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Capital Account Liberalization and The Role of the IMF

Recent market turbulence in Southeast Asia has again prompted concerns about the impact of capital account liberalization and whether its costs outweigh its benefits. Stanley Fischer, First Deputy Managing Director of the IMF, argues, in a paper presented at a seminar on Asia and the IMF, that countries have much to gain from liberalization. Clearly, he notes, there are dangers inherent in premature and disruptive liberalization, but these can be minimized through an orderly adaptation and strengthening of the appropriate policy and institutional infrastructures. The IMF is well positioned to assist its members with this task, and a new amendment to the IMF's Articles of Agreement will facilitate the organization's work in this area.

The following is a summary of "Capital Account Liberalization and the Role of the IMF," presented by Stanley Fischer in Hong Kong, China, on September 19, in conjunction with the World Bank-IMF Annual Meetings.

Why Liberalize Capital Accounts?

The arguments in favor of liberalization are essentially two:

- it is an inevitable step in development and thus cannot be avoided; and
- it can bring major benefits to a country's residents and government—enabling them to borrow and lend on more favorable terms and in more sophisticated markets. A country's own financial markets can grow in efficiency with the introduction of advanced financial technologies. And with better allocation of both saving and investment, economic growth can be more rapid and sustainable. This is not to dismiss the reality that with liberalization the economy will be more vulnerable to market sentiment and that market shifts—while usually rational—will be excessive at times.

(Please turn to the following page)

Peru Restores Macroeconomic Balance, Normalizes Relations with Creditors

PERU

The following article is based on the recent Article IV discussions by the staff of the IMF's Western Hemisphere Department with the Peruvian authorities.

In early 1990, the Peruvian economy faced a severe economic crisis. It suffered from hyperinflation and a sharp drop in output stemming from large fiscal imbalances, negative real interest rates, widespread wage and price controls and subsidies, and a highly distorted exchange rate system. Unsustainable fiscal and monetary policies implemented during the second half of the 1980s had resulted in the accumulation of large external arrears. With the escalation of rural and urban terrorism, the social environment had also deteriorated. Since 1990, the authorities' determined implementation of sound financial policies and comprehensive reforms has helped consolidate macroeconomic stability and improve living standards. Inflation has declined to single-digit levels, and a protracted period of economic contraction has shifted to one of strong expansion. At the same time, external debt arrears have been virtually eliminated. A reduction in urban and rural terrorism has also had a positive impact on the social sector.

Restoring Financial Relations

The administration that took office in Peru in July 1990 introduced ambitious stabilization measures and structural reforms supported by an IMF-monitored Rights Accumulation Program (under which members in protracted arrears to the IMF are able to accumulate rights to future drawings of IMF resources upon successful completion of the program). The

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Managing a Liberalized System

What is the right response to operating in a system that offers major benefits but may penalize mistakes severely and occasionally burden the economy with inappropriate shocks? The prime need is to avoid policies that can cause rapid capital flow reversals and to strengthen the structure of the economy and its policy framework. The importance of pursuing sound macroeconomic policies, strengthening the domestic financial system, and phasing capital account liberalization appropriately—which means retaining some capital controls in the transition—is virtually axiomatic now. More controversial are the issues surrounding the provision of information to the markets, the role of surveillance, and the potential needs for financing.

Macroeconomic Policy Framework. A sound macroeconomic policy framework promotes growth by keeping inflation low, the budget deficit small, and the current account sustainable. The sustainability of the current account depends on the economy's growth rate and the real interest rate at which the country can borrow. But sustainability also entails the ability to withstand shocks. Large current account deficits—in the range of 5–8 percent of GDP and certainly any higher—should be a cause for concern. Current account deficits financed by longer-term borrowing and, in particular, by foreign direct investment are more sustainable; sizable deficits financed largely by short-term capital flows are a cause for alarm.

It is sometimes difficult to deal with short-term capital inflows that are a response to high domestic interest rates, particularly in a context in which policy limits exchange rate flexibility. This is the famous capital inflows problem that so many countries seeking to stabilize from moderate rates of inflation have faced. There is no easy answer to this, but a tightening of fiscal policy is the first line of defense, and increasing the flexibility of the exchange rate is a second.

Better informed markets are likely to make better decisions.

