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Interview with Paul Chabrier

Middle Eastern and North African Countries Need To Accelerate Process of Economic Integration

Paul Chabrier, Director of the IMF's Middle Eastern Department since 1993, spoke with the IMF Survey about recent developments in the Middle East and North Africa (MENA), the effects of the Asian crisis on the region, and the prospects for integration in the world economy. Chabrier, a French national, was Deputy Director of the Middle Eastern Department before assuming his present position.

IMF SURVEY: Growth slowed in the MENA countries in 1997 and is projected to weaken further in 1998, due to declines in oil prices—an indirect result of the Asian crisis. How heavy has the impact of the Asian crisis been on the MENA countries and how have they responded to its effects?

CHABRIER: So far, the impact of the Asian crisis on the MENA countries has generally been quite moderate. One might almost say that the crisis has had a certain beneficial effect, in the sense that it has increased these countries' awareness of the importance of financial sector reforms and the need to reduce their dependency on oil and diversify their output.

Of course, the big story for the region in 1997 and 1998 was the behavior of oil prices. Since October 1997, the decline of oil prices has been quite substantial—about 30–40 percent. Most of the affected countries—such as



Chabrier: The Asian crisis has increased awareness of the importance of financial sector reforms and the need to diversify output.

Algeria, Egypt, and the Gulf countries—have sufficiently strong reserves to accommodate a temporary decline. But in the context of our policy dialogue with country authorities, we are saying the problem is real, and nobody knows whether this decline is durable or just temporary. Our advice is don't be *(Please turn to the following page)*

extend the EFF for a fourth year. [The total credit, approved in March 1996, was \$10.1 billion. See Press Release No. 96/13, *IMF Survey*, April 1, 1996, page 119.]

The IMF mission currently in Moscow is discussing a wide range of financial and economic matters with the Russian authorities, including, if necessary and appropriate, the possibility of additional financing, in the context of strengthened policies, from the IMF and other sources.

IMF Executive Board Completes Review of Russian Program

On June 25, the IMF Executive Board completed the seventh review of Russia's economic and financial program, which is being supported by an Extended Fund Facility (EFF). As a result of the completion of the review, a further \$670 million is available to Russia, bringing total disbursements from the IMF under the program to \$5.8 billion. At the same time, the Executive Board also approved Russia's request to

(Continued from front page) complacent, adjust; but also use this time to rethink your policy, both in terms of fiscal structure and in terms of diversification of the economy and encouragement of the private sector.

IMF SURVEY: *After stagnating for more than a decade, performance in most of the MENA countries began to pick up in 1996 and 1997. How do these economies compare with other emerging market economies in terms of attracting investment, managing debt, and integrating into the global economy?*



Chabrier: *Investment has not always been directed at the most efficient sectors.*

CHABRIER: It is true that performance in the MENA region picked up in the 1990s. But the region still lags behind others in important respects. Per capita real growth was negative during the 1980s, according to recent *World Economic Outlook* estimates, and barely positive during 1990–97—that is far below the performance of developing countries in Asia and Latin America.

The disappointingly low per capita growth occurred despite relatively high rates of investment. This points to something that we have not focused on sufficiently until recently—the efficiency of investment. It is true that there has been a lot of investment, but it has not always been directed at the most efficient sectors. And very often, these investments were made on the basis of wrong signals. There has been considerable price distortion—subsidized prices, low energy prices, for instance—which, when their effects surfaced, lowered the efficiency of investment.

The MENA countries also lag behind other developing country regions in their progress toward integration with the global economy. The region's share in world trade declined to barely 4 percent during 1990–97 from 7 percent in the 1980s, compared with much smaller declines for Africa and the Western Hemisphere and a strong increase in Asia.

Foreign direct investment has picked up sharply in the 1990s compared to the 1980s—heavily weighted by investment in the oil industry. But it remains much lower than the other regions—for example, 0.7 percent of GDP, compared to 1 percent for sub-Saharan Africa, 1.6 percent for Western Hemisphere and 2 percent for Asia.

At the same time, the debt burden has climbed from a relatively low level in the 1980s to an average 38 percent of GDP during the 1990s—about the same level as the Western Hemisphere and well above that of Asia.

Of course, the MENA region is not homogenous, and these aggregate measures mask important differences among individual countries. A few countries, such as Tunisia, have established good track records in the

1990s; Morocco and Egypt's privatization programs have recently attracted sizable foreign investment; and many Gulf countries remain in strong external creditor positions. But this is a region where, in general, growth is well below potential. An important deterrent to higher growth, despite several successful stabilization efforts, is a general timidity toward structural adjustment. Even though virtually all policymakers in these countries have embraced private-sector-led, market-based strategies that include opening the economy to world markets, many MENA countries have been too slow in dismantling state controls over prices, enterprises, and banks. And it is not a particularly open region—average tariff rates are considerably higher than in other regions.

Regional leaders are quite determined to move ahead, but we need to understand that for many of these countries, integration in the world economy requires a change in culture—a culture based on controls and state ownership of a large part of the economy. Although there has been progress, it is not moving as rapidly as in other countries. A key lesson policymakers have to grasp is that it is not how fast you run; it is whether you run faster than your competitors. What is needed are much more ambitious privatization programs, financial and banking sector restructuring, and better governance and greater transparency.

IMF SURVEY: *How will European Economic and Monetary Union (EMU) affect the countries in your region, many of which have close ties with the European Union (EU) through, for example, the EU's trade initiative, the Mediterranean Strategy?*

CHABRIER: The effects of EMU on MENA countries will mainly depend on the effects EMU has on Europe itself. A well-managed EMU will boost growth in Europe. Higher growth in Europe will, in turn, boost demand for exports from the MENA countries—particularly those countries, like Morocco and Tunisia, that have strong trading links with EU countries.

However, efficiency gains from Europe may lessen the competitiveness of investment in individual MENA countries, given that there is increasingly free access to MENA markets from Europe, while trade barriers between MENA countries persist.

Traditionally, the MENA countries have not traded with each other. Of course, it is difficult for two countries producing oil to trade oil. But other barriers—physical and political—have also discouraged intraregional trade. Obviously, if they want to contain the adverse effects of EMU-generated efficiency, they will need to phase out barriers to trade among themselves—and, preferably, with the rest of the world.

In this context, the EU's Mediterranean Strategy can be seen as an important catalyst. Association agreements signed with a number of countries secure free trade in

industrial products and somewhat freer trade in agriculture and services. The association agreements also provide some incentives for regional integration. It is true that the tariff reductions in the agreements apply only to trade with Europe. But the strategy is nevertheless a good and well timed one that, like EMU, should be viewed as a stepping-stone toward more liberalization.

Of course, in the end, it falls to the MENA countries to agree to reduce barriers to regional trade, investment, capital, and labor flows. There are many political obstacles—not least, the halting peace process—but we are encouraged by recent moves to lower tariffs between Arab countries, or between certain MENA countries on a bilateral basis.

IMF SURVEY: *In March 1997, a report by a staff team from the Middle Eastern Department projected a rise in GDP growth and a slight falling off in unemployment in the West Bank and Gaza Strip, assuming modest improvements in security and political conditions and the implementation of economic and adjustment reform measures. Given current events, how well is the economy of the West Bank and Gaza Strip faring?*

CHABRIER: Actually, the situation has improved recently, notwithstanding what we read in the daily newspapers. The number of Palestinians employed in Israel has increased rapidly in the last six months—to about 60–70 thousand—and this is a large source of income.

Nevertheless, economic conditions in the West Bank and Gaza Strip remain difficult, with an unemployment rate of 25–30 percent.

