international groupings and regional development banks.



Main Elements

The strategy's main objective is to promote the establishment, adoption, and implementation of sound principles and practices to ensure financial stability. To this end, the working party calls for:

- development of an international consensus on the key elements of a sound financial and regulatory system by representatives of the G-10 and emerging market economies;
- formulation of norms, principles, and practices by international groups of national authorities with relevant expertise and experience—such as the Basle Committee on Banking Supervision, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions;
- use of market discipline to provide incentives for adopting sound supervisory systems, better corporate governance, and other key elements of a robust financial system; and
- promotion by such multilateral institutions as the IMF, the World Bank, and the regional development banks of the adoption and implementation of sound principles and practices.

In developing this strategy, the working party was guided by three fundamental premises. First, the ultimate responsibility for policies undertaken to strengthen financial systems must lie with the national authorities. Second, financial sector stability is most likely to be achieved when international prudential standards are met and when markets operate competitively, professionally, and transparently, according to sound principles and practices that generate the relevant information and appropriate incentives. Third, sound macroeconomic and structural policies are essential for financial system stability to prevent, or at least limit, the

emergence of serious financial imbalances, misleading price signals, and distortions in incentives.

Sources of Financial Instability

Past experience demonstrates that a wide range of microeconomic and institutional failings contribute to financial instability in emerging market economies. Almost invariably, however, these failings give way to systemic crises in the presence of an unstable macroeconomic environment, in the wake of major structural transformations, or as a result of important distortions in the real economy. Emerging market economies have been more prone to boom-bust cycles and to sudden corrections in asset prices, in part because they have tended to be less diversified and less able to absorb shocks than more mature economies.

The root causes of financial crises, as mentioned above, are generally to be found in microeconomic and institutional failings. Problems typically begin with lax management within financial institutions. Poor internal controls, connected lending, insider dealing, and fraud are often the causes of poor asset quality. Weaknesses in the legal framework compound the problems of lax management and weak corporate governance, for instance, by undermining the collection of collateral. Once credit quality has been compromised, regulatory shortcomings and supervisory forbearance can aggravate matters further by failing to identify problems and preventing them from being addressed in a comprehensive and timely fashion. The market can play a crucial role in disciplining bad performers, but this function can be hindered by inadequate information or distorted incentives, such as explicit or implicit government guarantees. In the absence of effective market discipline, the full burden of external oversight falls on regulators and supervisors, who may lack the requisite capacity.

Key Elements of Robust Financial Systems

Given the above sources of financial instability, the working party identifies several actions as crucial for strengthening financial systems:

• creation of an institutional setting and financial infrastructure to underpin sound credit culture and effective market functioning;

• promotion of the functioning of markets so that owners, directors, investors, and other actual and potential stakeholders exercise adequate discipline over financial institutions; and

• creation of regulatory and supervisory arrangements that complement and support the operation of market discipline.

Developing and Implementing Sound Practices

The working party also recommends that a single set of principles be developed through a broad international consultative process involving national experts for each activity required for robust financial systems. For example, in the areas of accounting, payments and settlements, banking supervision, securities market supervision, insurance supervision, and financial conglomerates, specific international groupings should establish sound principles and practices and precise timetables for completing their work. Involving a wide range of countries in the process of formulating principles and practices facilitates their adoption and implementation because it generates a degree of commitment that would be difficult to achieve in the absence of such consultation. A variety of complementary methods contribute to the adoption of sound practices:

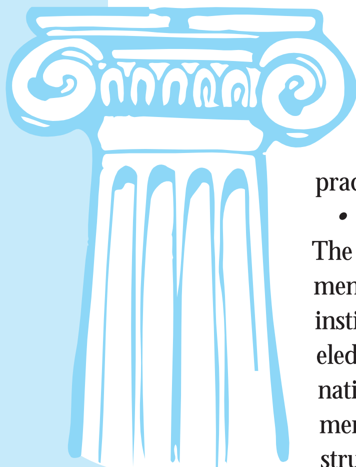
• *Market access.* Authorities in both the advanced and emerging market economies should provide well-managed financial institutions with access to their markets, thus promoting the spread of high-quality management systems and professional skills and contributing to the strengthening of the "credit culture." International organizations—such as the IMF, the World Bank, regional development banks, and the OECD—can contribute to this process by supporting efforts to reduce the macroeconomic imbalances and eliminate the structural distortions that contribute to financial instability. By promoting the improvement of information and encouraging further data dissemination, they can also enhance shareholders' capacity to monitor progress and to provide the incentives and discipline that will bolster the robustness of financial systems.