Choice of Exchange Regime. How flexible should exchange rates be? The Group of Seven [industrial] countries, except for those intending to join the European economic and monetary union, long ago decided on flexible rates. But freely floating rates, even among the major currencies, have moved excessively, and no developing country seeking growth through integration into the world economy would want to live with such fluctuations. East Asian countries were well served over a long period by exchange rates that were fixed or accorded limited flexibility. But countries that allowed their rates to float when threatened by imminent speculative attacks nonetheless made the right choice.

What, then, is optimal in more normal conditions? There is no agreed answer. If the exchange rate is pegged, it is almost certainly better to peg to a basket of currencies. Countries may return to some form of exchange rate band, with very wide margins, perhaps a crawling band. If they do, they should stand ready to move the band as circumstances warrant. Macroeconomic policy will also need to be adjusted when the exchange rate (equivalently, the balance of payments) shows signs of moving out of desired ranges.

Strengthening the Financial Sector. One clear lesson from the crises of the 1990s is that the health of the financial sector matters. Financial systems can be strengthened by improving supervision and prudential standards; ensuring that banks meet capital requirements, provide for bad loans, limit connected lending, and publish informative financial information; and ensuring that insolvent institutions are dealt with rapidly. Implementation of these reforms can be hampered by political pressures, but the task is urgent. A healthy banking and financial system is essential, and a weak banking system is a standing invitation to a macroeconomic crisis and a guarantee of the severity of such a crisis.

Phasing and Use of Capital Controls. Where the macroeconomic framework and the financial sector are weak, there is a strong case to be made for phasing capital account liberalization. Due regard should be paid to the macroeconomic situation (including the balance of payments), the stage of development of the financial markets and institutions, and the impact of existing controls, but there are few hard and fast rules.

Without coordination of capital account liberalization and financial sector reform, regulatory distortions and regulatory incentives for capital movements unrelated to underlying economic conditions can cause instability. Weak domestic financial institutions may be unable to efficiently intermediate large flows of funds to which they have access as a result of capital account liberalization; they may also be adversely affected by movements in asset prices that result from international capital flows. Weak financial institutions can be especially vulnerable to potential reversals of capital flows.

On the other hand, controls—except for prudential controls—are generally inefficient and costly. Markets view them as an additional country risk factor, and their prolonged use has often been associated with capital flight. A theoretical case can be made for countries whose financial systems are not sufficiently robust to restrict selected forms of capital inflows—such as the short-term inflows that produce the capital inflows problem. Controls are likely to do less damage if they are market-based—for example, reserve requirements on foreign deposits—rather than quantitative controls. Controls on outflows may have been retained for balance of payments reasons and because they provide a captive source of funds for domestic financial institutions. Their gradual removal is generally desirable.

Prudential controls on foreign capital are already in place in many countries. They may take the form, for example, of restrictions on the open positions that domestic banks can take in foreign currency. They are intended to reduce the vulnerability of domestic institutions to shifts in foreign capital flows and could well become part of internationally accepted prudential standards.

Every currency crisis produces demands that something be done about hedge funds and speculators. Usually the anger is better directed closer to home, but these occasional cases of market overreaction deserve serious analysis to determine whether better provision of information to and by market participants, as well as improved prudential regulations, could increase market efficiency. Since speculative positions have counterpart transactions in the domestic economy, it is useful to ask whether prudential regulation of the domestic economy could reduce the occasional excesses of speculative attacks—perhaps also increasing the efficiency of the international capital markets.

Information Provision. One of the many lessons drawn from Mexico was the extent to which the crisis was worsened by the poor quality of information supplied to both the official sector (including the IMF) and the markets. In response, the IMF created the Special Data Dissemination Standard in early 1996 and has made considerable progress with the development of a Dissemination Standards Bulletin Board.

The Thai crisis reinforces the argument for better and more timely provision of information, including information on central bank forward operations. Better informed markets are likely to make better decisions. In the Mexican and Thai crises, this would have meant that the markets would have withdrawn funds sooner than they did, thereby hastening needed adjustments. Second, the obligation to publish information on certain interventions would affect the extent and nature of those interventions, and help prevent some unwise decisions.

There is much work to be done in thinking through the question of the optimal extent and timing of information provision. If the policy game is thought of as a battle between the authorities and hostile markets, then the official penchant for secrecy is easy to understand. But if the goal is to design a framework that influences both the choice of policies and the effectiveness of markets in responding to and disciplining policies, then there is a strong case for providing more information. Market participants also need to make information public to discipline their own actions and increase market efficiency.