Because the West Bank and Gaza Strip is not a member of the IMF and cannot, therefore, receive financial support from the IMF, our contribution is confined to technical assistance, including a resident representative office. The Middle Eastern Department has been very active, particularly in providing advice for improving fiscal performance. One important development is that the recurrent budget has been brought into balance. This is no small achievement. The authorities have also made significant progress in tax collection, shown restraint on most current outlays, and increased spending on education and health. We have also helped them establish a budget procedure, with coordination between various ministries, cabinets, and the parliament. This has helped increase the transparency and accountability of the process.

We will continue to concentrate our efforts on fiscal issues, but we would also like to move in the direction of fostering coordination among the individual ministries and the Palestinian Monetary Authority, which now tend to operate autonomously.

IMF SURVEY: *Egypt has made considerable progress in stabilizing and reforming its economy, but considerable challenges remain, including a high incidence of poverty. Also, lower oil prices and declines in tourism related to a recent terrorist attack are expected to slow growth in 1998. What*

measures are needed to reverse the slowdown and help speed up Egypt's integration into the global economy?

CHABRIER: Egypt has clearly been a success in the 1990s, especially compared with the bleak economic picture in the late 1980s. There were no miracles; it was a joint effort undertaken by the Egyptian authorities who implemented good policies, by creditors that provided generous debt-reduction packages, and by the financial institutions that supplied financial support.

But Egypt still faces considerable challenges if it is to realize its economic potential and reduce poverty and unemployment. Growth has picked up recently to about 5 percent, despite some weakening in the tourist sector due to terrorist incidents, and inflation has been reduced to 3–4 percent. These are the best weapons against poverty. At the same time, the domestic economic environment is favorable, with the budget nearly in balance, ensuring continued low inflation.

To ensure a durable shift to higher growth and ensure its integration into the global economy, however, Egypt needs to move more forcefully in two areas: privatization and liberalization. Trade restrictions, especially tariffs, are still too high. Although there have been some measures aimed at deregulation and opening up the economy to the private sector and foreign competition, this process needs to be accelerated, supported by financial sector modernization—another area that should be moving faster—and a strengthening of the tax system.

One has to realize, of course, that accelerating the process of liberalization involves vested interests and political considerations. Even the best schemes have to go through a normal process of approval, from the cabinet, through the parliament. And even before that, colleagues and authorities have to be convinced. But we consider Egypt's experience to be important, because as the largest Arab country with the largest population, Egypt provides an example for the other countries in the region to follow.

IMF SURVEY: *How successful have attempts at regional integration among the MENA countries been—for instance, the Arab Maghreb Union (AMU)—compared with other regions? How useful has regional integration been in providing a stepping-stone toward global integration?*

CHABRIER: Regional integration among the MENA countries has lagged behind other regions in the world. As I mentioned earlier, most MENA countries trade far less with each other than with the rest of the world. Although this low level of integration reflects to a certain extent natural impediments—identical products and vast distances and associated transportation costs—it also reflects man-made barriers to trade. These are the result of different levels of development,

Regional integration among the MENA countries has lagged behind other regions.

political differences, and different development strategies—such as between rich and essentially open states and the poorer states with a heritage of state-centered strategies and closed economies.

For these reasons, the AMU has not been working very well. As the countries in the AMU begin to adopt similar liberal systems there is no reason why integration among themselves would not be feasible. What still needs to happen, however, is for leaders to realize that the opportunities are greater with a combined market of 60 to 70 million people than with one's own individual markets. Also, large markets attract foreign investors who have little interest in coming to a small market.

This is a process that takes time. The authorities and—more important—the business community are beginning to appreciate the benefits of opening up their economies, intraregional trade, and the opportunities that are missed if each country remains an individual market.

I think, though, that the principal catalyst for openness and liberalization is more likely to come from external examples—the European common market and the Southern cone of Latin America, for example, clearly demonstrate the benefits of regional integration. As economies worldwide are becoming much more integrated, there is a realization among many MENA policymakers that the potential of regional integration has not been utilized. That is why we are seeing efforts among the Arab countries to phase out tariffs over the next ten years, as well as preparatory work among the Gulf Cooperation Council countries to establish a customs union, liberalize freedom of establishment, and coordinate economic policy.

These are moves in the right direction. I do not think such efforts will retard the liberalization process. It is probably better to start integrating within the region, because it

feels more comfortable. Once these countries begin to experience the benefits and get the confidence to move on, they can move forward with more global integration.

IMF SURVEY: *What challenges and prospects do you foresee for the MENA countries?*

CHABRIER: I think the region has turned the corner. What we have seen in the 1990s has been an increase in investment and savings. These countries are no longer the outliers. Growth in general has been picking up. Inflation has moderated dramatically from 20 percent in the 1980s to 10 percent and below in some countries at present. But investment levels have remained too low—basically at 20 percent of GDP, compared to an average of close to 28 percent for all developing countries.

But the turn has been taken, as evidenced by the dynamic strategies country leaders are adopting. There is general agreement about the need to contain budget deficits and reduce cost controls. There is also general agreement that the public sector is too large and needs to disengage from areas in which the private sector is better equipped to operate.

The region's leaders still need a greater awareness that the quality of investment is even more important than the level. Attracting quality investment means sending out the right signals—getting rid of distortions in interest rates, the exchange rate, administered prices, and, in particular, energy prices—and creating the necessary regulatory environment to attract more direct investment.

This is a dynamic region with considerable potential and a well-educated population. If the authorities can speed up the process of trade liberalization and structural reform, the MENA countries have a good chance of integrating successfully into the global economy. ■

Camdessus Speech to Council of Europe

Asian Crisis Intensifies Need for A New Global Architecture



The following are edited excerpts of an address by IMF Managing Director Michel Camdessus to the Parliamentary Assembly of the Council of Europe in Strasbourg, France, June 23.

The world is at a dangerous crossroads. Once again, we are the witnesses both of the benefits of globalization—a huge pool of resources for investment and the growth of well-managed countries—and of its risks: financial instability, crises, and the marginalization of countries that are unable to join this powerful current of world economic unification. A world of promise, but a dangerous world!

What Went Wrong in Asia?

We have all admired the “Asian miracle” based on saving, prudent fiscal policies, investment in physical and

human capital, and the liberalization and opening up—albeit in unequal measure—of economies. The results are there to see, particularly in terms of a reduction in extreme poverty. But there was a dark side, and the lesson from this crisis is that in a globalized economy a few macroeconomic virtues are not enough. Constant vigilance must be maintained over all the socioeconomic parameters; yet in each of these countries, there were lapses. The soundness of the banking system in particular must be monitored at all times; yet, here too, these countries failed, and, what is more, their unsustainable accumulation of short-term financing made them vulnerable to swift changes in market sentiment. Finally, countries must take great care to ensure that their affairs are conducted in an irreproachable and transparent manner and that all forms of corruption, nepotism, and favoritism are shunned; yet, over time in

Asia, these afflictions took hold and overpowered systems that were otherwise remarkably successful.

What Is the IMF Doing to Contain the Crisis?

As soon as it was called upon—unfortunately, typically, too late—the IMF helped Indonesia, Korea, and Thailand formulate, and adapt as necessary, reform programs aimed at restoring investor confidence, reestablishing access to international capital markets, and reversing excessive currency depreciation. These programs go far beyond restoring the major fiscal, monetary, or external balances. Their aim is to strengthen financial systems, improve governance and transparency, and restore economic competitiveness through, for example, the elimination of monopolies and the modernization of the legal and regulatory environment. To ensure the success of these efforts, we have marshaled an unprecedented volume of financial support. And in varied ways, we have helped all the countries throughout the world that were being threatened with contagion to strengthen their equilibria and their structures.

But now, in recent weeks, a new crisis—a crisis within the crisis—has emerged with the dramatic fall of the yen. This new development reflects a serious lack of confidence, provoked by Japan's sluggish reaction to an economic slowdown that is turning into recession and a crisis in its financial institutions. Clearly, the fall of the Japanese yen is not unrelated to the Asian crisis, but it could also seriously jeopardize the ongoing recovery of the economies that were hit first. And it adds to the market instability that is again affecting Russia and some emerging economies.

