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Enhanced Policy Package

Management Welcomes Board Decision to Provide Additional Credits for Russia

In a statement issued on July 20 in response to the IMF Executive Board's approval of additional support for Russia, Stanley Fischer, Acting Managing Director of the IMF, said: "The management of the IMF welcomes today's decision of the Executive Board to provide additional financial support in 1998 totaling SDR 8.5 billion (about $11.2 billion) for the Russian Federation.

"The enhanced policy package represents a strong and appropriate response to overcome Russia's current difficulties. Management welcomes in particular the many up-front actions taken, the government's efforts to secure political support for these actions, and the emphasis on fiscal policy correction and the accumulation of international reserves to reestablish confidence.

"Unfortunately, parliamentary backing has not been forthcoming for needed actions relating to the personal income tax, nor have permanent measures to strengthen the finances of the pension fund. I welcome the government's intention to seek parliamentary approval of measures in these areas in a special parliamentary session scheduled for August.

"Because of the delay in implementing these measures, the amount being made available immediately—SDR 3.6 billion (about *(Please turn to the following page)*

Activation of GAB

IMF Approves $11.2 Billion in Financing To Support Russia's Economic Program

On July 20, the IMF approved financial support totaling SDR 8.5 billion (about $11.2 billion) for the Russian Federation. Following is the text of Press Release No. 98/31, issued on July 20.

The financing consists of an augmentation of Russia's extended arrangement by the equivalent of SDR 6.3 billion (about $8.3 billion) to support the government's economic program for 1998, and SDR 2.2 billion (about $2.9 billion) under the Compensatory and Contingency Financing Facility (CCFF) to compensate for a shortfall in export earnings.

Of the augmented amount to be provided under the extended arrangement, the equivalent of SDR 4.0 billion (about $5.3 billion) is to be made available under the Supplemental Reserve Facility (SRF) (see Press Release No. 97/59, *IMF Survey*, January 12, page 7).

The equivalent of SDR 3.6 billion (about $4.8 billion) is available immediately, comprising drawings of SDR 768.4 million (about $1.0 billion) under the Extended Fund Facility (EFF), SDR 675.0 million (about $0.9 billion) under the SRF, and

(Please turn to the following page)

Table 1. Russian Federation: Schedule of Drawings

Amount of Drawing (in million SDRs)				Expected Availability Date	Conditions Necessary
CCFF	EFF	SRF	Total	(on or after)	for Drawing
2,156.6	768.4	675.0	3,600.0	07/20/98	Executive Board endorsement
. . .	1,440.3	1,806.3	3,246.6	09/15/98	Completion of eighth review under EFF and observance of the end-June 1998 performance criteria
. . .	1,104.4	1,511.2	2,615.6	12/15/98	Completion of the ninth review under EFF and observance of end-September 1998 performance criteria
0.0	500.0	0.0	500.0	02/15/99	Completion of tenth quarterly review under EFF and observance of end-December 1998 performance criteria

IMF Management Welcomes Board Decision

(Continued from the front page) $4.8 billion)—is less than the amount earlier envisaged—SDR 4.2 billion (about $5.6 billion). The difference, SDR 0.6 billion (about $0.8 billion), is expected to be made available in September, assuming that the measures are satisfactorily implemented in the meantime.

"The laws and other legal acts adopted over the last few days lay a solid basis for a fundamental improvement in Russia's fiscal position and a revitalization of structural reforms. However, the government will need to ensure full implementation of the policies envisaged in the program and its associated legislation. Weaknesses in implementation have been the Achilles heel of Russia's economic policies in the past. Thus it is critical that Russia take advantage of this opportunity to make the fundamental changes in economic policy that are needed.

"Management welcomes the intention of the Russian authorities to continue the existing exchange rate and monetary policy strategy. It is important that the Central Bank of Russia move ahead expeditiously to put in place a solid bank restructuring framework.

"I welcome the authorities' decision to request a successor EFF arrangement for 1999–2001. This should support the continuation of reforms in a period that is likely to see important political changes in Russia. This request will be considered by early 1999." ■

Memorandum of Policies

On July 16, the government of Russia issued a Memorandum of Economic and Financial Stabilization Policies. The full text of the memorandum is available on the IMF's web site at http://www.imf.org/external/np/loi/071698.htm.

IMF Approves Financing for Russia

(Continued from the front page) SDR 2.2 billion under the CCFF. (The schedule of drawings under the augmented arrangement and the CCFF is summarized in Table 1.) Relative to the envisaged schedule of disbursements announced on July 13, the first disbursement has been reduced by SDR 600 million (about $800 million), in light of delays in implementing certain prior actions. This amount, SDR 600 million, is expected to be made available as an addition to the disbursement previously scheduled for September, provided that the measures are satisfactorily implemented in the meantime.

Russia's extended arrangement, for the equivalent of SDR 6.9 billion (about $9.2 billion) was approved in March 1996 (see Press Release No. 96/13, *IMF Survey* April 1, 1996, page 119).

The IMF is financing the SDR 6.3 billion augmentation of the extended arrangement by borrowing the equivalent of SDR 6.3 billion (about $8.3 billion) under the General Arrangements to Borrow (GAB). Calls on the participants will be made in proportion to the amounts in Table 3, and in line with drawings by Russia under the EFF.

Background

Russia's financial markets, which have faced considerable volatility since October 1997, have been under intensified pressure since May. Capital outflows have led to steep increases in interest rates, undermining fiscal consolidation and the nascent economic recovery. Real GDP has fallen slightly in the first five months of 1998, compared with the same period in 1997, and while inflation has declined faster than projected, the balance of payments was in deficit during the first half of the year because of lower oil and gas prices, and the reversal in market confidence.

The government has responded by strengthening its efforts to correct the fiscal imbalance and by accelerating structural reforms. On June 25, it presented to the

Table 2. Russian Federation:

	1996	1997	1998	1999
			Projections	
	(annual percentage changes unless otherwise indicated			
Production and prices				
Real GDP	–2.8	0.8	–1.0	1.0
Change in consumer prices				
Annual average	47.8	14.7	7.2	5.8
12-month	21.8	11.0	6.8	5.0
		(percent of GDP)		
Gross national saving	22.5	21.3	18.8	18.6
Federal government	–9.3	–7.0	–5.6	–2.8
Other	29.2	28.3	24.4	21.4
Foreign saving[1]	–0.6	0.1	2.2	2.3
Gross domestic investment	21.9	21.4	21.0	20.9
Enlarged government deficit	9.5	7.9	6.2	3.3
Federal government (cash basis until 1996)				
Fiscal deficit	9.3	7.0	5.6	2.8
Domestic financing[2]	8.6	5.8	4.4	2.8
External financing[3]	0.7	1.2	1.2	0.0
		(percentage change)		
Money and credit (end-period change)				
Base money, narrow definition	26.2	28.0	22.4	...
Ruble broad money	33.6	30.0	24.7	...

[1]Negative number implies current account surplus.
[2]Includes domestic bank financing, change in the stock of government securities held with the private sector, proceeds fro[m] privatization and the sale of gold and other precious metals, principal repayments to domestic nonbanks, and other financin[g]
[3]Includes rescheduling of principal and interest plus (net) disbursements.

Chambers of the Federal Assembly (the Duma and the Federation Council) a comprehensive package of stabilization measures and has geared monetary policy toward defending the exchange rate, allowing domestic interest rates to rise substantially.

Fiscal and Monetary Policies

The enhanced economic package supported by the additional financial assistance from the IMF builds on the government's anticrisis program and contains a number of supplementary measures. With the objectives of accelerating a return to financial stability and intensifying structural reforms, the program comprises a major fiscal adjustment in 1999, with supporting fiscal measures being put in place at an early stage; a strengthened structural agenda for the remainder of 1998, emphasizing actions to address the nonpayment problem and to promote private sector development; and steps to ensure the viability of the government debt position.

The fiscal adjustment calls for reducing the federal budget deficit from 5.6 percent of GDP in 1998 to 2.8 percent of GDP in 1999. This will be accomplished by significantly strengthening revenue performance from 10.7 percent of GDP in 1998 to 13 percent in 1999. A key element of improving tax collection will be the full establishment of large taxpayers' units, with increased monitoring and control of taxpayers' payment of their current tax liabilities.