Role of Surveillance. The IMF strengthened its surveillance in response to the Mexican crisis. It is fair to say that its new procedures worked well in Thailand, and it is reasonable to expect they will work well in the future. But it would be a mistake to imagine that IMF or any surveillance could ever be made perfect. The IMF will surely miss the warning signals of some future crisis, and just as surely will predict some crises that do not happen. The international system cannot be built on the assumption that improved surveillance or increased information will prevent all future crises, though they should reduce their frequency. A country may also be warned but not take action. And since the IMF depends on privileged access to information to do its job, it can not make its concerns fully public.

Fischer: Sizable current account deficits financed largely by short-term capital are a cause for alarm.

There is also room for mutual surveillance within smaller groups of countries. Such mutual surveillance enables countries with similar experiences, or likely to be affected by what their neighbors do, to become more familiar with their neighbors' policies and to exert mutual pressures for good policies. To be effective, this surveillance should be based on a sound analysis of the economic situation, and here the IMF is willing to lend its support to regional and other groups.

The prime responsibility for pursuing the right policies, however, rests with the national authorities; the IMF and neighbors can provide information, analyze, suggest, seek to persuade, and cajole. But ultimately, the government must evaluate the situation and make the right decisions. Market participants must also appraise the underlying economic situation accurately; if they do so, market incentives will ensure that markets operate efficiently.

Need for Financing. The IMF has provided financing to countries attempting to correct maladjustments in their balance of payments. It will continue to do so, but the Mexican and Thai crises, and the proposed capital account amendment of the Articles of Agreement, have raised two important interrelated questions about IMF lending: does the increased scale of international capital flows require a re-examination of the criteria that determine the size of IMF loans, and does the IMF's willingness to lend create a moral hazard? The answer to both questions is yes.

Increased efficiency in international capital markets and increased capital account liberalization should produce fewer financial crises. But crises are likely to be bigger than they were in the past. It would thus be appropriate to review IMF lending criteria to ensure that IMF loans remain adequate to the task.

The moral hazard posed by IMF lending does not arise primarily from governmental but rather from private sector behavior. IMF conditionality is

such that governments in trouble typically approach the IMF too slowly rather than too fast. The private sector may be too willing to lend, however, if it knows that a country will go to the IMF rather than default. Spreads in some markets are so low as to support this view. The international community needs to ensure that the private sector shares in the financial costs of dealing with crises.

One classic rule of lender-of-last-resort financing is not to be too clear about the circumstances and amounts in which such lending will be available. There is thus a trade-off between the volume of funds known to be available to deal with crises and the likely size of crises. This needs to be considered in weighing both the size of IMF lending limits and the desirability of pre-positioning regional support funds rather than leaving them to be arranged on an ad hoc basis.

Capital Account Amendment

In April 1997, the IMF's Interim Committee agreed that there would be numerous benefits from amending the Articles of Agreement to enable the IMF to promote the orderly liberalization of capital movements. Under this provision, the IMF is likely to develop transitional provisions analogous to those in place for current account liberalization.

Such an amendment, with transitional arrangements, would allow the IMF to encourage the liberalization of capital flows while paying due regard to the varying circumstances of members. It would facilitate the establishment and application of a universally applied code of good behavior in the use of capital controls, enabling the IMF to determine when macroeconomic, structural, and balance of payments considerations require adherence to—or permit exemptions from—obligations relating to capital account liberalization.

The amendment, and the IMF's greater involvement in promoting orderly liberalization, is all the more important because the IMF is often called upon to finance the balance of payments problems caused by capital movements. Giving the IMF jurisdiction in this area would strengthen its surveillance role over international capital flows and complement existing bilateral, regional, and multilateral agreements and initiatives.

The increasing importance of international capital flows is a fact that needs to be better reflected in the laws and agreements that help bring order to the international economy and to the process by which individual countries liberalize their capital accounts. The proposed amendment to the Articles of Agreement will serve this purpose and our member countries well. ■

The full text of Stanley Fischer's paper, "Capital Account Liberalization and the Role of the IMF," is available on the IMF's web site. The address is www.imf.org/external/np/apd/asia/FISCHER.htm.

Putting Africa on a Sustainable, High-Quality Growth Path

Following are edited excerpts of an address by IMF Deputy Managing Director Alassane D. Ouattara at a seminar on the IMF and Sustainable Development, sponsored by the Swiss Coalition of Development Organizations, in Berne, Switzerland, August 25.