Faced with these developments, an immediate, forceful reaction was required. The joint interventions of the United States and Japan on the foreign exchange market to help the yen regain lost ground were justified, but the effect will be lasting only if Japan promptly adopts energetic measures for the rehabilitation of its banking sector, tax relief, public investment, and the opening up and deregulation of its economy. The world cannot stand by, however, and simply wait for the good health of the U.S. economy and the strength of the recovery in continental Europe to dispel the crisis and restore harmonious, broad-based growth. Other urgent tasks face the international community:

- First, we must strengthen the adjustment programs of the countries most severely affected by the crisis in southeast Asia and support their economic recovery. The multilateral institutions—the IMF, the World Bank, and the Asian Development Bank—have taken on this task. But there is also a need for countries that have been accumulating balance of payments surpluses

for some time now, including certain European Union countries, to recycle those surpluses in the form of untied loans to countries in the process of adjustment. I appeal to the European countries—particularly those with surpluses—to increase their humanitarian aid. As creditors, they should stand ready to grant generous terms for the restructuring of their claims, support the recovery in Asia through new loans, and, above all, keep their markets open. This will be a good investment in their own future.

- Second, we must strengthen policies to improve fiscal management and guard against further economic downturns. This message applies to all countries, including those now taking the historic step of adopting the euro. It applies in particular to the transition countries and certain emerging countries, particularly those in Latin America, which are more vulnerable than others. It applies most especially to Russia, which has also been severely shaken by the crisis and which knows that additional external assistance would provide only scant relief unless accompanied by far-reaching financial adjustment measures that are long overdue.

- Third, we must help preserve the stability of exchange rates in countries whose actions may be crucial to market stability, such as China and Hong Kong SAR, despite the short-term negative impact of the crisis on their exports and growth. In these countries, as in Singapore and Taiwan Province of China, there is a certain margin for fiscal stimulus, which should be used without delay if it becomes necessary.

- Lastly, the attention focused on the problems of Asia should be coupled with an equally determined effort to help Africa escape marginalization and accelerate its growth, which is finally positive again after two lost decades.

I am convinced that if such a package of measures is promptly adopted, the crisis will be averted and those who have suffered the most will soon emerge stronger than ever. I trust, however, that no one will want to stop there. We have lessons to learn and an international financial system in need of rebuilding. These are the requirements for stable world growth in the era of globalization.

What Can We Do Globally?

What kind of new architecture of the global system could make the world less prone to financial crises? Let me describe for you four areas of reform on which the IMF has been asked to work.

- We must continue our efforts to *make IMF surveillance more effective and to enhance transparency in international finance*. If the IMF receives the necessary

We have lessons to learn and an international financial system in need of rebuilding.

resources, it can play a central role in crisis prevention by encouraging members to strengthen their macroeconomic policies and financial sectors. The IMF must now step up its efforts on surveillance of the financial sector, capital flows, and the risks posed by a sudden reversal of capital flows. Work is also under way to develop a “tiered response,” whereby countries that are believed to be seriously off course in their policies would be given increasingly strong warnings.

For our surveillance to be effective, however, data provision needs to be timely, accurate, and comprehensive. Thus, the IMF has decided to be more demanding about the coverage and quality of the data provided to us and communicated to the markets.

• *Financial and banking systems, as well as their supervision, must be strengthened.* For some time now, the IMF has been working to help disseminate a set of “best practices” in the banking area—as developed by the Basle Committee—so that standards and practices that have worked well in some countries can be adapted and applied in others. These efforts will now be stepped up.

• We need to establish *more effective procedures to involve the private sector in preventing and resolving debt crises.* Clearly, better ways must be found to involve private creditors at an early stage, in order to achieve equitable burden sharing vis-à-vis the official sector and to limit moral hazard.

• We must *continue to liberalize international capital flows.* This does not mean a mad rush to liberalization, regardless of the risks. What it does mean is liberalizing these flows in an *orderly* manner that takes account of the specific circumstances prevailing within each individual country, without forgetting that the countries that take appropriate steps to achieve liberalization, while strengthening their economic equilibria and structures, will reap the rewards of global competition.

In the months and years ahead, we look forward to working with the international community on shaping this new global architecture. In the ultimate analysis, our goal is to ensure that the world—and each country at its own particular stage of development—is afforded adequate protection against the risks entailed by globalization and is helped to embrace the opportunities that globalization provides. ■

Recent IMF Publications

Books

Tax Law Design and Drafting, Vol. 2, edited by Victor Thuronyi (\$25.00). A comprehensive guide to income tax legislation.

Working Papers (\$7.00)

98/78: *Reducing Inflation: Lessons from Albania's Early Success*, Caryl J. McNeilly and Doris Scheiesser-Gachnang. Discusses Albania's success in rapidly reducing inflation once comprehensive stabilization policies and market-oriented reforms were launched in 1992.

98/79: *Responses of the Stock Market to Macroeconomic Announcements Across Economic States*, Li Li and Zulu F. Hu. Employs the daily returns of key indexes to examine stock market reactions to macroeconomic announcements.

98/80: *A Model for Financial Programming*, Jan G. Mikkelsen. Presents a simple simulation model that enables the formulation of a consistent growth-oriented, medium-term adjustment program.

98/81: *Exchange and Capital Controls as Barriers to Trade*, Natalia T. Tamirisa. Considers the effect of exchange and capital controls on trade in the gravity-equation framework.

98/82: *Selected Transition and Mediterranean Countries: An Institutional Primer on EMU and EU Relations*, Heliodoro Temprano-Arroyo and Robert A. Feldman. Describes the institutional framework for relations between EU and transition countries and selected Mediterranean countries (see page 211).

98/83: *Financial Liberalization and Financial Fragility*, Asli Demirgüç-Kunt and Enrica Detragiache. Supports a cautious approach to financial liberalization where institutions are weak.

98/84: *Trading Blocs and Welfare—How Trading Bloc Members Are Affected by New Entrants*, R. Scott Hacker and Qaizar Hussain. Uses the three-country duopoly model to examine the effects of lowered trade barriers when a new entrant joins a trading bloc.

98/86: *Japanese Effective Exchange Rates and Determinants—Prices, Real Interest Rates, and Actual and Optimal Current Accounts*, Jun Nagayasu. Empirically analyzes Japanese long-run exchange rates.

IMF Staff Country Reports (\$15.00)

98/48: Philippines—Selected Issues

98/50: Philippines—Statistical Appendix

98/51: Republic of Poland—Selected Issues and Statistical Appendix

98/52: Singapore—Statistical Appendix

98/53: Spain—Selected Issues

Other Publications

External Evaluation of the ESAF (\$15.00; academic rate: \$10.00), by an external group of experts. Complements the IMF's internal review of the ESAF, published as Occasional Paper 160. It looks at the social impact of ESAF programs, how the programs affect the countries' external viability and ownership and governance issues.

Correction: In the previous *IMF Survey*, the price of *The Economy of the West Bank and Gaza Strip: Recent Experience, Prospects, and Challenges to Private Sector Development* was incorrectly listed. It is available for \$15.00.

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EMU Has Institutional Implications for Countries Aspiring to Join the European Union

Economic and Monetary Union (EMU) has a number of institutional implications for the transition countries of Central and Eastern Europe (CEECs) and selected Mediterranean countries that aspire to join the European Union (EU). In IMF Working Paper 98/82, *Selected Transition and Mediterranean Countries: An Institutional Primer on EMU and EU Relations*, Heliodoro Temprano-Arroyo and Robert A. Feldman of the IMF's European I Department describe the current institutional framework for these countries' relations with the EU and examine two main types of institutional implications of EMU for countries with EU membership aspirations: those stemming from the need to satisfy the Maastricht convergence criteria before joining the euro area, and those stemming from the need to adopt the EU's institutional and legal provisions in the area of EMU. The latter include the need to establish fully independent central banks, the prohibition of central bank and other privileged government financing, and the liberalization of capital flows. Temprano-Arroyo and Feldman spoke with the *IMF Survey* about their study.