As part of the strategy to lengthen the maturity of its domestic debt, the Ministry of Finance has offered holders of treasury bills (GKOs) the opportunity to exchange them for foreign currency Eurobonds with long maturities at market rates. The results of this offer are being made public today.

Monetary and exchange rate policy should remain broadly unchanged during the remainder of 1998, with a view to preserving the singular achievement of the sharp fall in inflation in recent years and taking the inflation rate gradually lower.

Structural Reforms

The structural measures in the package, which are part of broader structural reforms supported by the World Bank, call for expanding and strengthening existing policies and for taking new actions to address the nonpayment problem and promote private sector development.

The authorities are committed to adopting a comprehensive approach to address underlying problems in the banking sector. This will be aimed not only at resolving problems of weak and insolvent banks, but also at improving the accounting, legal, and regulatory framework; strengthening supervision and compliance; and formulating a longer-term strategy for developing competition in the banking system.

Table 3. Activation of GAB
(U.S. dollars)

Participant	Total Credit	Proposed Total Calls
United States	4,250,000,000	1,576,392,500
Deutsche Bundesbank	2,380,000,000	882,779,800
Japan	2,125,000,000	788,196,250
France	1,700,000,000	630,557,000
United Kingdom	1,700,000,000	630,557,000
Italy	1,105,000,000	409,862,050
Swiss National Bank	1,020,000,000	378,334,200
Canada	898,500,000	331,042,425
Netherlands	850,000,000	315,278,500
Belgium	595,000,000	220,694,950
Sveriges Riksbank	382,500,000	141,875,325
Total	17,000,000,000	6,305,570,000

Summary Macroeconomic Indicators

	1996	1997	1998	1999
			Projections	
	(percentage change)			
Interest rates (percent a year)				
Central Bank of Russia refinance rate	48.0	21.0	...	...
Treasury bill rate	102.0	40.4	...	...
	(billion U.S. dollars unless otherwise indicated)			
Total exports, fob	90.5	88.7	81.3	85.1
Total imports, fob	73.9	74.8	74.1	77.0
External current account	2.5	–0.4	–9.6	–10.4
Public external debt service due	14.8	8.9	11.7	20
Public external debt service after rescheduling	9.5	6.3	10.1	19.2
Stock of external debt	. . .	123.5	147.0	149.0
Debt as a percentage of GDP	. . .	27.5	33.9	33.6
	(percent of exports of goods and nonfactor services)			
Public external debt service due	14.5	8.7	12.3	20.2
Public external debt service after rescheduling	9.3	6.2	10.6	19.3
	(months of imports of goods and nonfactor services)			
Gross reserves coverage	2.0	2.3	3.8	3.7
Memorandum items:				
GDP (billion rubles)	2,256.0	2,602.0	2,700.0	2,900.0
Exchange rate (rubles per $1; average)	5,123.0	5,786.0	6.22	6.53
GDP (billion U.S. dollars)	440.0	450.0	434.0	444.0

Data: Russian authorities and IMF staff estimates and projections

Drawing under the CCFF

Russia's drawing under the CCFF is being made in respect of an export shortfall, related mainly to lower prices of crude oil during 1998. A calculated shortfall of about SDR 2.9 billion (about $3.8 billion) in merchandise exports is attributable to the sharp decline in oil prices in the first half of 1998 and the expectation that the downward trend will continue through much of the rest of the year.

Russia joined the IMF on June 1, 1992, and its quota is SDR 4.3 billion (about $5.7 billion). Its outstanding use of IMF financing currently totals SDR 10.7 billion (about $14.3 billion). ■

Address at Kobe University

Sugisaki Outlines Basis for Sustainable Recovery in Japanese Economy

Shigemitsu Sugisaki

Following is an edited excerpt of remarks by Shigemitsu Sugisaki, a Deputy Managing Director of the IMF, at a Kobe University-IMF Symposium, on July 14, on the outlook for Japan and its global implications.

During recent months, we have had several vivid reminders that the "Asian" crisis is still with us. We have seen pressures spreading from many of the emerging economies of Asia, but also from Russia and, of course, from Japan itself. And we have begun to see data showing the magnitude of the economic downturns that many of the countries in the region are suffering. It will take determined policies to achieve a turnaround in Asia and relieve these threats to the global economy. As the second largest advanced economy in the world, the biggest market in Asia, and the largest supplier of financing to its regional partners, Japan will play a critical role.

Japan and Asia

The economic challenges that Japan faces today are perhaps the most difficult since the immediate postwar period. How well these challenges are addressed is, of course, of major domestic concern. But Japan's economic weight is so large that it also has a major impact on prospects for the entire global economy and especially for Asia:

- With a little over 2 percent of the world's population, Japan accounts (at market prices) for about 14 percent of world GDP and for over half of Asia's GDP.
- Japan is one of the most important markets for Asia's exports, accounting for about 17 percent of exports from the Asia-5 countries (Indonesia, Korea, Malaysia, the Philippines, and Thailand) and China. Exports to Japan represent a remarkable 12 percent of Malaysia's GDP and 4–7 percent of that of Indonesia, Thailand, and Korea.
- Japan's banks have been the largest lenders to the region, accounting for about one-third (around $97 billion) of total Bank for International Settlements (BIS) exposure to the Asia-5 countries at the start of the crisis in mid-1997, and a similar proportion to China. Japanese banks are especially important in Thailand, accounting for over half of all international bank lending.
- Japan is the largest single source of foreign direct investment inflows into East Asia ($6 billion a year on average during the 1990s, or about one-fifth of the total).

Reflecting these close linkages, spillover effects from the economic downturn in Japan are already affecting recovery prospects more broadly in Asia. IMF staff estimates suggest that the downturn in Japanese domestic demand and the depreciation of the yen against the dollar could lower GDP in the Asia-5 countries by almost 1 percent in 1998. On the other hand, the Asia crisis is estimated to lower Japan's GDP by 1–1¼ percent in 1998.

Capital flows within the region have also been adversely affected by the financial strains in both Japan and the recipient countries. Japanese bank loans to the Asia-5 countries fell by 10 percent (or about $10 billion) in the second half of 1997. This was a much sharper decline than from other BIS-area banks (where the decline was about 3 percent). If Japanese banks are not swiftly restored to financial health, these trends are likely to continue, reducing their ability to finance new projects and regional trade. So far, foreign direct investment flows have been less affected. However, there appears to be a well-established link between foreign direct investment outflows from Japan and the real exchange rate, suggesting that a weaker yen could dampen such outflows.

Fostering a Sustainable Recovery

So what is needed to foster a sustainable recovery in Japan? There is broad agreement on the critical steps, and the government has already begun action on many of them. At the heart of Japan's protracted economic slowdown are structural problems associated with the financial system that were first revealed by the bursting of the asset price bubble. So the central task is to deal decisively with the problems in the banking sector. The recent further weakening of the economy reinforces the urgency of this task but also suggests that additional macroeconomic stimulus is needed to provide adequate short-term support to the economy.

In Japan's present circumstances, there is little alternative to the use of fiscal policy to provide such a stimulus. So the government is correct to implement as quickly as possible the recently approved fiscal stimulus package, including about ¥12 trillion of "real water" measures that will have a direct impact on aggregate demand. Indeed, in view of the continuing signs of weakness of aggregate demand, there now seems little scope for a withdrawal of fiscal stimulus next year. So, longer-term fiscal consolidation, while still necessary, will have to be temporarily postponed. One useful way of achieving the necessary fiscal stimulus would be through up-front cuts in tax rates, rather than a further extension of temporary tax rebates. High marginal tax rates on both individuals and corporations could be lowered, while announcing a multiyear commitment to gradual base broadening.

But fiscal action will only provide temporary relief unless the underlying banking sector problems are addressed decisively to restore public confidence and to ensure that banks can play an effective role in financial intermediation. An aggressive, far-reaching strategy is needed. Fortunately, there now appears to be a clear recognition by the government of the need for a decisive break with the past. Earlier this month, the second report on the Plan for Financial Restructuring announced a number of welcome initiatives that represent further important steps toward a comprehensive approach. Let me briefly summarize what, in the IMF's view, are the necessary ingredients of the overall strategy, a number of which are now under way.