• *Taking stock of progress.* In its surveillance, the IMF should take stock of the progress that countries make in adopting sound principles and practices developed by the international groupings. In its policy advice, the IMF should consider the macroeconomic implications of financial sector or supervisory

Participants in Working Party on Financial Stability

Argentine Ministry of Finance
Bank of Indonesia
Bank of Thailand
Banque de France
De Nederlandsche Bank (Netherlands)
Deutsche Bundesbank (Germany)
H.M. Treasury; Bank of England
Hong Kong Monetary Authority
Japan Ministry of Finance; Bank of Japan
Mexican Banking Securities Commission
Narodowy Bank Polski (Poland)
Singapore Monetary Authority
Sveriges Riksbank (Sweden)
Bank of Korea
U.S. Treasury Department; Federal Reserve Board
Bank for International Settlements
Basle Commission
Commission of the European Communities
International Monetary Fund
International Organization of Securities Commissions
Organization for Economic Cooperation and Development
World Bank Group

weaknesses and draw the attention of national authorities to macroeconomic imbalances that can disrupt the banking and financial sector. The IMF and the World Bank should develop modalities for sharing their assessments of financial sector strength and the regulatory and supervisory regimes. Other multilateral organizations can also contribute to monitoring the adoption of sound practices.



• *Advice for financial sector reform.* The World Bank and regional development banks are the most appropriate institutions for providing advice modeled on norms developed by the international groupings for the development of robust and efficient financial structures in emerging markets.

• *Financing financial sector reform programs.* The World Bank and regional development banks should provide financing for financial sector reform and structural measures to strengthen financial systems. In cases where immediate balance of payments problems or macroeconomic strains arise because of weakness in the financial sector, IMF-supported programs could include steps to correct these shortcomings.

• *Technical assistance* can be of great help in developing the skills needed for a robust financial system. The private sector and the bilateral official sector have highly relevant expertise and experience in this area and are in a good position to provide such assistance. The multilateral institutions should foster the spread of this experience as they give higher priority to financial sector issues.

• *Coordination.* Because the role and responsibilities of the IMF and the World Bank overlap in many respects, close coordination between them is essential in their assessment of financial systems, program design, and technical assistance. They should also further clarify their respective roles to ensure complementarity, bearing in mind their different comparative advantages. In all three areas, the IMF and the World Bank should develop practical and effective means to ensure close collaboration and adequate cooperation with other multilateral institutions. ■

To obtain a free copy of "Financial Stability in Emerging Market Economies," April 1997, please fax the IMF Public Affairs Division: (202) 623-6278.

Goldstein Proposes International Banking Standard

"I'm about to embark upon a hazardous and technically unexplained journey into the outer stratosphere," said the Wizard of Oz. With the rapid integration of world financial markets and continuous financial innovation, most central bankers will empathize with the Wizard. The world over, there is increasing worry about the soundness of the banking system. Regulators and other supervisory bodies are preoccupied with the degree of systemic risk to which the global system is exposed. IMF Managing Director Michel Camdessus has several times expressed concern that the next systemic crisis could be triggered by a banking crisis.

Goldstein: Banking standards are not a substitute for disciplined financial policies.

The vulnerability of developing countries exceeds that of advanced countries. "Gone are the days when efforts to prevent international financial crises could focus almost exclusively on the industrial countries," said Morris Goldstein at a recent seminar sponsored by the Washington-based Institute for International Economics (IIE). Goldstein, a former senior IMF staff member and currently Senior Fellow at the IIE, was referring to the alarming frequency and severity of banking crises in the developing world. With nearly three-fourths of all countries experiencing one serious bout of banking problems during the last 15 years, "the IMF's list of banking crises read like a global phone book." Bulgaria, the Czech Republic, Korea, Romania, and Thailand are just the latest casualties.

International banking guidelines, including capital adequacy, that are in place today were designed largely for the Group of Ten (G-10) or other industrial countries. They do not address adequately the problems underlying banking systems in developing countries, such as heavy government involvement in the banking system, poor asset classification and provisioning practices, or weak information and disclosure systems. To improve on existing international banking agreements, Goldstein argues for a voluntary international banking standard.

As First Deputy Managing Director Stanley Fischer pointed out in his introductory remarks at the IIE sem-

inar, the idea of an international banking standard has gained momentum since its inception as a ".. two-page memo [from then-visiting scholar Goldstein to Fischer] in April 1996." From there on, Goldstein has "mobilized institutions and got them moving at a hitherto unseen speed." Fischer referred to the involvement of the Basle Committee on Banking Supervision, the IMF, and the joint G-10-emerging market country working group of finance and central bank deputies in coming out—within six months—with action proposals on the subject (see page 158)—"a task that would normally have taken ten years."

Genesis of the Idea

The motivation for Goldstein's international banking standard is clear: the costs and frequency of banking crises in developing countries. Since 1980, the public costs of bailing out banks in developing countries alone have totaled almost $250 billion. In more than a dozen developing countries, the cost of resolving these crises has amounted to 10 percent or more of their GDP. By contrast, the U.S. savings and loan debacle of 1984–91—whose cost amounted to 2 percent of GDP—does not even make the "misfortune 50 list."

The costs of banking crises, however, extend far beyond their enormous fiscal impact, according to Goldstein. More specifically, banking crises worsen downturns in economic activity, prevent savings from flowing to their most productive use, and reduce the availability and increase the cost of credit to small and medium-sized firms. They can also seriously constrain the flexibility of monetary policy.