IMF SURVEY: *What is the current institutional framework for relations between the European Union and the CEECs?*

FELDMAN: Most CEECs are developing an increasingly close economic and political relationship with the EU. Since the fall of the Berlin Wall, the EU has concluded trade and cooperation agreements, and then association agreements with most CEECs. Association agreements (also known as Europe agreements) have as a fundamental objective the establishment of a free trade area in industrial products between the EU and the associated CEECs—that is, those CEECs with association agreements—but they are much more than trade agreements. They are seen as a stepping-stone toward future EU membership of the associated CEECs and cover a number of areas (such as political dialogue and harmonization of legislation) that cannot be properly understood without taking into account the perspective of membership. The EU accepted in 1993 the idea of an enlargement encompassing the associated CEECs and subsequently developed a “pre-accession strategy” aimed at intensifying economic and political dialogue with these countries and helping them adapt to the requirements of membership. Meanwhile, all the associated CEECs have formally applied for EU membership. This evolutionary process has culminated with the beginning of accession negotiations with the Czech Republic, Estonia, Hungary, Poland, and Slovenia in March 1998.

IMF SURVEY: *What are the CEECs' prospects for joining the EU?*

TEMPRANO-ARROYO: Accession negotiations for the five CEECs just mentioned are expected to last at least two years. The accession treaties must then be ratified by the parliaments of the incumbent EU members and the new members—a process that can easily take another year and a half. Furthermore, a new EU Intergovernmental Conference has yet to resolve the issue of the institutional reforms required by the new enlargement of the EU, a thorny issue that was left pending at the 1997 Intergovernmental Conference. For all these reasons, the integration of these five CEECs into the EU may likely take place in 2002 or 2003. As for Bulgaria, Latvia, Lithuania, Romania, and the Slovak Republic, which also have association agreements, the EU has decided that they are not yet ready to start formal accession negotiations. The EU, however, will review these countries' progress every year in areas such as macroeconomic stability, the consolidation of democratic institutions, and the adoption of EU legislation, and may decide to start accession negotiations with some of them. For CEECs without association agreements, membership prospects are more remote.

IMF SURVEY: *What is the institutional setup for relations between the EU and the Mediterranean countries you examine in your study—Cyprus, Malta, and Turkey?*

TEMPRANO-ARROYO: The EU is also reinforcing its institutional relations with these countries. Notwithstanding the political difficulties related to the division of the island, Cyprus started accession negotiations with the EU in March 1998. Although the EU decided at the Luxembourg summit of December 1997 to exclude Turkey from the next rounds of EU enlargement, integration between Turkey and the EU has also made substantial progress in recent years. At the end of 1995, a customs union between the EU and Turkey was established, and Turkey is harmonizing its legislation with that of the EU in a number of domains, as part of a process that could one day lead to its full integration into the EU. Malta is reconsidering its relations with the EU following the decision taken by its government in 1996 to freeze its



Temprano-Arroyo: *The EU is reinforcing its institutional arrangements with several countries.*

Association agreements aim to establish a free trade area in industrial products.

membership application. Malta is discussing with the EU the possible creation of a free trade area between the two (consistent with the customs unions project envisaged in its Association Agreement with the EU), but a future reactivation of its membership application cannot be ruled out.

IMF SURVEY: *Where do these countries stand in terms of meeting the macroeconomic convergence criteria laid down in Maastricht?*

FELDMAN: First of all, both Heli and I would like to emphasize that the Maastricht convergence criteria are not EU membership criteria but, rather, conditions EU member states must meet for joining the euro area.

These convergence criteria, however, are regarded in many of the countries reviewed in our study as relevant references and are already influencing to some extent economic policymaking in them. None of the countries examined currently meets all the Maastricht criteria, but a majority of them appear to satisfy the fiscal criteria and a few are also reasonably close to meeting the inflation and interest rate criteria. However, no country is expected to meet all the convergence criteria before 1999 at the earliest—further progress toward inflation and interest rate convergence could be slow and difficult in some of the countries concerned.

IMF SURVEY: *The EU has agreed on the main features of a new Exchange Rate Mechanism (ERM II) that will link the euro with other EU currencies. Will ERM II be open to the CEECs and the Mediterranean countries covered by your study?*

TEMPRANO-ARROYO: ERM II has been conceived only for EU currencies, and no exchange rate arrangement is currently being envisaged to link the euro and the currencies of the non-EU countries studied. In particular, the association agreements between these countries and the EU do not foresee any form of exchange rate cooperation. While the EU has not ruled out developing such cooperation in the future, it has stressed that any such cooperation should not threaten the

price stability objective of the European Central Bank. ERM II, however, will be open to these countries once they join the EU. Furthermore, ERM II will be a voluntary and flexible system that should accommodate the

varying circumstances of the CEECs and Mediterranean countries joining the EU. Countries with currency boards or other (formal or de facto) fixed pegs could replace the currency (or basket) to which they peg with the euro upon the launching of EMU, and continue with similar arrangements within ERM II after joining the EU, with the associated advantages in terms of intervention and financing facilities. However, for countries with preannounced crawling pegs (for example, Hungary and Poland) or floating rates (for example, Romania), participation in ERM II would require modification of their exchange rate regimes.

IMF SURVEY: *What are other main institutional implications of EMU for countries with EU membership prospects?*

FELDMAN: These countries will need to adapt their central bank legislation in order to eventually participate in the European System of Central Banks, even if they remain outside the euro area for some time after joining the EU. This implies in particular the need to comply with provisions aimed at guaranteeing the independence of the national central banks and limiting central bank and other privileged financing of the government. Some CEECs have recently amended their laws with that objective in mind, and central banks in most CEECs have a relatively high degree of statutory independence (although not necessarily equivalent to operational independence), with a few of them already fully complying with EU standards. In the selected Mediterranean countries, substantial reforms of their legislative frameworks would be required to meet EU standards in this area.

Other implications of EMU for countries planning to join the EU stem from the obligation—reinforced by the provisions contained in the association agreements and the liberalization commitments undertaken by some countries vis-à-vis the OECD—to liberalize their capital flows (including vis-à-vis third countries) as of their dates of membership. For those countries that hope to be part of the EU as early as 2002, the strategy in the area of capital account convertibility is thus likely to be affected by institutional forces. Finally, EMU will reinforce these countries' need to develop sound and market-oriented financial systems, rely increasingly on indirect instruments of monetary policy, and get ready for their eventual participation in the EU's system of coordination and surveillance of macroeconomic policies. ■

Copies of Working Paper 98/82, *Selected Transition and Mediterranean Countries: An Institutional Primer on EMU and EU Relations*, by Heliodoro Temprano-Arroyo and Robert A. Feldman, are available for \$7.00 each from IMF Publication Services. See page 210 for ordering information.



Feldman: Maastricht convergence criteria are not EU membership criteria.

ERM II will be a voluntary and flexible system that should accommodate varying circumstances.

Globalization Spurs Need to Adapt Taxes to Address Highly Mobile Financial Capital

With globalization intensifying and vast amounts of capital instantly mobile, national authorities are growing increasingly concerned about their ability to tax financial capital appropriately and effectively. Communication innovations, increasingly complex and mutable financial instruments, and intensifying international tax competition are rapidly eroding the effectiveness of traditional means of collecting taxes on capital income.

What options are available to national authorities and what opportunities are there for multilateral solutions? A recent internal study prepared by the IMF's Fiscal Affairs Department explores the nature and the extent of the changes introduced by highly mobile financial capital. The study suggests that the simplest and most effective solution may lie in withholding taxes, although this step would require a broad multilateral approach.