• The self-assessment framework is the right approach for recognizing the full extent of bad loans, but will need to be rigorously enforced by supervisors. The forthcoming intensive inspections of the 19 major banks to be carried out by the Financial Supervision Agency, in conjunction with the Bank of Japan, will be an important test of this framework and one that markets will be watching carefully.

• The recently approved bridge bank facility provides a potentially valuable means for resolving insolvent institutions in an orderly manner that preserves values and avoids disrupting credit relations. To be effective, however, the approach will require clear procedures to ensure that bad assets are identified, that assets are subject to proper valuation, and that new loans are only provided on prudent commercial criteria. Private sector buyers for the bridge banks will also need to be identified quickly.

• The proposed bridge bank scheme is a mechanism for dealing with failed institutions only. However, it is just as important to advance the restructuring of those major banks that are undercapitalized but that may be solvent. As part of this effort, injections of public funds will be needed to avoid a contraction of credit that would further weaken the economy. The use of public funds should be linked to strong restructuring plans. A mechanism needs to be put in place to ensure that banks are coming forward and tapping the restructuring funds.

• Aggressive efforts are needed to dispose of problem loans in all banks and to improve the institutional mechanisms for debt workouts.

• Finally, the Financial Settlement Agency should be given increased independence, authority, and staff resources.

The use of public funds should be linked to strong restructuring plans.

None of this will be easy. It is an ambitious agenda. But there is no advantage to further delay: the problems will only become more difficult. Now, more than at any time, Japan's leadership needs to take strong action to ensure that Japan gets back on the path of high growth it enjoyed in the past. I trust that the Japanese government will grasp this opportunity to press forward forcefully with radical plans to transform the financial sector as outlined above. Early action will help improve the health of not only the Japanese economy but that of Asia and the world. ■

Dubrovnik Conference

Discussions Focus on Central Banking Issues, Financial Stability in Transition Economies

Experts from academia, multilateral financial institutions, and central banks and governments of transition economies gathered in Dubrovnik in late June for a four-day conference on Central Banking and Monetary Policy in Transition Economies. This, the fourth in a series of Dubrovnik Conferences on Transition Economies, was sponsored by the Croatian National Bank and organized by Marko Škreb, Governor of the Croatian National Bank, and Mario I. Blejer, Senior Advisor in the IMF's Monetary and Exchange Affairs Department. The eclectic mix of theorists, international experts, and national practitioners stimulated a wide-ranging exchange of ideas on the difficulties involved in achieving monetary stabilization and the lessons that had been learned through both success and failure.

Conference participants examined a full spectrum of issues confronting central bankers—from the question of central bank independence and the choice of an appropriate nominal target, to the possibility of using capital controls to gain a breathing space for the successful implementation of transition policies, and to problems associated with the stability of the financial system, which could so easily undermine any macroeconomic policy regime. The discussions were conducted amid a deep awareness of the vulnerability of such policies to internal political or external market attack. Finally, the conferees looked to the future, examining the options open to transition economies as several European countries moved toward a single currency regime.

Central Bank Independence and Targets

Alex Cukierman of Tel-Aviv University (presenting a paper co-authored with Geoffrey Miller of New York University and Bilin Neyapti of Bilkent University) listed a number of measures of central bank independence across some 30 transition economies based on an

examination of their relevant laws. The level of legal independence appeared greater than in developed economies, but the authors warned that the degree of compliance with such laws may be lower in transition economies, thereby rendering the level of actual central bank independence somewhat lower also.

Frederic Mishkin of Columbia University examined the role of a central bank in a democratic society and the apparent conflict between a desire to grant central bank independence and overcome time-inconsistency problems, on the one hand, and the desire to hold policymakers accountable to the electorate, on the other. He concluded that, to preserve accountability, a central bank should have instrument independence rather than goal independence and that an inflation-targeting regime, with the inflation target set by the government, is probably the most transparent expression of a democracy's desire for price stability.

Charles Wyplosz (left), Mario Blejer, Ricardo Martin, and Paul Masson at the Dubrovnik Conference.

As if to underscore the tension between independence and policy consistency, Allan Drazen of the University of Maryland found strong cross-country evidence of opportunistic, pre-electoral manipulation of economic policy. He argued that the impetus for such behavior usually comes from a pre-electoral increase in transfer payments, with monetary policy accommodating the resulting fiscal impetus, rather than from an attempt by central bankers to engineer an opportunistic monetary stimulus—which is, in any event, likely to be thwarted by rational economic agents. Monetary accommodation in these circumstances could be seen as a periodic attempt by central banks to preserve their otherwise independent status.

Steve Hanke of The Johns Hopkins University argued that a currency board system, while not a panacea for attempted political subversion, is particularly appropriate to transition economies that tended to have weak monetary authorities and a history of monetary instability. Currency boards, because they do not afford central banks flexibility in base-money creation, generate a level of credibility that provides resistance to internal and external shocks. However, a currency board regime requires absolutely fixed rules and exchange rates, as was demonstrated during the Argentine crisis of 1995, and is politically difficult to introduce, as has recently been demonstrated in Indonesia.

A lack of structural reform undermined the independent monetary policy of the Bulgarian National Bank in the mid-1990s, according to Lyubomir Filipov of Credit Bank in Bulgaria, leading to a severe financial crisis in 1996 that culminated in the transition to a currency board arrangement. He argued that, given the severe set of constraints facing the Bulgarian economy at the time, the National Bank did not have the luxury of policy independence in any event. Warren Coats, Advisor in the IMF's Monetary and Exchange Affairs Department, described how the Central Bank of Bosnia and Herzegovina had recently been established as a currency board. The introduction of such a simple system facilitated public acceptance of the new central bank and its currency and also eased the task of establishing a central bank in difficult circumstances.

On the other hand, Leonardo Leiderman (in a paper written with Gil Bufman, both of the Bank of Israel) attributed recent moves toward inflation targeting in many transition economies to the difficulty of maintaining exchange rate targets in the context of greater capital mobility. When such a regime change is undertaken, it is important that inflation targets be clearly set, supported by an appropriate set of fiscal and wage policies, and compatible with any residual exchange rate aspirations, as expressed, for example, in a crawling exchange rate band.

Miroslov Hrnčiř from the Czech National Bank examined the factors behind the Czech currency crisis of 1997, which forced the monetary authorities to abandon a pegged exchange rate regime. He concluded that large capital inflows—which arose when cultivation of the domestic institutional and legal framework significantly lagged behind external liberalization—had exacerbated macroeconomic imbalances. The subsequent shift to inflation targeting preserved macroeconomic stability, however, and the entire episode could be seen as a "wake-up call" to proceed with structural reforms in tandem with financial liberalization. Istvan Szekely of the National Bank of Hungary argued that a crawling exchange rate band could provide an effective mechanism to achieve a rate of disinflation in line with the objectives of policymakers and, at the same time, secure an acceptable balance of payments position.

Capital Controls

Charles Wyplosz of the Graduate Institute of International Studies in Geneva argued that, with the advent of heightened capital mobility to transition economies, self-fulfilling crises are ever more likely to overcome weak domestic financial systems and threaten the rest of the world with contagion. Good macroeconomic policies might not be sufficient to deter such crises, because the required structural reforms often cannot be introduced quickly enough. The retention of capital controls might provide a breathing space in which to complete the reform

process. Indeed, Wyplosz suggested that all countries should be required to "apply" for capital liberalization from some international body that would assess a country's ability to survive in such an environment.

The recent introduction of curbs on capital inflows in Croatia was necessitated by an inability to control credit growth in the context of a stable exchange rate regime and increased bank borrowing from abroad, according to Velimir Šonje of the Croatian National Bank. He argued that the controls worked and were desirable as a short-term expedient to preserve a sustainable external position. Velimir Bole of Slovenia's Economics Institute of Law faculty also described the difficulty of controlling domestic credit growth in the face of capital inflows and suggested that the volatility of such inflows could lead to an undermining of the domestic banking system.