And this is not the whole story. Industrial countries are also affected by the economic fortunes of developing countries, said Goldstein. The increasing weight and integration of emerging economies in international financial markets have made potential spillover effects a serious concern. Developing countries now account for approximately 45 percent of global output, about one-third of global foreign direct investment and portfolio flows, and roughly one-eighth of global stock market capitalization and global banking assets. They also purchase 25 percent of industrial countries' exports. Because banking crises in developing countries depress their growth and foreign trade, strain their debt-servicing capacity, often wind up as liabilities of their governments, and frequently require new loans from the IMF and the World Bank, industrial countries have an important stake in promoting stronger banking systems in the developing world. Moreover, the industrial countries' own spotty record on banking problems—including the "massive ongoing bad loan problems in Japan"—suggests that they, too, have ample scope for improving their systems of banking supervision, Goldstein pointed out. Clearly, this large gap in existing crisis prevention arrangements needs to be filled urgently.

The "Goldstein Prescription"

Existing international agreements on banking supervision are not comprehensive enough to deter banking crises in developing countries. "With relatively high macroeconomic instability, limited diversification of bank loans, and a relatively small financial cushion in the form of capital and loan-loss provisions, banks in developing countries have been skating on thin ice," said Goldstein. In some cases, developing country governments use banks to channel government assistance to ailing industries, which falls outside traditional measures of the fiscal stance and escapes public scrutiny—until the crisis erupts. Accounting conventions are typically not rigorous enough to prevent banks from concealing the true size of their nonperforming loans. Official safety nets do not give bank owners, managers, and uninsured creditors "enough to lose" when they bring a bank to insolvency.

A key problem is the lack of a model for banking reforms that developing countries can use.

A key problem has been the absence of a widely endorsed model for banking reforms that can be used by developing countries. An international banking standard, Goldstein emphasized, can be such a model. It should be seen as part of a comprehensive reform effort for banking and banking supervision.

The "Goldstein prescription"—eight priority elements of an international banking standard—includes:

- bringing greater transparency to excessive government involvement or ownership in banking systems;
- encouraging better public disclosure of banks' financial condition;
- adopting strict international accounting standards;
- upgrading banks' internal controls;
- raising bank capital to levels commensurate with the volatile macroeconomic environment in many developing countries;
- establishing an exposure limit on lending to connected parties (such as employees, owners, or associate companies);
- redesigning official safety nets to include safeguards against strong political pressures for regulatory forbearance; and
- subjecting national bank supervisory systems to international surveillance.

Banking standards are not a substitute for disciplined monetary, fiscal, and exchange rate policies, stressed Goldstein. Nor can international banking standards "engineer structural changes in the real economy." A realistic objective for an international

banking standard is that it lead to a lower incidence of serious banking crises in developing countries than would occur in its absence. "And given the cost of previous banking crises, this objective if achieved, would be an important accomplishment," Goldstein said. Past experience with other international standards and guidelines in financial markets—including the IMF's Special Data Dissemination Standard, the Group of Thirty's guidelines on clearance and settlement and on risk management of derivatives, and the 1988 Basle Capital Adequacy Accord—suggests they can induce countries to make improvements they would not make on their own.

A banking standard can induce countries to make improvements they would not make on their own.

What Next?

Goldstein identified several tasks that should be high priorities on the policy agenda over the next six months.

- Developing a consensus within the official sector on which individual guidelines should be accorded the highest priority.
- Taking into account the views of the commercial banking industry in the design of the international banking standard.
- More intensified discussions and preparations by the international financial institutions for implementing an international banking standard (for example, clarifying the allocation of responsibility between the IMF and the World Bank in implementing an international banking standard).

The goal should be to arrive at a consensus proposal for an international banking standard to be taken up at the September 1997 IMF-World Bank Annual Meetings in Hong Kong. Goldstein acknowledged that an international banking standard was an ambitious undertaking. He joked that if he were to have a subtitle for his new book, it would be "An Immodest Agenda" (a reference to his earlier IIE book, subtitled *A Modest Agenda*). But given what is at stake and the lack of better policy options, Goldstein said, it is time we "get on with the job—and with a clear sense of urgency." ■

The Case for an International Banking Standard, by Morris Goldstein, elaborates on Goldstein's proposal for an international banking standard. For copies, at $12.95 each, write to Institute for International Economics, 11 Dupont Circle, NW, Washington, DC 20036.

World Bank Development Strategy Targets Corruption, Environment, and Institution-Building

"Countries that pursue appropriate policies have a better chance of economic success than those that do not; the challenge is to understand what are the appropriate policies and how to target assistance to promote growth and poverty alleviation most effectively," said Joseph Stiglitz, Chief Economist of the World Bank in his keynote address to the World Bank's annual conference on development economics.