Background

One of the most pressing questions posed by globalization is which national policies, crafted in an era of more inward-looking national economies, are beginning to lose their effectiveness in a more international environment. In tax policy, the study finds, the most notable policy degradation has occurred in the taxation of capital income. Increasingly, capital income has proven to be highly responsive to international differences in tax policy, thus frustrating the scope that national authorities have to set domestic capital income tax rates and mobilize revenue.

Traditional tax policy concerned itself with basic issues such as choosing a residence-based or source-based principle of taxation, addressing economic effects (notably the impact on saving and investment), applying credits or exemptions to avoid or lessen the burden of double taxation, making provisions to implement the chosen regime, and negotiating bilateral agreements where needed. These precepts largely presuppose, however, that the taxable income to be drawn from economic activities and their location can be readily identified and that the primary residence of the involved parties can be verified.

In fact, the study says, the highly integrated nature of international commerce and the speed and volume of flows are no longer allowing authorities to take these basic steps for granted. Identifying economic transactions—and the parties involved in them—is becoming an increasingly complex task, and has spurred a rethinking of capital income taxation—in particular, the treatment of interest and dividends by domestic residents or remitted from abroad.

Portfolio investment—particularly the ultimate owners of portfolio capital, who may not be readily identifiable and who may thus more easily evade taxation—poses the greatest challenges for authorities. According to the IMF study, the central question in taxing financial capital is how to properly and effectively tax interest and dividends from portfolio investment that is either remitted abroad or received by residents from foreign sources.

Globalization and Tax Policy

Over time, national tax systems evolved an elaborate system of residence- and source-based taxation, bolstered by a network of bilateral arrangements, to treat interest and dividends in an international context. Because most treaty arrangements accord only limited rights to the source country to tax passive income remitted abroad, the burden of effective taxation traditionally fell on the residence country where the income was received. In a globalized economy, however, the residence countries have found themselves with the lion's share of responsibility for taxing interest and dividends but with dwindling ability to exercise these rights effectively.

Three factors—extraordinary innovation in communication technology, rapid growth in the volume and complexity of financial instruments, and heightened international tax competition—are straining the capacity of national tax administration to keep pace with the transformation of the global economy. The growth of the Internet, for example, has dramatically broadened the access that large segments of the public have to foreign financial markets while simultaneously “weakening the traceability of these transactions in terms of their real (as opposed to electronic) points of origin and destination,” according to the IMF study.

Likewise, innovative financial instruments, such as derivatives, while they allow greater efficiency in risk diversification, also blur the lines between these instruments and the securities that underlie them, thus creating thorny classification, measurement, and point of taxation issues for national authorities.

Revolutions in communications and financial market transactions have also fueled the competition for the resulting large and highly mobile flows of capital. This heightened rivalry has characteristically taken the form of competition in extending tax benefits. To the extent that competition lowers tax rates on capital income—the trend over the past two decades—it can produce economic benefits, according to the study. But to the degree that the competition is excessive or deliberately facilitates tax evasion—the classic case of many tax havens—it can be injurious, particularly where bank secrecy laws abet tax evasion.

Policy Options

In response to the growing scope for tax evasion, national authorities are exploring two principal avenues of redress: amending existing tax codes (or introducing new tax codes) to close loopholes and developing schedular (or separate) tax regimes to address interest and dividends concerns.

Closing Loopholes. The authorities' efforts to close loopholes have centered on measures to strengthen enforcement of the international tax system, notably provisions covering transfer pricing, thin capitalization, and controlled foreign corporations. While these efforts are chiefly intended to address the ease with which taxes can be evaded through conduit enterprises in low- or no-tax foreign locations, their effectiveness is ultimately dependent upon the availability of relevant information on resident activities in tax haven countries.

Establishing Separate Tax Regimes. Proposals to establish a minimum withholding tax on interest, a uniform withholding tax on dividends, or a dual income tax system (which combines a proportional tax at the corporate tax rate on all capital income accruing to residents with a progressive tax on earned income) share a similar objective—to enhance the ability of tax systems to capture the most mobile forms of capital income.

The simplest and most direct means of combating the tax evasion problems associated with capital income is, the study finds, a shift toward source taxation of cross-border flows of interest and dividends. Such a shift could be set in motion by a multilateral model tax treaty that would set minimum source withholding tax rates on interest and dividends that are materially above the present withholding ceilings stipulated by the Organization of Economic Cooperation and Development (OECD). These minimum rates

could also be made conditional on the scope and quality of information exchanged between tax authorities in the treaty countries.

Since most interest and dividend payments are made by easily identifiable entities such as governments, financial institutions, and corporations, higher withholding taxes—globally implemented—are likely to be effective in stemming tax evasion on capital income, according to the study. But such a shift would entail a number of important policy implications.

All schedular taxes generate distortions, the study observes, but these distortions are further complicated when schedular taxes cover international transactions. In a situation of full compliance, the foremost impact is a redistribution of tax revenue toward net capital importers (developing countries). It remains an empirical question, the study says, whether reduced tax evasion would offset lost revenue in net capital exporting countries in circumstances of less than full compliance.

The study also examines which type of withholding tax would be most effective. It concludes that there is little compelling economic justification for imposing a withholding tax on dividends, because the underlying profits from which the dividends would be paid are already subject to corporate income taxes in the source country. Tax competition may drive corporate income taxes lower, but it is unlikely that corporate income taxes will be subject to widespread evasion.

Withholding taxes on interest payments remitted abroad, however, are a deductible expense for the paying enterprise and the likeliest avenue for any increased reliance on withholding taxes. According to the study, the principal concern about a withholding tax on interest is the extent to which such a tax might deter foreign savings, slow the development of domestic financial

Indonesia and IMF Sign New Agreement

On June 24, the Indonesian government and the IMF signed a Memorandum of Economic and Financial Policies, aimed at halting the deterioration of the Indonesian economy and paving the way for a resumption of international financial assistance. Copies of the memorandum were distributed on Thursday, June 25, following a meeting between Indonesian President B.J. Habibie and Hubert Neiss, Director of the IMF's Asia and Pacific Department. During a press conference in Jakarta on June 25, Neiss said that "Indonesia faces a situation of emergency," and the "emphasis has to be on first things first: to ensure that essential goods are distributed to the people at affordable prices; to restart production and trade; to keep the banks functioning; and to prevent the outbreak of hyperinflation."

The memorandum, which sets out the measures and targets under the economic program for Indonesia, forecasts a contraction in the economy of about 10–15 percent and inflation of 80 percent in 1998, and a budget deficit of 8.5 percent of GDP for fiscal 1998/99. "Despite the considerable support being provided by bilateral and multilateral sources," the memorandum said, "additional balance of payments support of \$4–6 billion from these sources is needed to finance the budget deficit and close the gap in the balance of payments." During his press briefing, Neiss said that the international community is supportive of Indonesia's efforts to overcome the crisis and that additional financing was expected to come from bilateral donors and international organizations.

The full text of the memorandum is available on the IMF's web site at <http://www.imf.org/external>.

From the Executive Board

markets, or drive domestic credit market operations offshore. To counter these possible developments, domestic debtors may have to offer higher pretax rates of return on their borrowings, and this could have negative macroeconomic consequences.

The possible downsides all suggest, the study adds, that raising withholding taxes on interest should be tackled within a broad multilateral framework with possible resort to supportive multilateral institutions and supplementary bilateral agreements. The study also underscores that to ensure that taxes withheld by private entities are properly remitted, collection, audit, and enforcement procedures in some countries will have to be strengthened.