Ricardo Martin (presenting a paper written with Marcelo Selowsky, both of the World Bank) asked whether Chilean-type capital controls, which discriminate against short-term flows, are preferable to measures aimed at short- and long-term flows alike. He argued that short-term capital inflows are often a necessary precursor to long-term inflows, because they offer foreign investors the opportunity to learn about a country before undertaking a long-term position; the restriction of short-term capital intake could therefore also reduce longer-term inflows.

Stability of the Financial System

William White of the Bank for International Settlements (BIS) underlined how monetary and financial stability were two sides of the same coin. He described the role the BIS plays in preserving financial stability across countries—mainly by providing a forum for central bankers to meet, exchange ideas, and develop a consensus on international standards. It is particularly important, when modern financial markets develop rapidly and become increasingly complicated and opaque, that efforts to strengthen financial systems be comprehensive, market-disciplined, complementary, and agreed at an international level.

To support monetary policy, central banks need to maintain a sound financial system (through appropriate supervision) and an efficient payments system (through appropriate development), according to Maxwell Fry of the University of Birmingham. This is particularly relevant in transition economies where banking systems are weak and central banks play an important role in the payments system. In this context, George Kaufman of Loyola University (Chicago) stressed that banks are particularly vulnerable in periods of uncertainty, such as during a transition, and would be tempted to undertake excessive risk. Moreover, the provision of deposit insurance is usually a political imperative that only serves to exacerbate risky behavior by removing market discipline on banks. Kaufman advocated a system of structured early intervention and resolution that would mimic market regulation through explicit and progressively harsher sanctions as banks deteriorate, culminating in mandatory closure.

Reaction to the Euro

Two papers, by Robert Mundell of Columbia University and Paul Masson of the IMF's Research Department, examined the options open to central and eastern European countries as western Europe moves toward the adoption of a single currency and the central and eastern European countries progress from the transition phase and move toward European integration. Mundell, who said he believed the euro would achieve parallel importance with the U.S. dollar in the international monetary system, went on to argue that most central and eastern European countries would benefit from the discipline of having their currencies rigidly fixed to the euro. Masson suggested that, in practice, a hybrid system with some weight given to both inflation and the exchange rate is likely to be preferable to the adoption of either as a sole target. Structural differences and volatile capital flows are likely to make parity adjustments occasionally desirable while, on the other hand, central and eastern European countries do not appear to have the stable and predictable relationship between monetary instruments and future inflation that is required for successful inflation targeting.

Marko Škreb, Governor, Croatian National Bank

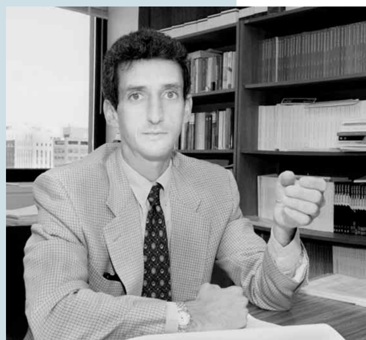
Summing Up

In a concluding roundtable discussion, participating central bank governors echoed many of the themes developed earlier and stressed the practical difficulties in achieving monetary and financial stability in the face of political and other constraints. They emphasized the need for perseverance in implementing policy, practicality in setting objectives, preservation of central bank credibility, and the generation of a social consensus through communication with the public and the government. No blueprint exists for central bank governors, and central banking skills are acquired by experience. Indeed, Mario Blejer wrapped up the conference by stressing the need for humility in considering the topics discussed and the value of such interchanges as had occurred over the previous four days. ■

Gary O'Callaghan
IMF Resident Representative, Croatia

Study Analyzes Links Between International Currency Crises and Current Account Reversals

Three waves of crises have swept international capital markets during the 1990s: the European Monetary System crisis in 1992–93, the collapse of the Mexican peso with its induced "tequila effects," and, most recently, the financial crisis in East Asia. In Italy and Mexico, the currency crisis was followed by a sharp reversal in the current account: Italy went from a deficit of 2.4 percent in 1992 to an average surplus of 2 percent in 1993–97, and Mexico, from a deficit of 7 percent in 1994 to virtual balance in 1995–96. In East Asia, very large currency depreciations and sharp output declines are generating large swings in the current account.



Milesi-Ferretti: Even solvent borrowers may face severe liquidity constraints, owing to a sudden reversal in capital flows.

In Working Paper 98/89, *Current Account Reversals and Currency Crises: Empirical Regularities,* Gian Maria Milesi-Ferretti of the IMF's Research Department and Assaf Razin, Professor of Economics at Tel-Aviv University, study sharp reductions in current account deficits and exchange rate depreciations in low- and middle-income countries over the period 1970–96. They examine which factors help predict the occurrence of a reversal or a currency crisis, and how these events affect macroeconomic performance. Milesi-Ferretti and Razin spoke with the *IMF Survey* about their study.

IMF Survey: *In theory, a reversal in capital flows can cause a currency crisis and force a reduction in current account deficits because of the drying up of external financing. However, a reversal can also occur in response to a change in macroeconomic policy. What triggers large and persistent reductions in current account deficits?*

Razin: The most obvious indicator of a future reversal is the size of the current account deficit over the past few years.

Milesi-Ferretti: In a world economy with problems such as asymmetric information, moral hazard, adverse selection among borrowers, and the absence of international bankruptcy arrangements, even solvent borrowers may face severe liquidity constraints, owing to a sudden reversal in capital flows. These problems are particularly relevant to developing country economies, which are characterized by shallow financial markets, high vulnerability to terms of trade shocks, and political uncertainty. Indicators of a country's vulnerability to sharp capital flow reversals, such as the composition of external liabilities, can therefore provide information regarding the likelihood of a sharp turnaround in the current account balance.

Razin: The most obvious indicator of a future reversal is, of course, the size of the current account deficit over the past few years. Reversals are also more likely in countries with low foreign exchange reserves and with worsened terms of trade. We also find some evidence that reversals are more likely in countries with high investment rates: insofar as high investment contributes to export capacity, it can lead to a narrowing of external imbalances. Reversals appear less likely in countries that peg their exchange rates. If a peg precludes an adjustment in the nominal (and real) exchange rate, it can hamper the reduction of external imbalances. The business cycle in industrial countries also seems to have an impact on the likelihood of a reversal. Indeed, reversals in developing countries are more likely to occur in years when the growth rate in industrial countries is high and after a period of high real interest rates in international capital markets.

IMF Survey: *What are the consequences for domestic output?*

Milesi-Ferretti: For current account reversals, we do not find any systematic difference between the growth rate before and after the event. However, country experiences vary a great deal, with some countries experiencing dramatic growth slowdowns and others with growth accelerating. This suggests that reversal events have very different characteristics, going from full-fledged balance of payments crises to rapid expansions driven by export growth. Among the countries undergoing a reversal, those more open to trade and with a less appreciated level of the exchange rate before the event are likely to grow faster after the event. We also find some evidence that countries with high external debt tend to grow more slowly.

IMF Survey: *What triggers sharp exchange rate depreciations or currency crises? What impact do they have on domestic output?*

Razin: Two strong indicators of sharp exchange rate depreciations are the degree of real exchange rate overvaluation and the level of foreign exchange reserves, measured as a fraction of imports or as a fraction of broad money. Crashes are more likely in countries in which the real exchange rate is appreciated relative to its historical average and in countries with low reserves.

In addition, a number of external factors help predict the occurrence of a currency crash: high interest rates and low growth in industrial countries, as well as weak terms of trade. Also, crashes appear to be less likely in countries that receive a large share of debt at concessional terms. This finding may be explained by the fact that these flows are less likely to be reversed. Countries with an IMF program in place are less likely to suffer a crash the following year. In addition to a possible credibility effect, this finding could reflect the fact that programs are approved or

remain in place in countries willing to strengthen their fundamentals. Last but not least, for a reduced sample of middle-income countries we also find that a crash is more likely when the current account deficit is large.

For currency crises episodes, growth tends to be below average in the run up to the crisis and to fall severely the year of the crisis, with a recovery to the pre-crisis level in the following years. Overall, the most robust predictor of output performance after a crisis is the average growth rate before the crisis, suggesting a stronger degree of "continuity" in output performance in the case of currency crises than in the case of reversals. We also find evidence that countries more open to trade tend to grow faster after a currency crisis, especially for the sample of middle-income countries. The growth rate for the year of the crisis and the current account balance prior to the crisis are not good predictors of subsequent performance, after controlling for other growth determinants.