This year's conference, held in Washington on April 30–May 1, focused on issues affecting growth and development: corruption, the quality of economic policy and institutions, and poverty and the environment. Important in this connection was how assistance from the World Bank could be most effective in helping countries realize the full potential of the new development strategy.

Corruption and Development

Widespread corruption is a symptom that the state is functioning poorly, and ineffective states can retard and misdirect economic growth, according to Susan Rose-Ackerman of Yale Law School. Corruption is a particular problem in poor countries. Even with reform-minded rulers, poverty limits the options for reform of public institutions and government policies. The World Bank can assist reform programs, but only if the country's political leaders are willing to bear the cost of change by reducing incentives for payoffs, establishing credible law enforcement, reforming the civil service, and increasing the government's accountability.

For its part, the World Bank can help by making it clear in its grants and loans that corruption will not be accepted as normal. Further, the Bank must move to cancel projects in which corruption is uncovered or cost overruns suggest that venality or incompetence is pervasive. Helping countries develop anticorruption strategies can both improve the legitimacy and effectiveness of governments and aid development by making it easier to target projects to overcome poverty and facilitate shared growth, said Rose-Ackerman.

Corruption is particularly pernicious when it is entrenched, according to Michael Johnston of Colgate University. Citizens and investors see corruption as inevitable and efforts to fight it as futile. Johnston suggested that entrenched corruption embodies a kind of equilibrium. By altering the political and economic environment, however, it is possible to shift toward low-corruption, higher-growth equilibria that benefit

from and help sustain accountable politics and administration. Aid agencies are well placed to help with this transition process, using their resources, staff, and knowledge of the countries in question.

Good Policies and Institutions Essential

Most of the high-flying East Asian economies passed through two similar stages of development, explained Takatoshi Ito of Hitotsubashi University. In the first stage, the economy "takes off" from a stagnant state. Accelerating growth is accompanied by structural changes: resources shift from agriculture to simple manufacturing and then to more sophisticated manufacturing. In the second stage, as the share of manufacturing hits a plateau and the technological gap narrows, growth slows.

Countries wishing to emulate the East Asian example need to pay more attention to the initial stage, Ito said. It is natural for a low-income economy to grow fast, but only if the conditions are right for take-off—that is, if the basic infrastructure and macroeconomic fundamentals are in place. Maintaining social and political stability is also important in this first stage.

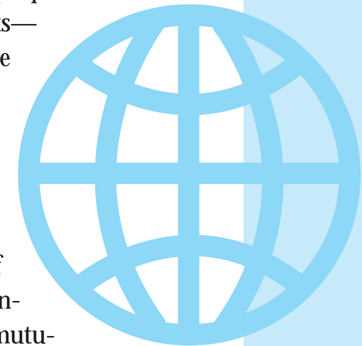
Institutional quality—measured by bureaucratic efficiency, degree of corruption, protection of property rights, and the rule of law—is important for growth, according to Alberto Alesina of Harvard University. Recent studies have shown that government consumption, often supported by foreign aid, has no positive effect on growth and can be seriously harmful in countries in which a large government sector coexists with poor institutions. In addition, government consumption does not appear to have a positive effect on improving social indicators and reducing poverty and income inequality, particularly in countries with poorly developed institutions.

Because foreign aid typically increases government consumption, especially in countries with poor institutions, Alesina suggested that the international community in general, and the World Bank in particular, rethink conditionality. Financial assistance should be withdrawn from countries that do not satisfy minimum standards of institutional quality. The World Bank should provide technical assistance for institution building, however.

Poverty and Environment

In developing countries, environmental resources are used mainly as input in household production or in small-scale production units, according to Kärl-Goran Mäler of the Beijer Institute and Stockholm School of Economics. Thus, they are of substantial value, particularly since they may be essential for survival. Any degradation of the resource base will greatly affect the population, and maintenance of it is thus critical for economic development.

Although it is difficult to understand the interactions between economic and ecological systems, Mäler said that developing countries can take certain actions to alleviate poverty while protecting the environment, such as introducing well-defined property rights and establishing markets—particularly capital and insurance markets—wherever they support better management of environmental resources.



In agrarian communities, increasing population density can set in motion a virtuous cycle of increased income and environmental sustainability, or a cumulative, mutually reinforcing process of ecological disaster and massive poverty, according to Ramón López of the University of Maryland.

The goals of increased rural income and a stable and healthy natural resource base, López suggested, are more likely to be achieved in communities that have a resilient environmental base, where a culture of cooperation and partial exclusive rights existed prior to population expansion, and where population expands at a gradual rather than an explosive pace. Specific recommendations to national authorities and technical advisers for achieving this goal include:

• supporting the institutional conditions of agrarian communities—for example, by providing legal titles to land and other resources to communities or individuals;

• identifying areas that are environmentally vulnerable and concentrating extension services, supportive infrastructure, and credit in these areas; and

• focusing land reform in areas where access by the poor is particularly restricted and where there are large private landholdings in the surrounding areas. ■

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
May 12	3.99	3.99	4.37
May 19	3.96	3.96	4.55

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

Russian Tax Reform Is Critical For Fiscal Viability

(Continued from front page) boundaries of the economic policy debate in Russia since the onset of reform in the early 1990s through the support of stable prices and by encouraging foreign investment. The IMF had also played a major role in encouraging trade liberalization, more flexible ex-change rate management of the ruble, and improved performance on the inflation front. But Desai argued that the IMF should have been more insistent in encouraging the authorities to develop a tax code at an earlier stage in the reform process. Such an effort, she suggested, might have succeeded in heading off a number of subsequent ill-conceived measures to generate revenue. Looking to the future, Russia's most urgent policy priorities, in Desai's view, were to devise a strengthened tax code and clarify existing foreign investment laws.