The effective taxation of cross-border flows of interest and dividends has become increasingly problematic under existing conditions (including the limited degree of cooperation and information exchange between national authorities), the study concludes. With globalization making it increasingly easy to hide or disguise portfolio capital income and national authorities facing an ever more daunting task of identifying resident recipients of international interest payments, raising the currently low levels of withholding tax rates at the source appears to offer the simplest and most effective means of taxing this income. To be politically viable, however, such a measure will need to be adopted within a broad multilateral framework (notably to address the difficulties associated with nonparticipating countries), supplemented by bilateral agreements to address revenue distribution issues. ■

This article is based on an internal staff study. An abridged version of the study will appear in an article by Howell Zee entitled, "Taxation of Financial Capital in a Globalized Environment: The Role of Withholding Taxes," in the September 1998 issue of *National Tax Journal*.

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
June 22	4.32	4.32	4.62
June 29	4.28	4.28	4.58

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 or check the IMF web site (<http://www.imf.org/external/np/tre/sdr.thm>).

Data: IMF Treasurer's Department

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).

F. Y. R. of Macedonia: ESAF

The IMF has approved the second annual loan under the Enhanced Structural Adjustment Facility (ESAF) for the former Yugoslav Republic of Macedonia (FYRM), in an amount equivalent to SDR 18.2 million (about \$24 million), to support the government's eco-

F. Y. R. of Macedonia: Selected Economic Indicators

	1995	1996	1997	1998	1999	2000
	(percent change)					
Real GDP	-1.2	0.8	1.5	5.0	5.0	5.0
Consumer prices (12 months, end of period)	8.6	-0.7	2.7	3.0	3.0	3.0
	(percent of GDP)					
Overall fiscal balance (accrual)	-1.2	-0.5	-0.4	-0.7	-1.7	-1.5
Current account balance ¹	-5.7	-7.3	-8.3	-7.3	-7.3	-6.5
	(months of imports)					
Gross official international reserves	1.9	2.0	1.9	2.3	2.8	3.0

¹There are indications that the current account deficit is substantially overestimated due to unreported remittances.

Data: Macedonian authorities and IMF staff estimates

nomics program for 1998/99. The loan is available in two equal semiannual installments, the first of which is available this month [June].

1998 Program

The overall strategy for 1998–2000 aims to improve living standards by consolidating private ownership and strengthening market-based institutions; macroeconomic policies will focus on providing a stable financial environment to engender enterprise adjustment, reduce interest rates, and promote investment and jobs. The 1998 program supported by the ESAF targets real GDP growth of 5 percent, end-year inflation of 3 percent, and a current account deficit of 7.3 percent of GDP. Monetary policy will continue to be based on the deutsche mark anchor.

Structural Reforms

Key objectives of the structural policy agenda are to strengthen corporate governance and bank lending practices. The authorities also intend to rationalize public expenditure and introduce a value-added tax to place the fiscal accounts on a more sustainable footing and provide room for a reduction in the direct tax burden. Efforts will continue toward liberalizing labor markets, developing financial markets, and removing barriers to trade and foreign investment to promote the

transfer of needed capital and technology and reduce high unemployment.

Addressing Social Needs

The government will continue to improve the adequacy and targeting of the means-tested social assistance program for persons capable of work and to improve its poverty monitoring capacity. These, along with supplemental programs for the elderly and disabled, are the main vehicles for protecting the poor.

The FYRM succeeded the former Socialist Federal Republic of Yugoslavia to membership in the IMF on December 14, 1992. Its quota is SDR 49.6 million (about \$66 million), and its outstanding use of IMF credit totals SDR 65 million (about \$87 million).

Press Release No. 98/23, June 19

Rwanda: ESAF

The IMF approved a three-year loan for Rwanda under the Enhanced Structural Adjustment Facility (ESAF) in an amount equivalent to SDR 71.4 million

Rwanda: Selected Economic Indicators

	1996	1997 ¹	1998 ²	1999 ²	2000 ²	2001 ²
	(percent change)					
Real GDP growth	12.0	10.9	6.7	8.0	8.0	7.5
Consumer prices (end of period)	9.2	17.0	7.0	5.0	5.0	5.0
	(percent of GDP)					
Overall fiscal balance (excluding grants)	-13.1	-9.9	-13.7	-10.7	-9.3	-8.3
External current account balance (excluding official grants)	-19.1	-17.6	-20.1	-18.2	-17.0	-15.8
	(months of imports)					
Gross foreign exchange reserves	5.0	5.3	6.0	6.5	5.9	4.4

¹Estimates.

²Projections.

Data: Rwandese authorities and IMF staff estimates and projections

(about \$95 million) in support of the government's economic program for April 1998–March 2001. The first annual loan, equivalent to SDR 23.8 million (about \$32 million) is available in two equal semiannual installments, the first of which is available immediately.

Medium-Term Strategy and 1998–2001 Program

Over the medium term, the program for 1998/99–2000/01 supported by the ESAF seeks to achieve sustainable high economic growth and poverty reduction. It focuses on fiscal consolidation and prioritization; the enhancement of administrative and institutional capacity; and the acceleration of structural reforms to improve private sector savings, investment, and competitiveness.

The program for 1998/99 seeks to achieve a real GDP growth rate of about 7 percent in 1998 and 8 percent, reduce the end-of-period rate of inflation to 7 percent in 1998 and to 5 percent in 1999, and temporarily increase gross official reserves to just over six months of imports during 1998–99.

Structural Reforms

Structural reforms during the program period will be deepened and accelerated, and will be supported by efforts to improve governance as well as consolidate national reconciliation and economic security through the reintegration of refugees. The authorities intend to proceed promptly with civil service reform and further trade liberalization.

Addressing Social Needs

The program's medium-term fiscal framework foresees significant increases in public expenditure on primary health and education. The government will undertake by September 1998 a public expenditure review of the education and health sectors to assess the level, structure, and efficiency of recurrent and capital outlays. Based on the outcome of this review, the social spending targets for 1999 and beyond will be reconsidered at the time of the mid-term review.

Rwanda joined the IMF on September 30, 1963. Its quota is SDR 59.5 million (about \$79 million). Rwanda's outstanding use of IMF financing currently totals SDR 29 million (about \$39 million).

Press Release No. 98/24, June 24

Tajikistan: ESAF

The IMF has approved a three-year loan for the Republic of Tajikistan under the Enhanced Structural Adjustment Facility (ESAF), equivalent to SDR 96 million (about \$128 million), to support the government's 1998–2001 economic program. The first annual loan is equivalent to SDR 36 million (about \$48 million) and is divided into two equal semiannual installments, the first of which is available immediately.

Medium-Term Strategy and 1998/99 Program

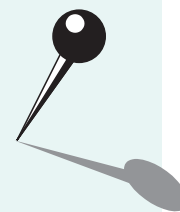
The government's medium-term strategy is based on export-led growth, building on a liberal foreign trade and investment regime. It envisions real GDP

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:

- Korea, No. 39, June 19
- Peru, No. 40, June 22
- Trinidad and Tobago, No. 41, June 24
- Netherlands, No. 42, June 24
- Austria, No. 43, June 24
- Thailand, No. 44, June 25
- Tunisia, No. 45, June 26
- Mauritius, No. 46, June 29

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



Tajikistan: Selected Economic Indicators

	1997 ¹	1998 ²	1999 ³	2000 ³	2001 ³
	(percent change)				
Real GDP ⁴	1.7	3.4	4.0	4.0	4.5
Consumer prices (12 months, end of period)	163.6	16.8	12.5	10.0	8.0
	(percent of GDP)				
Fiscal balance (cash) ⁵	-3.3	-3.3	-2.7	-1.1	-0.3
Current account balance	-5.5	-4.5	-4.1	-4.1	-4.1
	(months of imports ⁶)				
Gross international reserves	0.6	1.9	2.5	3.0	3.0

¹Preliminary.²Program.³Projections.⁴Year-on-year growth rates.⁵Excluding the externally financed component of the Public Investment Program.⁶Imports of goods and services excluding alumina and electricity.