IMF SURVEY: *Is there a link between current account reversals and currency crises?*

MILESI-FERRETTI: A comparison of currency crises and current account reversals shows that these are in general distinct events. Less than one-third of all current account reversals are preceded by a currency crisis, suggesting that the conventional wisdom that large nominal depreciations precede a turnaround in the current account is not always accurate. This points to the need to look more closely at current account reversals, distinguishing between those that reflect an external crisis and those that do not. Indeed, our sample of current account reversals comprises both crisis episodes, in which capital flows dry up abruptly and the country suffers a currency collapse and is forced to undertake costly adjustment measures and improvements in the external position, which are driven by favorable external conditions, such as high growth in industrial countries, as well as by a timely shift in macroeconomic policy.

RAZIN: Indeed, the empirical analysis in this paper tries to identify the contribution of each single variable to the probability of a reversal happening and thus includes both "favorable" and "unfavorable" developments—high growth on the one side, high real interest rates on the other—behind these events.

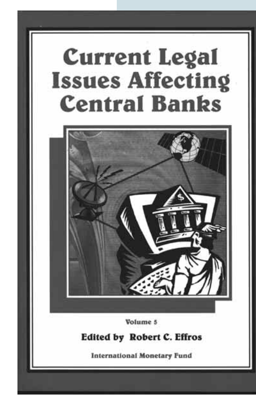
IMF SURVEY: *What implications does your study have for policymakers, and what is the agenda for further research?*

MILESI-FERRETTI: Overall, we find that currency crashes have many factors in common, and that traditional "fundamentals" do provide useful information on the likelihood of a sharp devaluation. Both domestic and external factors have an impact on the likelihood of a crisis. The obvious, if trivial, policy implication is to keep fundamentals under close watch. At the same time, these models do a reasonable job of predicting crises that have already occurred, but are less effective in predicting "out of sample"—that is, future—crises. This is to some degree inevitable: we learn from experience. Furthermore, the lessons from the past are often drawn from contexts in which the macroeconomic and external environment had different characteristics—for example, less "market orientation" and less capital mobility than today.

RAZIN: With regard to future research, an interesting question we are currently pursuing is whether swings in the current account are merely a reflection of reversals in capital flows. One would expect that for those reversals associated with external crises, the size of the capital outflow will be much larger than for countries that reduced their current account imbalances in the context of an improving output performance. We also plan to look at whether countries with an exchange-rate peg are more vulnerable to swings in capital flows. ■

Copies of Working Paper 98/89, *Current Account Reversals and Currency Crises: Empirical Regularities,* by Gian Milesi-Ferretti and Assaf Razin, are available for $7.00 each from IMF Publication Services. See page 249 for ordering information.

World Banking Systems Must Respond to New Global Innovation and Competition



As the global village becomes a reality, financial systems around the world must respond to innovation and competition. Integral to this process are the central bank and the laws that affect its operations. *Current Legal Issues Affecting Central Banks*, Volume 5, a new book from the IMF's Legal Department, examines a wide range of issues of interest to anyone concerned with how international financial institutions, central banks, and commercial banks are working to meet the world economy's new challenges.

Edited by Robert C. Effros, Assistant General Counsel, the book's more than thirty authors analyze the legal issues surrounding traditional payments systems and the new stored value products, cross-border electronic banking, and banking supervision, among others. They discuss case histories of recent bank failures and examine how countries' own liquidity crises are resolved. The book also has a section devoted to topics of special interest to central banks, including derivatives activities by banking institutions, the international law of bank secrecy, and a discussion of the framework and negotiations covering financial services in the General Agreement on Trade in Services.

SDRs at the IMF

Current Legal Issues Affecting Central Banks begins with a description of the way the IMF acts to meet the need to supplement reserve assets by allocating SDRs to members that are participants in the IMF's Special Drawing Rights Department. IMF General Counsel François Gianviti discusses the IMF reserve asset known as the SDR (special drawing right). SDRs were created by the First Amendment of the IMF's Articles of Agreement to supplement existing reserve assets but were not explicitly recognized as reserve assets. Instead, their main use was to be exchanged for currencies among IMF members that participate in the SDR system. The Second Amendment made SDRs the unit of account of the IMF's General Resources Account (instead of gold) and stated that SDRs were intended to become the principal reserve asset of the international monetary system.

Initially, the creation of the SDR appeared to be a complete success: SDR 9.5 billion was allocated by the IMF in 1970–72. Thereafter, unexpected economic developments cast doubt on the continued need for SDR allocations. Nevertheless, further allocations totaling SDR 12 billion took place in 1979–81. From that time until 1997, there had not been allocations of SDRs, but debate took place over whether there was a need for a new one. On September 23, 1997, the IMF's Board of Governors approved the proposed amendment of the Articles of Agreement to allow for a special one-time allocation. In explaining how the SDR system operates, Gianviti offers an analogy to the play money distributed to begin the board game Monopoly, but he notes a substantial difference: in the IMF's SDR Department the "play money" is used to buy real assets and discharge real liabilities and, in the end, real value must be returned if the allocated SDRs have been spent.

Payments Issues

How do payments get made outside the IMF system? With an estimated $1 trillion plus of foreign exchange trades arranged daily, the resulting large exposures raise significant concerns for individual banks and the entire international financial system. The section on payments issues discusses how the collapse of Germany's Herstatt Bank in 1974 first brought foreign exchange settlement risk into sharp focus. In response to the Herstatt episode, and under the auspices of the Group of Ten central banks, a series of reports was issued on foreign exchange risk. Authors Garland D. Sims and Robert S. Steigerwald observe that a 1996 landmark report—*Settlement Risk in Foreign Exchange Transactions*—may lead to significant steps by central banks to reduce settlement risk.

Risk is an inherent part of all payment processes, and in his introduction, Effros provides a comprehensive survey of existing and emerging payments systems. He compares the UN Commission on International Trade Law's Model Law on International Credit Transfers with both the EC Council Directive on Cross-Border Credit Transfers and the United States' Uniform Commercial Code Article 4A. Both Effros and Thomas C. Baxter, Jr., General Counsel and Executive Vice President of the Federal Reserve Bank of New York, in his own chapter, examine the "new frontier for retail payments systems"—electronic money or stored value products. Providing a step-by-step description of a stored value card's use, Baxter discusses the legal uncertainty surrounding these products and concludes that central banks can help foster the development of appropriate rules, thereby permitting stored value products to act as an efficient payment mechanism for consumers without unnecessary or uncontrollable risk. Professor Raj Bhala considers that cross-border electronic banking has made the international banking system inherently riskier; he examines six components of systemic risk to support his thesis.

While these banking innovations are receiving their share of media attention, disaster stories grab headlines. The book provides insight on some Titanics of the industry, along with the bank supervisory methods designed to prevent them.

Bank Failures

Technological advances, product innovation, and globalization are trends that have fundamentally altered the business of banking, in the view of Chester Feldberg, Executive Vice President of the Federal Reserve Bank of New York. These trends, he continues, have produced major new challenges for bank supervisors and have raised questions in many countries about the adequacy of bank supervisory techniques and overall performance, as well as the need for fundamental changes in supervisory approaches. This section on banks in distress includes discussions of common themes in bank supervision in light of a multinational cooperative effort. Authors examine the work of the Basle Committee on Banking Supervision, including the Basle Concordat—a set of common supervisory principles for banks' foreign establishments that the Committee adopted. Virgil Mattingly, General Counsel of the U.S. Federal Reserve System's Board of Governors, describes the Board's experiences in sharing information and the ways in which it has sought to balance competing interests in this area. He reviews cases of the Bank for Credit and Commerce International, Daiwa Bank, and Barings. Other authors examine various types of bank failures in the United States, including the Continental Illinois National Bank, a rescued bank; and the Ohio thrift crisis, a series of failures; as well as bank failures in Latin America and Scandinavia. Jimmy Barton, former Chief National Bank Examiner of the U.S. Office of the

Comptroller of the Currency (OCC), analyzes a new OCC program that focuses on the risk management systems of banks. Manuel Guitián, Director of the IMF's Monetary and Exchange Affairs Department, concludes the section by considering what degree of independence the banking supervisor should have; what the government's role should be when systemic threats arise; and how transparent the rules governing bank failures should be.