Padma Desai

John Odling-Smee

Aleksei Mozhin

Charles Wyplosz

The chief obstacle standing in the way of Russian fiscal viability—if not the future of reform itself—was the collapse of the country's tax collection system and the need to create a new system for generating revenues, argued Wyplosz. Piecemeal reforms of the existing mechanism were "a waste of time." A combination of time constraints—it would take at least a year before Russia would be able to effectively implement an improved tax collection mechanism—and political objections to further cuts in domestic spending argued for a more lenient IMF position on Russian fiscal policy, said Wyplosz. Under the circumstances, the IMF should be prepared to tolerate a larger fiscal deficit over the short term and a temporary suspension of the IMF's monthly monitoring practices. Russia's new government, he said, was ready to move forward rapidly on the reform front, but given the seriousness of the country's revenue situation, time was at a premium. In view of these time constraints—months rather than years—Wyplosz urged the IMF and the Russian authorities to come together promptly in support of a joint action program to achieve a more effective tax collection system. Because private capital and investment were expected to play an important part in Russia's future reforms, the country would continue to need the IMF "seal of approval," he observed.

A Russian View

Characterizing 1996 as a "defensive year" for reform, Mozhin argued that Russia could still point to a number of positive developments—in particular, a growing public acceptance of a powerful Russian central bank. While corruption remained worrisome, the dismantling of central control over many commercial activities had substantially reduced its scope.

The IMF's stepped-up monitoring of the Russian economy over the past year deserved considerable credit for the progress Russia has achieved under adverse political circumstances, said Mozhin. The major unsolved task facing the authorities, he emphasized, is to address the country's growing arrears problem, which has largely been responsible for the breakdown of public trust in Russian governmental institutions. A necessary first step is a viable budget. The current situation in which technically bankrupt monopolies continue operating is unacceptable. Although the current government's economic program is more coherent than its predecessor, the political risks facing the new team are substantially greater: if their policies prove unsuccessful, there is no telling what this might portend for the future of economic reform.

"This is the team that has no right to fail," Mozhin said. ■

John Starrels
External Relations Department

Members' Use of IMF Credit
(million SDRs)

	April 1997	Jan.–Apr. 1997	Jan.–Apr. 1996
General Resources Account	343.8	1,358.8	1,690.6
Stand-by arrangements	126.4	372.4	1,007.0
EFF arrangements	109.8	878.8	683.6
CCFF	107.6	107.6	0.0
SAF and ESAF arrangements	61.9	158.9	162.9
Total	**405.7**	**1,517.7**	**1,853.5**

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

How Will National Tax Systems Fare As Globalization Proceeds?

Current tax systems are largely the product of an era when economies were closed and capital flows all but nonexistent. The world has changed drastically, and now national authorities are struggling to keep pace with the rapidly evolving world of international finance, according to Vito Tanzi in an IMF Working Paper entitled *Globalization, Tax Competition, and the Future of Tax Systems.* Tanzi, Director of the IMF's Fiscal Affairs Department, outlines the principal developments and spillovers that have arisen and speculates on the future of tax systems in an increasingly integrated world economy. It is only a matter of time, he concludes, before the level as well as the structure of taxation reflects the pressures of globalization and heightened tax competition.

Spillover Effects

Most tax systems were devised when countries could tax incomes and activities without much thought to tax policies elsewhere. Globalization and increasing economic integration have changed that. Now what other countries do matters. Taxation's spillover effects are common and significant for almost all major forms of taxation.

Sales Taxes. Countries, particularly small countries, are increasingly enticing foreign consumers with low sales taxes—especially on expensive, readily portable goods. More open borders, better information, more international advertising, lower transportation costs, greater individual mobility, mail order shopping, and technological developments—such as Internet shopping and credit cards—have all facilitated this process.