Data: Tajik authorities and IMF staff estimates

growth of 4–4.5 percent a year from 1999 through 2001. To support this objective, the program calls for tight monetary policy and fiscal policies that contribute to a stable nominal exchange rate and a further reduction in inflation to 8 percent in 2001 from close to 164 percent in 1997. Increased domestic savings, supported by strong fiscal adjustment and combined with steady net foreign financing, would facilitate an increase in investment to 13 percent of GDP in 2001 from 7 percent in 1997.

At the same time, policies will aim to reduce the fiscal deficit to 0.3 percent of GDP in 2001 from 3.3 percent in 1997. To enhance the tight monetary policy, the program calls for no central bank financing of the budget after mid-1999.

In the first year of the program, GDP growth is targeted at 3.4 percent in 1998; inflation at 16.8 percent; and the external current account deficit at 5.0 percent of GDP. To support these objectives, the fiscal deficit on a cash basis is projected at 3.3 percent of GDP and will rely on noninflationary deficit financing through loans from international donors and treasury bill sales to meet priority expenditures during a period of fiscal restraint. Monetary policy will remain tight and will include ceilings on the creation of central bank credit, including credit to the government, consistent with the targeted increase in foreign reserves and the need to contain the growth of the monetary base.

Structural Reforms

Given the important link between structural reform and economic growth in transition economies, Tajikistan's program strategy places great weight on strong structural policies to enhance productivity growth. Three areas are assigned high priority under the program. First, privatization will be accelerated to strengthen financial discipline, improve the economic incentive structure, enhance economic efficiency, and encourage investment. Second, land reform is expected to increase agricultural yields and consolidate output

recovery in the cotton sector. Third, bank restructuring is necessary to facilitate domestic savings and channel funds to those investments offering the best rates of return.

Addressing Social Needs

The program will balance the need to reduce the general government deficit to attain the program's savings targets with the need to improve the basic social safety net, health services, education, and the rebuilding of the public infrastructure.

Tajikistan joined the IMF on April 27, 1993, and its quota is SDR 60.0 million (about \$80 million).

Its outstanding use of IMF financing currently totals SDR 30 million (about \$40 million).

Press Release No. 98/25, June 25

F. Y. R. of Macedonia: Article VIII

The former Yugoslav Republic of Macedonia 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 June 19, 1998. 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 145 countries have now assumed Article VIII status.

The former Yugoslav Republic of Macedonia succeeded to the membership in the IMF of the former Socialist Federal Republic of Yugoslavia, effective December 14, 1992. Its quota is SDR 49.6 million (about \$66 million).

Press Release No. 98/26, June 29

Kyrgyz Republic: ESAF

The IMF has approved a new three-year loan for the Kyrgyz Republic under the Enhanced Structural Adjustment Facility (ESAF), equivalent to SDR 64.5 million (about \$86 million), to support the government's economic program for 1998–2000. The first annual loan, equivalent to SDR 21.5 million (about \$29 million), is available in two equal semiannual installments, the first of which is available immediately.

Medium-Term Strategy and 1998/99 Program

The new three-year program supported by the ESAF aims at a steady output growth, a permanent reduction in inflation to single-digit levels, and a strengthening of the external position. Fiscal tightening and retrenchment will be the centerpiece of the program. Over the program

period, government dissavings will be sharply reduced by cutting the overall fiscal deficit by almost one-half, considerably strengthening tax revenue, and restraining expenditures. This will be complemented by a tight monetary policy, as well as structural measures aimed at creating an environment conducive to private sector development.

The economic program for 1998 and 1999, supported by the first annual arrangement under the ESAF, aims at

targeted structural reforms that could promote private sector investment and enhance the creation of savings.

To support the program goals, fiscal policy will focus on ensuring that the budget conforms with the overall macroeconomic objectives and the availability of domestic and concessional external financing. There will be a number of expenditure cuts, for which the Ministry of Finance will be responsible by issuing monthly limits to the spending units. While expenditures will decline only marginally in 1998 compared with 1997, their composition will improve considerably.

Structural Reforms

The program contains a wide array of second-generation structural reforms covering a comprehensive overhaul of the public pension system, civil service reform, privatization and enterprise reform, the further strengthening of the legal and regulatory framework, the adoption of sectoral strategies for agriculture and energy and of a water management plan, a completion of the modernization of the financial sector, and improvements in statistics.

Addressing Social Needs

It is the firm intention of the authorities that all segments of the population benefit from the economic recovery and the move to a market economy. Continued improvements in the targeting and efficiency of essential social services will ensure that the most vulnerable groups of the population receive at least 60 percent of the benefits.

The Kyrgyz Republic joined the IMF on May 8, 1992, and its quota is SDR 64.5 million (about \$86 million). Its outstanding use of IMF financing currently totals SDR 117 million (about \$157 million).

Press Release No. 98/27, June 29

Kyrgyz Republic: Selected Economic Indicators

	1995	1996	1997 ¹	1998 ²	1999 ²
	(percent change)				
Real GDP	-5.4	7.1	6.5	6.0	4.6
Consumer prices (December–December)	31.9	35.0	14.7	12.0	8.0
	(percent of GDP)				
Overall fiscal balance (accrual basis)	-17.0	-9.0	-9.4	-8.1	-7.1
Current account balance	-16.3	-23.5	-8.2	-7.5	-6.9
	(months of imports)				
Gross international reserves	2.5	1.6	3.0	3.3	3.5

¹Estimates.

²Projections.

Data: Kyrgyz authorities and IMF staff projections

real GDP growth of about 6 percent and 4.6 percent, respectively; end-of-period inflation of 12 percent and 8 percent, respectively; and an external current account deficit of about 7.5 percent of GDP and 6.9 percent, respectively. The principle policies are to reduce the accrual-based overall fiscal deficit to 8.1 percent of GDP in 1998 and to 7.1 percent in 1999; to slow the growth of reserve money from 21.1 percent in 1997 to about 15.5 percent in 1998 and 9 percent in 1999; and to initiate well-

IMF Announces External Evaluation of Its Surveillance Role

The IMF Executive Board has approved proposals by its Evaluation Group, chaired by Bernd Esdar, IMF Executive Director for Germany, for an external evaluation of the effectiveness of the IMF's surveillance over members' policies under Article IV of the Articles of Agreement.

The evaluation will focus on the effectiveness of all aspects of IMF surveillance and will be carried out by three independent experts: Ricardo Arriazu, Professor of Macroeconomics and Monetary Theory, Universidad Catolica, Argentina; John Crow, former Governor of the Bank of Canada, who will serve as chairman; and Niels Thygesen, Professor of Economics, University of Copenhagen. The experts have been asked to assess the overall effectiveness of IMF surveillance in identifying those macroeconomic, structural, and financial weak-

nesses and imbalances in member countries and the world economy that are an obstacle to achieving sustainable noninflationary economic growth and external viability. The experts are expected to comment on the appropriateness of the substance of IMF surveillance recommendations, the impact of these recommendations on members' policies, and the procedures and methods of surveillance.

It is expected the evaluators will start their work in July 1998, and they are expected to complete their report no later than June 1999.

This is the second external evaluation project approved by the IMF's Executive Board. The first external evaluation concerned the IMF's enhanced structural adjustment facility (ESAF), which was published as *External Evaluation of the ESAF*, and is also available on the IMF's web site (<http://www.imf.org>).

Globalization and Declining Aid Bring Sub-Saharan Africa to a Turning Point

After an extended period of mediocre performance, the economic situation in sub-Saharan Africa has improved markedly in the last few years, sparking renewed optimism about the continent's economic future. For the region as a whole, real GDP growth averaged 4¼ percent a year in 1995–97, up from 1½ percent in 1990–94; per capita output rose at an average annual rate of almost 1½ percent in the past three years, compared with an average decline of 2 percent a year in the first half of the 1990s; and after reaching a high of 44 percent in 1994, annual inflation dropped to 13 percent in 1997. However, these averages conceal significant differences in performance among countries and the region's economic situation remains difficult, with many countries heavily dependent on foreign assistance. Recent improvements are nevertheless encouraging because they have resulted mainly from improved macroeconomic and structural policies in a number of African countries and are not due to favorable exogenous developments, such as changes in weather conditions or terms of trade gains.