Sovereign Liquidity Crises

What happens when it is not merely one bank in distress but an entire country? The book explores the ramifications of the sovereign liquidity crisis. Gianviti explains "sovereign liquidity crisis" as a situation in which a government is unable to service the country's debt. If the debtor is a sovereign state, it cannot be subjected to bankruptcy procedures or other normal legal remedies applicable to national subjects because of its sovereign immunities. As a consequence, the only remedies available will be those that can be negotiated between the sovereign debtor and its creditors. Gianviti examines several key concepts: sovereign debtor, liquidity crisis, and external debt. Concerning sovereign external debt, he stresses the primary significance of the residence of the parties and explains why attention is often given to the currency of payment. Gianviti maintains that the resolution of sovereign liquidity crises involves a number of different, and sometimes conflicting, considerations, and points out that while greater attention has been given to foreign creditors and to the problems created by the shortage of foreign exchange, a sovereign liquidity crisis cannot be resolved by ignoring the situation of local creditors and the impact of local currency payments.

Reference Source

In addition to the authors' analyses, the volume contains 14 appendices covering statutes and other documentation on international finance, payments, and financial institution supervision. With an additional 60 pages of annotation and citations, this book is intended to be a reference source for lawyers, bankers, policymakers, and others concerned with these issues. ■

Rachel Ray
IMF Legal Department

Current Legal Issues Affecting Central Banks, Vol. 5 (809 pp.), edited by Robert C. Effros, is available for $65.00 from IMF Publication Services. A set of all five volumes in this series can be purchased for $210. See page 249 for ordering information.

From the Executive Board

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).

Guyana: ESAF

The IMF approved a three-year loan under the Enhanced Structural Adjustment Facility (ESAF) equivalent to SDR 53.8 million (about $71 million) to support Guyana's economic program for 1998–2001. The first annual loan of SDR 17.9 million (about $24 million) will be available in two equal semiannual installments, the first of them shortly.

The authorities' medium-term program for 1998–2001 seeks to attain satisfactory growth within the context of low inflation, a strengthened balance of payments position, and a robust exit from the debt-rescheduling process after the delivery of assistance under the HIPC Initiative. The program aims at achieving average real GDP growth of about 4 percent a year, a reduction in inflation to about 3.6 percent (period average), and a narrowing of the external current account deficit while maintaining gross international reserves at the equivalent of 4–5 months of imports.The main elements of the program include a reduction in the fiscal deficit, a tightening of credit policy, a more flexible exchange rate policy, and the continuation of structural reforms.

Guyana: Selected Economic Indicators

	1996	1997[1]	1998[2]	1999[2]	2000[2]	2001[2]
			(percent change)			
Real GDP	7.9	6.2	3.1	4.4	4.2	4.9
Consumer prices (period average)	7.1	3.6	4.6	4.5	4.0	3.5
			(percent of GDP)			
Overall fiscal balance	–3.2	–8.8	–2.0	–0.8	–0.1	1.3
External current account balance (excluding official transfers)	–9.3	–14.5	–10.7	–10.4	–9.1	–9.1
			(months of imports)			
Gross official reserves	5.2	4.6	4.7	5.0	4.9	4.9

[1]Estimates.
[2]Projections.

Data: Guyana authorities and IMF staff estimates and projections

The 1998–99 program aims at correcting the growth slippage that occurred in 1997, assuming a slowdown in real GDP growth to about 3 percent, reflecting a slow recovery in agricultural output from the lingering adverse effect of the El Niño phenomenon, and a slight increase of inflation to about 4.6 percent (period average). However, the external position would strengthen

with an accumulation of gross international reserves to maintain the import cover at about 4½ months.

To achieve these objectives, the overall public sector deficit will be reduced from about 9 percent of GDP in 1997 to 2 percent of GDP in 1998, while credit policy remains restrained, consistent with the inflation and balance of payments objectives.

Structural Reforms

Structural reforms will continue to focus on reducing the role of the public sector in the economy and creating an environment conducive to private sector development. To this end, efforts in 1998–99 will emphasize financial sector reform and improving the business environment, restructuring public enterprises, and civil service reform.

Addressing Social Needs

The authorities are aware of the need to maintain appropriate social and environmental policies. The government aims to improve the standard of living through increased emphasis on health and education and well-targeted poverty-reduction programs.

Guyana joined the IMF on September 26, 1966, and its quota is SDR 67.2 million (about $89 million). Its outstanding use of IMF financing currently totals SDR 30 million (about $39 million).

Press Release No. 98/29, July 15

Republic of Congo: Emergency Post-Conflict Assistance

The IMF approved a loan for the Republic of Congo equivalent to SDR 7.2 million (about $10 million), under the IMF's emergency post-conflict assistance, to support the government's economic program for 1998.

Medium-Term Strategy and 1998 Program

The Congolese authorities envisage a two-stage approach to address both the severe economic and developmental challenges exacerbated by the civil war and the near-term emergency reconstruction needs. The first priority is to consolidate the security of persons and property, reconstruct the central administration and institutional capacity, restore conditions conducive to macroeconomic stability, and rebuild the infrastructure in Brazzaville. The second priority is to move, by early 1999, to a comprehensive multiyear economic reform program that could be supported by an Enhanced Structural Adjustment Facility (ESAF).

Republic of Congo: Selected Economic Indicators

	1996[1]	1997[1]	1998[2]
	(percent change)		
GDP at constant prices			
Oil	13.2	14.7	15.5
Non-oil	2.8	–11.3	2.5
Consumer prices[3] (end-of-period)	9.7	13.1	1.1
	(percent of GDP)		
External current account balance (excluding grants)	–52.5	–13.2	–12.4
Primary fiscal balance[4]	10.8	6.4	11.9

[1]Estimate.
[2]Program.
[3]Consumer price index for African households in Brazzaville.
[4]Defined as revenue excluding grants minus noninterest current expenditures, domestically financed capital expenditure, and net lending.

Data: Congolese Ministry of Finance and Budget and IMF staff estimates and projections

The main macroeconomic objectives of the 1998 program are to resume non-oil economic growth, lower inflation, reduce the external current account deficit as a ratio of GDP, and regularize external arrears. Real non-oil GDP is projected to increase to 2.5 percent in 1998, while the 12-month consumer price inflation rate is targeted to decline to 1.1 percent in 1998 from 13.1 percent in 1997 (on an end-year basis). The external current account deficit, excluding grants, is programmed to fall to 12.4 percent of GDP in 1998 from 13.2 percent in 1997.

To support the program objectives, the primary fiscal balance is projected at 11.9 percent of GDP in 1998, from 6.4 percent in 1997.

Structural Reforms

Rapid progress in structural reforms is another critical part of the strategy to lay the basis for an open, market-based economic system and to pave the way for increased foreign direct investment flows, notably in the non-oil sector. Longer-term structural reform aims at institution-building and rehabilitation of damaged infrastructure. In the near-term, the authorities' priorities are to restructure the banking system, begin privatizing public enterprises, open key economic sectors to competition, and pursue civil service reform.

Addressing Social Needs

Social safety net protection in the Congo, most of which has been provided directly by state-owned enterprises and family networks, has been severely eroded in recent years, particularly during the conflict. In the short term, the emergency program, which accords priority to the health and education sectors, should help alleviate the serious pressures on the most vulnerable segments of the population, while laying the basis for economic recovery and employment creation.

The Republic of Congo joined the IMF on July 10, 1963, and its quota is SDR 57.9 million (about $77 million). Its outstanding use of IMF financing currently totals SDR 20.15 million (about $27 million).

Press Release No. 98/30, July 17

Central African Republic: ESAF

The IMF approved a three-year loan under the Enhanced Structural Adjustment Facility (ESAF) equivalent to SDR 49.4 million (about $66 million) to support the Central African Republic's economic program for 1998–2000. The first annual loan of SDR 16.5 million (about $22 million) is available in two equal semiannual installments, the first of which will be made available shortly.