Enterprise Income. With highly integrated production processes spanning the globe, many multinationals have lost their original national identity. Indeed, nearly one-third of world trade is now intrafirm trade. This far-flung integration poses two types of problems for national authorities:

- *tax competition,* which may induce governments to lower tax rates or provide tax incentives to lure prospective investors. Lower tax rates or tax incentives initially reduce tax revenues for the host country but may ultimately result in larger total tax benefits, since salaries will be taxed, as will the products bought with these salaries; and
- *enterprise manipulation of the cost of imported inputs* to shift taxable profits to subsidiaries located in jurisdictions with lower tax rates. Enterprises can manipulate the cost of inputs ("transfer prices") because of the difficulty in establishing the market value of some inputs. The manipulation of transfer prices reduces the multinational enterprise's worldwide tax liability and can significantly erode tax revenues in affected countries. Although tax administrators have expressed rising alarm over this and have increased resources to combat it, Tanzi notes that over the long run they may be fighting a losing battle. The complex and technical nature of modern products makes control of transfer prices by tax authorities particularly difficult. More and more, modestly salaried employees of tax administrations find themselves pitted against "an army of highly paid, well-trained, and sophisticated accountants, lawyers, and tax experts" who promote the interests of multinational enterprises.

Over time, tax competition and globalization will particularly affect personal income taxes.

Tax considerations also appear to be an important element in locating multinational enterprises, Tanzi observes. Lower effective tax rates do influence these decisions, at least at the margin.

Individual Income Taxes. In recent years, personal income earned from foreign investments or activities has grown exponentially. Foreign-earned income tends to be underreported or unreported, when individuals assume that national tax authorities will be unable to track foreign earnings. According to Tanzi, exchange of information among national tax authorities and tax treaties are limited. The problem is compounded by policies that attract foreign capital (several countries allow nonnationals to set up tax-free savings accounts); tax havens, which facilitate tax avoidance and tax evasion; and new financial market instruments—such as derivatives—which pose daunting problems for tax authorities who must decide what is being taxed, who the taxpayer is, and when income and loss occur. These problems can only intensify as rapid technical developments increasingly outpace the authorities' ability to measure, and tax, these activities.

Future of Tax Systems

The impact of globalization and tax competition is not yet fully understood, says Tanzi, and, as a consequence, is particularly hard to gauge. Globalization and tax competition are now a chief suspect when revenues dip below forecasted levels. They have also been linked to sudden capital outflows, when countries attempt to introduce certain tax changes in isolation from their neighbors. Fear of tax base migration has also caused countries not to act—forgoing, for example, tax rate adjustments or abandoning certain types of taxes (as on dividends and interest incomes in many Latin American countries).

Broader fears have arisen about the impact of globalization and tax competition on tax equity and about the ability of countries—particularly industrial countries—to address pressing fiscal deficits with declining tax revenues. Clearly, differences in tax systems do engender spillover effects. Looking at available data from OECD countries, Tanzi finds no evidence that total tax revenue, as a share of GDP, has been negatively affected. For the OECD as a whole, the percentage share of total tax revenue, in fact, rose by 4.3 percent between 1980 and 1994.

Tanzi finds a more varied scenario as he looks at specific types of taxes. Over the same period, the share of corporate taxes declined in many OECD countries. The share of personal income taxes offers no clear-cut trend, and unfortunately, the data cannot be disaggregated to differentiate between wage and nonwage revenue sources. Social security taxes have risen significantly in all OECD countries, particularly for employee contributions. This is indicative, according to Tanzi, of a trend over past years toward financing government expenditures from wage taxes. Finally, consumption taxes—typically value-added taxes—rose in all but three OECD countries.

What are the implications for national tax authorities?

Consumption. With expanded trade, improved physical mobility (for both goods and customers), and increased information, a progressively larger share of consumption becomes potentially more mobile. This is especially true, observes Tanzi, for light, high-value products. Sharply different tax rates on these products will be increasingly hard to sustain. Excise taxes in fact already reflect a broad trend away from taxing luxury goods to a reliance on taxes on petroleum, tobacco, and alcohol. Differential tax rates are more likely to be retained on nontradable, perishable, and less costly, less portable goods.

The European Union (EU) can expect strong pressures to harmonize its excise taxes and perhaps somewhat less pressure to harmonize its value-added taxes. Over the long run, Tanzi concludes, differences in VAT rates are likely to persist, but with narrowing spreads as the EU's population—and shopping habits—become more mobile. Large differences for specific products are likely to disappear and, because of tax competition, rates will generally be low.

Corporate Income. Tanzi concurs with the findings of the 1992 Ruding Report to the European Commission, which indicates that differentials in effective tax rates on corporate income will encourage significant capital movements and will be exploited by countries seeking capital flows. While many nontax considerations (such as natural resources, access to markets, and the availability of skilled labor) figure heavily in location decisions, at the margin tax competition is likely to induce some countries to reduce effective tax rates to attract investment. If transfer prices can be manipulated, the effects of differing tax rates can also be exploited by shifting taxable profits among countries and without moving real capital. Over the long run, Tanzi finds, competition will reduce the share of revenues drawn from corporate income taxes. A more likely outcome, according to Tanzi, is lower statutory rates, with conceivably some substitution of corporate income taxes for taxes based either on the value of assets or other criteria.