The basic question now is whether these developments are temporary or whether they augur a fundamental change in the region's economic fortunes. In a new study, *Africa: Is This the Turning Point?*, Stanley Fischer, the IMF's First Deputy Managing Director; Ernesto Hernández-Catá, Deputy Director of the IMF's African Department; and Mohsin S. Khan, Director of the IMF Institute, examine this question. They argue that changes in the external environment in the 1990s, such as increasing globalization and declining official development assistance (ODA), have indeed brought sub-Saharan Africa to a turning point. To meet these challenges and sustain the recent growth momentum, countries in the region will need to combine policies aimed at macroeconomic stability with enduring structural reforms to encourage private investment.

Challenges to Meet

According to the Organization for Economic Cooperation and Development (OECD), gross bilateral ODA disbursements to sub-Saharan Africa fell to \$10.7 billion in 1996 from \$13.9 billion in 1990—a declining trend that is likely to continue, the study notes. While a continuing fall in ODA will require far-reaching adjustment for many African countries, it could also help to bring about a fundamental reorientation of economic policies aimed at increasing the role of the private sector and private capital flows. The decline in ODA will make it clear that higher living standards in the future must be based on efforts to attract private foreign capital, raise private investment—both domestic and foreign—and increase the productivity of capital and labor.

As for globalization, the authors point out that Africa has very little to lose from globalization and much to

gain, provided that globalization is accompanied by policy changes that address four major problems that are observed in many, if not most, African countries:

- *High transactions costs.* In most sub-Saharan Africa countries, globalization, which involves a steep reduction in transactions costs, including the high costs and unreliability of transportation and telecommunications services, poor contract enforcement, and expensive ancillary public services, will result in private capital inflows and a shift in comparative advantage toward manufacturing and higher growth.

- *Inadequate physical infrastructure and an inadequate stock of human capital.* Globalization will induce local capital to move to other countries where the quality of physical infrastructure and human capital is higher, leaving the authorities no choice but to shift budgetary priorities toward infrastructure and education.

- *Barriers to foreign trade.* By continuing to liberalize trading regimes, sub-Saharan Africa would stand to gain from improved resource allocation and increased competition.

- *Corruption.* It is well recognized that corruption is a major obstacle to private sector activity. It reduces government revenue (and therefore the base to improve infrastructure and education), tilts government investment toward large and wasteful projects, and increases transaction costs.

Sustaining Recent Growth

Increasing Productivity. The recent improvement in sub-Saharan economic growth reflects in part an increase in capacity utilization. To be sustained, however, a high growth rate will require an increase in investment rates or an increase in total factor productivity—that is, an improvement in the technological, political, administrative, and economic factors that raise the rate of return on capital and labor. A major hindrance to productivity growth is Africa's lack of openness and the bias against agriculture, which reduce efficiency by distorting resource allocations. Many countries in the region have taken important steps toward rectifying this situation, the study points out. Côte d'Ivoire, for example, is liberalizing its cocoa and coffee sectors, a measure that will have far-reaching beneficial effects on trade, as well as on efficiency and income distribution.

Raising Investment Rates. Risk is an important determinant of the expected rate of return on an investment, and the relatively high rates of return on investment in sub-Saharan Africa reflect to a large extent high perceived risks associated with investments in that region. These risks stem in particular from the absence of a well-established institutional and legal infrastructure to support market transactions. For example, property rights



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may not be adequately protected, periods of economic instability may be relatively more frequent, and there may be dramatic changes in political and economic regimes.

What can African governments do to reduce the perceived high degree of risk in their economies? The experiences of other developing countries demonstrate that providing a stable macroeconomic environment can go a long way toward reducing the degree of domestic uncertainty facing investors. But beyond the macroeconomic fundamentals, legal and institutional changes are necessary to instill confidence in domestic and foreign investors that they are protected against sudden and arbitrary changes in the rules of the game and capricious judicial decisions.

A shortage of capital also constrains investment in Africa. Higher saving rates in sub-Saharan Africa would support higher investment while helping to reduce a reliance on foreign saving. This will not be easy, however, particularly in view of the low levels of income in most sub-Saharan Africa countries, the study points out. Governments in the region will need to improve their fiscal position without squeezing spending on education, public health, and infrastructure; in the case of private savings, the focus will have to be on financial sector reforms and interest rate policies. Several African countries have undertaken important financial sector reforms and are taking steps to make their economies more attractive to foreign investors. An important task facing the authorities in these countries is to reduce the perceived risk of policy reversals by providing credible commitments and increasing the cost of reneging on these commitments.

Policy Implications

In spite of recent gains, the economic situation in sub-Saharan Africa remains fragile. Almost half the population of Africa lives on less than \$1 a day, political disruptions are commonplace, and social unrest and ethnic rivalries continue to constrain development in some countries. Moreover, output in many countries in the region is concentrated in a few primary products, making them vulnerable to climatic changes and exogenous shifts in their terms of trade. It would not take much, the study notes, to wipe out the progress made in recent years and push the region back to a low-level equilibrium, characterized by low growth rates and stagnant, or even falling, per capita incomes.

An important condition for sustained high growth rates in Africa lies in raising investment rates, and in particular private investment rates. This will require the maintenance of a stable macroeconomic environment. Far-reaching improvements in governance are also essential to avoid official interference with private activity and to develop and maintain a transparent and stable legal and regulatory environment that reduces the risks that currently inhibit private domestic and foreign investors. Higher domestic saving rates will also be required to sustain higher rates of capital formation

Sub-Saharan Africa: Key Economic Indicators

	1990-94 ¹	1995-97 ^{1,2}
	(percentage change)	
Real GDP	1.6	4.3
Real GDP per capita	-2.0	1.4
Consumer price inflation	33.6	28.8
	(percent of GDP)	
Investment	16.4	16.9
Government	4.8	4.6
Private	11.6	12.3
Domestic saving	15.7	16.1
Current account balance ³	-5.3	-4.5
Grants	1.9	1.5
Overall fiscal balance ³	-7.7	-5.5

¹Averages.

²Data for 1997 are preliminary.

³Excluding grants.

Data: IMF African Department and *World Economic Outlook* databases

while reducing reliance on external saving. Action is also needed in many complementary areas in order to raise productivity and growth. These include:

- *Trade liberalization.* Progress is being made, but considerable scope remains for African economies to take further advantage of the opportunities offered by globalization. Sub-Saharan Africa's trading partners among the advanced countries can also help in this regard by reducing their own trade restrictions on African products.

- *Privatization.* Compared with Latin America, for example, sub-Saharan Africa still has a long way to go in privatizing state-owned companies, thus making room for the private sector (domestic and foreign) and increasing efficiency while helping to improve the public finances and the loan portfolio of commercial banks.

- *Civil service reform.* In many sub-Saharan African countries, government employment must be reduced for both budgetary and efficiency reasons, and the salary structure must be rationalized to provide adequate pay and reward merit.

- *Banking reform.* Essential measures include the modernization of regulation, strengthening of supervision, and, in some countries, increased domestic and foreign competition.

- *Liberalization of agricultural sectors.* The important progress made in some countries in deregulating agriculture needs to be extended throughout the region.

- *Labor market reform.* Flexibility and competitiveness must be improved in several countries to absorb the growing labor force and reduce structural unemployment.

This is a long agenda, the authors conclude, but it should be followed if Africa is to avoid being marginalized in the globalization process and develop its potential. ■

Copies of IMF Paper on Policy Analysis and Assessment 98/6, *Africa: Is This the Turning Point?*, by Stanley Fischer, Ernesto Hernández-Catá, and Mohsin S. Khan, are available for \$7.00 each from IMF Publication Services. See page 210 for ordering information.