Medium-Term Strategy and 1998–2000 Program

The authorities' medium-term program seeks to maintain an average annual real GDP growth of about 5 percent, stabilize inflation at about 2½ percent a year, and con-

tain the external current account deficit at 5 percent of GDP by 2000. The program aims at improving the fiscal position through tighter tax policy implementation and greater transparency in all government financial operations, strengthening institutional capacity and macroeconomic management, and resuming the structural reform process.

Early and sustained fiscal consolidation is an essential component of this strategy, with a reduction of the overall fiscal deficit (on a commitment basis) by some 2 percentage points of GDP during 1998–2000 to 4.6 percent.

Consistent with the medium-term strategy, the 1998 program projects a real GDP growth of 5.5 percent, an inflation rate of 2.6 percent (on an average annual basis), and an external account deficit of 6.1 percent of GDP, assuming a continuous strong growth in agriculture and a recovery of manufacturing output.

Structural Reforms

The authorities attach high priority to making rapid progress in privatizing nonfinancial public enterprises, reforming the banking and financial sectors, and revamping the legal and regulatory framework, in addition to resuming civil service reform.

Addressing Social Needs

To combat poverty and reduce unemployment, the government has embarked on a strategy based on achieving sustained and high economic growth, coupled with the implementation of social policies that target the most vulnerable groups of the population. The social strategy aims at increasing the share of spending on the social sectors, with a view to raising school enrollment and literacy rates and increasing the supply and quality of health care.

Central African Republic: Selected Economic Indicators

	1995	1996	1997[1]	1998[2]	1999[2]	2000[2]
			(percent change)			
Real GDP	6.0	–1.5	5.1	5.5	5.0	5.2
Consumer prices (period average)	19.2	4.4	0.6	2.6	2.6	2.6
			(percent of GDP)			
Overall fiscal balance	–11.2	–4.9	–6.4	–6.2	–5.9	–4.6
External current account balance	–7.1	–5.8	–4.3	–6.1	–5.4	–5.1

[1]Preliminary.
[2]Program.

Data: Central African Republic authorities and IMF staff estimates and projections

The Central African Republic joined the IMF on July 10, 1963. Its quota is about 41.2 million (about $55 million), and its outstanding use of IMF financing currently totals SDR 7 million (about $10 million).

Press Release No. 98/32, July 21

Georgia: ESAF

The IMF has approved the third annual loan under the Enhanced Structural Adjustment Facility (ESAF), in an amount equivalent to SDR 55.5 million (about $74 million), to support Georgia's economic program in 1998. The loan is available in two equal installments, the first of which is available immediately.

Medium-Term Strategy and 1998 Program

The government's medium-term strategy aims at consolidating macroeconomic stabilization gains, achieving

Recent IMF Publications

Books

Current Legal Issues Affecting Central Banks, Vol. 5, edited by Robert C. Effros. (See page 245.)

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

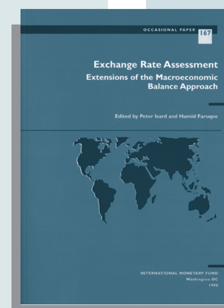
No.162: *Fiscal Policy Rules*, George Kopits and Steven Symansky. Identifies sensible fiscal policy rules that can succeed as an alternative to discretionary fiscal policies.

No. 167: *Exchange Rate Assessment: Extensions of the Macroeconomic Balance Approach*, edited by Peter Isard and Hamid Faruqee. Analyses prepared in association with the efforts of the Coordinating Group on Exchange Rate Issues, an interdepartmental technical IMF working group.

Working Papers ($7.00)

98/93: *Bank Lending and Interest Rate Changes in a Dynamic Matching Model*, Giovanni Dell' Ariccia and Pietro Garibaldi. Presents theory and evidence on the dynamic relationship between aggregate bank lending and interest rate changes.

98/94: *North-South Trade: Is Africa Unusual?*, David T. Coe and Alexander W. Hoffmaister. Examines empirically some of the determinants of Africa's bilateral trade with industrial countries.



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

greater external viability, accelerating structural reforms, and keeping the economy on a sustainable growth path while strengthening the social safety net. The main macroeconomic objectives for 1998–2000 are an annual growth rate of 8–10 percent, an inflation rate of 4 percent by 2000, and an increase in central bank gross reserves to the equivalent of 2.8 months of imports by 2000.

The 1998 program targets GDP growth of 10 percent, a fall in the inflation rate to 6 percent, and an increase in gross official reserves equivalent to about 2.3 months of imports. To these ends, the overall fiscal deficit will narrow to 2.5 percent of GDP in 1998 from about 3.8 percent of GDP in 1997 as a result of increasing revenue, while allowing expenditure to continue to rise moderately.

Structural Reforms

Structural policies aim at fostering private sector development and sustaining economic growth, in particular through urban and industrial land privatization, faster privatization of medium and large-scale enterprises, removing trade restrictions, restructuring the electricity sector, and strengthening of banks' prudential regulations.

Addressing Social Needs

Poverty alleviation will continue to be a key consideration in the reform program. The authorities intend to protect the poor and improve the targeting of benefits. They have given priority to eliminating arrears on wages, pensions, and social transfers. In addition, government spending on health and education is targeted to rise to 21 percent of total budgetary appropriations in 1998.

Georgia joined the IMF on May 5, 1992; its quota is SDR 111.0 million (about $148 million); its outstanding use of IMF credit currently totals SDR 189 million (about $252 million).

Press Release No. 98/33, July 28

Georgia: Selected Economic Indicators

	1994 Actual	1995 Actual	1996 Actual	1997 Prel. Act.	1998 Program Proj.
	(percentage change unless otherwise indicated)				
National income and prices					
Nominal GDP	8,273	169.0	55.0	19.0	17.0
GDP at constant prices	–11	2.0	11.0	11.0	10.0
Consumer price index (period average)	15,607	162.7	39.4	7.1	6.5
Consumer price index (end-period)	6,474	57.4	13.7	7.3	6.0
General government					
Total revenue	15,022	227	145	46	42
Total expenditure (excluding net lending)	5,376	33	88	21	13 [1]
External sector[2]					
Exports	...	–5	15	11	21
Imports	...	–6	10	23	15
Money, credit, and interest rates (end-period)					
Reserve money	2,480	275	36	33	12.0
Credit to enterprises and households (banking system)[3]	3,663	39	–15	38	41.0
Broad money (including forex deposits)	2,342	135	42	46	26.0
Velocity, level	17.9	20.5	22.3	18.2	16.9
Money multiplier	1.87	1.17	1.23	1.35	1.52
Deposit interest rate (percent; three-month maturity)	49	15	14	11	...
Lending interest rate (percent; three-month maturity)	115	66	51	49	...
Gross international reserves					
Months of imports of goods	0.7	2.7	2.5	2.2	2.3
Million U.S. dollars	41	157	158	173	210
Exchange rate, lari per U.S. dollars (end-period)[4]	1.28	1.23	1.27	1.30	...
	(percent of GDP, unless otherwise indicated)				
General government					
Revenue (excluding grants)	4.2	5.1	8.1	10.0	12.1
Tax revenue[5]	3.7	4.6	6.9	8.8	10.3
Tax revenue (percent of current expenditure)	17.0	53.3	53.8	66.0	81.6
Expenditure	23.5	11.6	14.1	14.4	13.9 [6]
Net lending	0.7	0.7	–0.2	0.1	0.5
Fiscal balance, cash basis	–7.4	–4.5	–4.4	–3.8	–2.5
Fiscal balance, commitment basis	–16.5	–5.3	–4.5	–4.1	–1.5
External sector					
Trade balance	–29	–12	–8	–9	–9
Current account balance					
Excluding official transfers	–36	–14	–9	–10	–10
Including official transfers	–22	–8	–6	–7	–7

[1]For 1998, excludes the programmed reduction of lari 70 million in expenditure arrears. Inclusive of this reduction in expenditure arrears, the nominal increase in expenditures during 1998 relative to the 1997 level would be 20 percent.
[2]Goods only; in U.S. dollar terms.
[3]The sharp fall in 1996 reflects the provision made for nonperforming loans from commercial banks' portfolio in the context of the bank restructuring program. Inclusive of this adjustment, credit to enterprises and households would have grown by about 30 percent in nominal terms during 1996.
[4]Lari replaced the Georgian coupon in September/October 1995 at a conversion rate of 1 lari/1million coupon. This rate is used to convert coupons to lari for the period prior to September 1995.
[5]Includes general government tax revenue and special state funds. The latter include the pension, employment, and road funds. Privatization revenue is excluded.
[6]For 1998, excludes the programmed reduction of lari 70 million in expenditure arrears. Inclusive of this reduction in expenditure arrears, total expenditure in 1998 (excluding net lending) would amount to 14.7 percent of GDP.