Personal Income Tax. Over the long run, the effects of tax competition and globalization, argues Tanzi, are likely to be particularly strong on personal income taxes. For several decades, authorities have tended to group all income, regardless of source, and taxed the total progressively at sometimes very high rates. In the process, income from capital sources (that is, interest, dividends, and profits) has been subject to very high marginal rates. The difficulties associated with tracking overseas income now may drive down tax rates on these incomes. Tanzi speculates that the all-encompassing income or "global" tax is unlikely to survive. Countries may find themselves continuing to tax wages and salaries at progressive rates, but taxing capital incomes at proportional and relatively low rates to withstand foreign competition. The Nordic countries have already introduced such an approach.

Social Security and Property Taxes. Social security taxes, which fall primarily on labor, are much less susceptible to international competition. Already high rates may depress demand for labor or encourage underground economic activities, but barring major pension reforms, social security taxes are unlikely to decline dramatically in the foreseeable future. On the other hand, the relative immobility of real property may encourage national authorities to raise rates on this tax base.

Ultimately, globalization increases the scope for tax competition and provides countries with the opportunity to export part of their tax burden. Some countries may use, even abuse, this opportunity. There are, thus, broad and significant implications for tax systems and policymakers. Revenues may decline, tax structures may be subject to desirable or, for many governments, undesirable changes, and tax systems may become less progressive and less equitable. Limited evidence suggests that the impact of globalization and tax competition on tax structures is already evident, and is likely to intensify. It is only a matter of time, concludes Tanzi, before total tax revenues are affected as well. ■

Copies of IMF Working Paper 96/141, *Globalization, Tax Competition, and the Future of Tax Systems*, by Vito Tanzi, 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.

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

Mali: ESAF

The IMF approved the second annual loan for Mali under the enhanced structural adjustment facility (ESAF), in an amount equivalent to SDR 20.7 million (about $28 million), to support the government's economic program for 1997. The loan is available in two equal semiannual installments, the first of which is available immediately.

1997 Program

In the context of a medium-term strategy, the program for 1997, supported by the second annual ESAF loan, is designed to achieve an increase in real GDP of almost 6 percent, boosted by the impact of a good agricultural crop and the start-up of a new gold mine. Average annual inflation is to be lowered to 3.5 percent and the external current account deficit will be reduced to 11 percent of GDP from more than 13 percent in 1996.

To these ends, the authorities will continue to pursue fiscal consolidation in 1997 and over the medium term, while ensuring that adequate provision is made for spending in the social sectors. In light of the exceptionally large reduction in the overall fiscal deficit in 1996, the cost of general elections being held in the first half of 1997, and necessary recruitment in priority areas, the overall fiscal deficit is expected to increase by almost 1 percentage point to about 8.8 percent of GDP in 1997.

Mali: Selected Economic Indicators

	1994	1995	1996[1]	1997[2]	1998[2]
			(percent change)		
Real GDP	2.3	6.4	4.0	5.8	4.7
Consumer prices (annual average)	24.8	12.4	6.5	3.5	2.5
			(percent of GDP)		
Overall fiscal balance	–13.7	–10.5	–7.9	–8.8	–7.7
External current account balance	–17.0	–15.0	–13.5	–11.0	–9.4

[1]Estimate.
[2]Program.

Data: Malian authorities and IMF staff estimates and projections

Structural Reforms

Structural reforms under the program will focus on further measures to promote private sector development, which will include steps to strengthen the judicial system; continuation of reforms in the agricultural sector to increase and diversify production; and privatization and restructuring of the remaining public sector enterprises.

Addressing Social Needs

Under the program, the authorities intend to strengthen their efforts to improve primary education and basic health services and continue to provide other targeted measures to reduce poverty.

Mali joined the IMF on September 27, 1963. Its quota is SDR 68.9 million (about $94 million), and its outstanding use of IMF credit currently totals SDR 112 million (about $154 million).

Press Release No. 97/18, April 21

Outside Experts Begin Evaluating ESAF-Supported Programs

On May 9, the IMF announced that independent external experts had begun an evaluation of several aspects of member countries' adjustment programs supported by the IMF's enhanced structural adjustment facility (ESAF) under terms of reference adopted by the IMF Executive Board in October 1996. The external evaluation of the ESAF is being undertaken in the framework of IMF policy for evaluating key IMF instruments, and is being coordinated by a committee of Executive Directors on behalf of the Executive Board.

The four experts are:

- Dr. Kwesi Botchwey, Harvard Institute for International Development;
- Professor Paul Collier, Oxford University;
- Professor Jan Willem Gunning, Free University, Amsterdam; and
- Professor Koichi Hamada, Yale University.

The experts will concentrate particularly on three topics related to ESAF-supported programs: developments in countries' external position; social policies and the composition of government spending; and the determinants and influence of differing degrees of national ownership of the programs. The experts have full access to all information in the IMF and have been invited to conduct all consultations they judge appropriate. They are expected to complete their report by the end of 1997.

Ukraine: Article VIII

The government of Ukraine has notified the IMF that it has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the IMF Articles of Agreement, with effect from September 24, 1997. IMF members accepting the obligations of Article VIII undertake to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval. A total of 138 countries have now assumed Article VIII status.