Data: Georgian authorities and IMF staff estimates

Links to Growth

Small Size of African Economies Explains Low Trade Levels with Industrial Countries

Is Africa's trade with industrial countries unusually low? David T. Coe and Alexander W. Hoffmaister, of the IMF's African and Research Departments, respectively, explore the question in an IMF Working Paper, *North-South Trade: Is Africa Unusual?* Their findings suggest that the relatively small size of the average sub-Saharan African economy explains the low level of bilateral trade with industrial countries. Thus, Africa's level is not unexpectedly low. In fact, if there was an atypical aspect to African trade, the study finds, it was the unusually high level of trade with industrial countries in the early 1970s.

Importance of Trade

Linkages between trade and development and between trade and growth have garnered increased attention over the past decade or more, particularly after the strong, sustained growth recorded by Asian and other economies that have relied on an outward-oriented development strategy. In contrast to these trends, many African countries have maintained a more skeptical approach to trade liberalization. Coe and Hoffmaister note that Africa's limited and hesitant steps toward trade reform in recent years pale beside the dramatic changes that have taken place in Latin America and in the transition economies of Eastern Europe and Central Asia.

Reflecting rising trade elsewhere, Africa's share of world trade fell sharply from 3.1 percent of global exports in the mid-1950s to less than 1.2 percent in 1990. Had Africa adopted an Asian-style outward orientation and maintained a stable real exchange rate, some researchers have estimated that it could have added as much as 2 percentage points to annual African growth over the 1976–85 period. Import-substitution policies were not the sole drag on Africa's economies, however. Other researchers have argued that its low stage of development and lagging output growth are themselves sufficient to account for Africa's poor trade performance.

To gauge more precisely the degree of Africa's trade with industrial countries, and to test whether the extent of this trade is unusual, Coe and Hoffmaister estimate a "gravity" model on a very large sample of bilateral trade data between 84 developing countries and 22 industrial countries from 1970 to 1995. Consistent with its name, the gravity model postulates that bilateral trade is positively related to the economic mass of the two countries and inversely related to the geographic distance between them.

Findings

The empirical results indicate that Africa's relatively low level of bilateral trade with industrial countries is chiefly a product of the relatively small size of most African economies. Africa's economic mass—the product of the GDPs of the importing and exporting countries—is only a fraction of that of developing countries

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
July 20	4.29	4.29	4.59
July 27	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.htm).

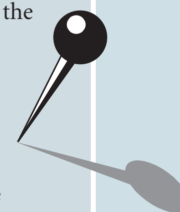
Data: IMF Treasurer's Department

Photo Credits: Denio Zara and Padraic Hughes for the IMF, pages 240 and 244.

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:

Solomon Islands, No. 98/50, July 16
Oman, No. 98/51, July 21
Lithuania, No. 98/52, July 21
Croatia, No. 98/53, July 27



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

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elsewhere, and while between the 1970s and early 1990s that mass increased by a factor of 9 in Africa, it has increased by a factor of 15–20 elsewhere.

Other influences have also helped shape the pattern of African trade with industrial countries, and the study cites four:

• *Population.* With other factors held constant, a larger population is associated with lower levels of bilateral trade. Africa's relatively small populations should tend to increase bilateral trade, but the study cautions that the very low levels of GDP are also key elements in trade performance.

• *Geography.* The average distance between northern and southern trading partners is remarkably similar across developing country regions and does not explain differences in trading patterns. Africa, however, has an unusually high number of landlocked countries, which on average trade 70 percent less than countries with access to the sea.

• *Language.* Linguistic and cultural ties boost bilateral trade, and these ties are strongest among French-speaking countries. The study suggests that trade between French-speaking countries is 210 percent higher than it is between countries with no linguistic ties (88 percent and 25 percent higher between Spanish- and English-speaking countries, respectively). And the positive effect of linguistic ties is strongest in Africa, where virtually all of the countries have linguistic ties with other French- or English-speaking countries.

• *Trade Policies.* Africa's considerably less open trade policies have contributed to the relatively low level of bilateral trade between African and industrial countries.

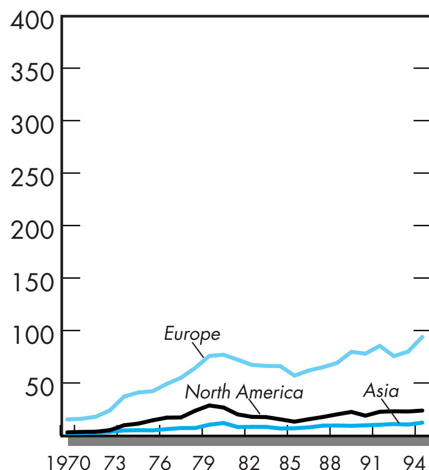
Given all of this, the study asks, is Africa's trade with industrial countries unusual? Not, Coe and Hoffmaister find, in terms of its low level. "If anything," the study concludes, "Africa overtrades compared with other developing country regions in the sense that its trade is higher than would be expected from the various determinants of bilateral trade."

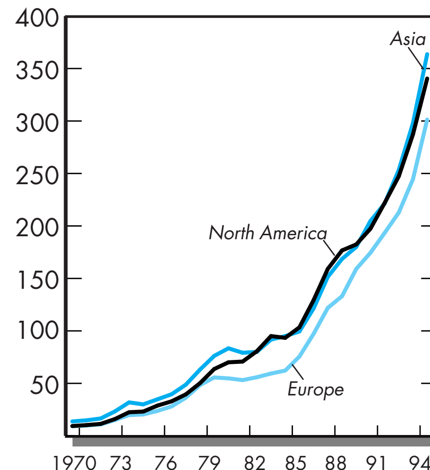
But Africa is unusual in that there has been a trend decline over the 1970–95 period, which contrasts sharply with Latin America, where trade increased sharply with industrial countries, and with Asia, whose pattern of trade with industrial countries remained broadly stable. This general decline in trade with industrial countries and Africa's stronger trade links with Europe rather than North America (again in contrast to Latin America and Asia) may also, Coe and Hoffmaister suggest, have negative implications for potential technology transfers.

There is clearly scope for broad-based trade liberalization in Africa to spur trade with industrial countries and increase the potential for technology spillovers. The relatively low level of African trade is fundamentally rooted, however, in the small size of most African economies.

Bilateral Trade of Developing and Industrial Country Regions

(billion U.S. dollars)





Data: IMF, *Direction of Trade Statistics*

Copies of IMF Working Paper 98/94, *North-South Trade: Is Africa Unusual?*, by David T. Coe and Alexander W. Hoffmaister, are available for $7.00 from IMF Publication Services. See page 249 for ordering information.

IMF Endorses Improvements to ESAF; Invites Comment on ESAF Report

The IMF Executive Board recently endorsed a number of important improvements to the IMF's Enhanced Structural Adjustment Facility (ESAF) that drew on internal and outside reviews of the ESAF. The changes are outlined in "Distilling the Lessons from the ESAF Reviews," which, together with a summary of the Board's July 8 discussion, is available on the IMF web site (www.imf.org).

In their discussion, Executive Directors noted that dialogue with interested parties outside the IMF is part of a continuing effort to adapt the IMF's strategy for growth and adjustment, and have invited their views on "Distilling the Lessons from the ESAF Reviews." Comments may be sent by e-mail to ESAF@imf.org by September 4, 1998.

Print copies of "Distilling the Lessons from the ESAF Reviews" are available to journalists from the IMF's Information Division (tel.: (202) 623-7100; fax (202) 623-6772), and to other members of the public from the Public Affairs Division (tel.: (202) 623-7300; fax: (202) 623-6278).