Ukraine joined the IMF on September 3, 1992. Its quota is SDR 997.3 million (about $1.4 billion).

Press Release No. 97/24, May 8

IMF SURVEY

Kuwait Restores Economy, Pursues Reforms

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In a relatively short period of time, Kuwait has turned its attention from reconstruction to accumulating wealth for future generations. A recently released IMF Occasional Paper, *Kuwait: From Reconstruction to Accumulation for Future Generations*, surveys Kuwait's impressive recovery and outlines the challenges ahead. Kuwait's efforts to put its fiscal accounts on an even firmer footing, expand the role of the private sector, and complete a debt workout process will, the authors state, leave the country with a more prosperous economy for its youthful population.

Oil and Sound Policies Spur Recovery

The Iraqi invasion in August 1990 destroyed basic infrastructure and extensively damaged oil production and export capacity. Kuwait drew down its foreign reserves to finance its liberation and then to restore its production capacity. The drawdown weakened its revenue stabilizer—investment income—and left it more vulnerable to international oil price declines. Invasion-related disruptions in financial markets and assets also exacerbated problems that emerged in the 1980s, owing to a crisis in Kuwait's informal stock market. And structural changes in Kuwait's labor market presented the authorities with an array of new challenges.

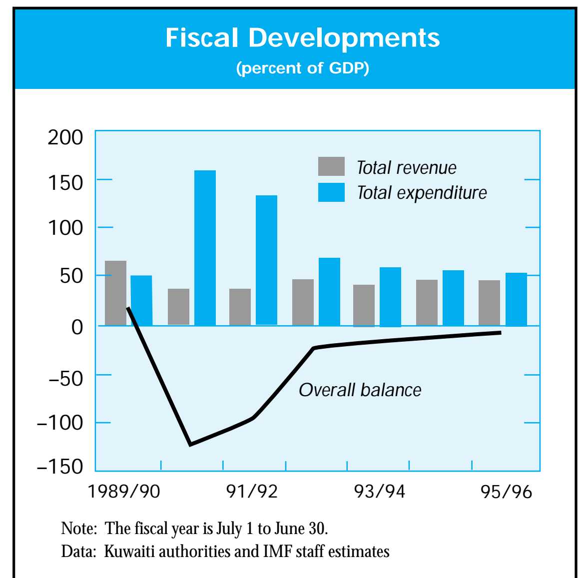
The rapid restoration of oil exports—by 1995, oil production had surpassed pre-invasion levels—and a winding down of many of the exceptional expenditures associated with liberation allowed Kuwait to quickly improve its financial balances. The drawdown in foreign reserves was not only halted but reversed.

The IMF study credits policies as well as oil resources for this turnabout. Kuwait quickly re-established sound macroeconomic fundamentals, and its ability to sustain growth, keep inflation low, maintain a stable currency, and promote a liberal external trade and payments system helped restore private sector confidence.

Challenges Ahead

With the principal task of reconstruction behind it, Kuwait is focusing its energies on eliminating its budget deficit by 2000, promoting private sector investment and addressing labor market constraints, and completing the debt workout process—a constellation of fiscal, labor market, and financial reforms that are expected to reinforce one another.

Following the Iraqi occupation, Kuwait ran a fiscal deficit to cover increased spending on wages, salaries, subsidies, transfers, and security. It drew down foreign reserves to finance this deficit. The Kuwaiti authorities recognize the importance of eliminating the budget deficit (see chart), and have moved to broaden their resource base and rationalize government expenditures.



Note: The fiscal year is July 1 to June 30.
Data: Kuwaiti authorities and IMF staff estimates

More than 90 percent of Kuwait's indigenous labor force is employed in the public sector, with wages and salaries significantly higher than the private sector, which relies upon expatriate workers. The budget consolidation process and the growing numbers of Kuwaitis entering the workforce call for labor market reforms and an expanding role for the private sector. The study suggests that the pricing of labor services and the productivity of the labor force can be improved by removing distortions that undermine private sector employment, investing more heavily in education and specialized training, and stimulating private sector development through deregulation, liberalization, and privatization.

The Kuwaiti financial sector experienced two major shocks in recent years associated with the collapse of the unofficial stock market in 1982, which resulted in widespread bankruptcies, and the Iraqi invasion. The nonpayments and loss of collateral undermined the soundness of the Kuwaiti financial system. Consistent implementation of a debt collection program has helped revive the financial sector, including by reducing moral hazard. The financial system is also benefiting from strengthened prudential regulation and supervision by the central bank.

Kuwait has made an impressive recovery. It has established a solid foundation from which to address the remaining structural weaknesses and thereby ensure growing prosperity for current and future generations. ■

Copies of IMF Occasional Paper 150, *Kuwait: From Reconstruction to Accumulation for Future Generations*, by Nigel Andrew Chalk, Mohamed A. El-Erian, Susan J. Fennell, Alexei P. Kireyev, and John F. Wilson, 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.