Ouattara: Africa must accelerate reforms to integrate itself into the world economy.

What does "sustainable development" mean? Initially, the focus was on the environment, but increasingly its meaning has been broadened to embrace the economic and social aspects of development as well. At the IMF, we strongly believe that high-quality growth lies at the center of sustainable development—that is, growth that brings lasting employment gains and poverty reduction, provides greater equality of income through greater equality of opportunity, including for women, and protects the environment.

Has the world moved any closer to sustainable development in recent years? I will focus my remarks on Africa—where the challenge of high-quality growth is the greatest. Certainly, Africa as a whole has made enormous strides in recent years, with growth picking up and per capita incomes on the rise. But poverty is still widespread, per capita incomes are far too low, and much remains to be done to improve health conditions and education, and reduce unemployment.

How can we help Africa catch up with Asia and Latin America, especially against a background of accelerating globalization? The answer lies in a new global partnership of Africa, the industrial countries, and the multilateral institutions. This partnership should have three objectives: increased growth with equity and financial stability; improved social conditions, particularly in the areas of health and education; and environmental sustainability.

Africa needs to sharply accelerate reforms to fully integrate itself into the world economy and take advantage of the opportunities globalization offers: higher productivity and living standards, access to a wider range of goods and services at lower costs, and the chance to mobilize a larger volume of financial savings to restore and speed up eco-

nomic growth and development and alleviate poverty. But globalization also poses new risks. For many African countries, given their limited access to capital markets, perhaps the greatest risk is marginalization—a process that threatens to leave behind those countries that fail to harness the new forces at work in the world economy.

What Africa Needs to Do

Africa should concentrate its efforts in two key areas:

• *Maintaining macroeconomic stability*. Efforts must be redoubled to reduce inflation and narrow fiscal and current account deficits. Policymakers must also focus on the quality of expenditure. Unproductive outlays, including military spending, must be reduced, so that more resources can be devoted to essential investments in health, education, agriculture, social safety nets, and basic infrastructure.

• *Accelerating structural reform*. Countries have been reasonably successful in implementing "first-generation" structural reforms. But the record on the more difficult reforms—comprehensive trade reform, restructuring and privatizing public enterprises, reforming the financial sector, and improving the environment for private investment—is much more uneven. What is needed now is a "second generation" of reforms.

On the trade front, Africa needs to speed up trade liberalization to boost the efficiency and competitiveness of domestic producers. Africa could also benefit from more determined efforts to develop efficient forms of regional economic cooperation and integration that facilitate progress toward nondiscriminatory, multilateral liberalization.

On the privatization front, tackling public enterprise reform is of crucial importance, given the growing recognition that the private enterprise sector will have to serve as the engine of growth and new investment. While many countries have begun privatizing and liquidating small and medium-sized enterprises, reform of large, strategic enterprises has been a protracted process.

A major effort to increase the private sector will need to be complemented by a redefinition of the role of government, away from direct involvement in production and toward the provision of essential public services. Moreover, it is vital that all of the second-generation reforms be carried out in an atmosphere of economic security, good governance, and a partnership with civil society.

What the IMF Needs to Do

The IMF is taking steps to put the Enhanced Structural Adjustment Facility (ESAF), its concessional loan facility, on a permanent footing so that it can continue to support reform in low-income countries over the long term. Besides being the centerpiece of the IMF's strategy to assist low-income countries, it is also the facility through which the IMF will participate in the debt initiative to help the poorest countries. Thus, if we seriously want the market to see Africa as a land of opportunity, it is imperative that ESAF programs be implemented steadfastly and financed credibly.

The IMF and the World Bank are implementing a debt initiative for the heavily indebted poor countries [HIPCs], most of which are in sub-Saharan Africa. The HIPC Initiative is designed to ensure that all heavily indebted poor countries that pursue strong policies of adjustment and reform reach a sustainable external debt position and can thus exit from the debt rescheduling process.

The IMF stands ready to provide emergency assistance in post-conflict cases, a policy aimed at helping countries whose reform process was interrupted by civil unrest or political turmoil. Rwanda is the first African country to benefit, with an IMF loan of about $12 million approved in April 1997, in support of the government's new economic program.

The IMF is considering a variety of measures that build on expanded international financial and technical support for bold reformers. These include defining a set of "best practices" to improve the business environment and foster growth; extending more technical assistance and helping to strengthen macroeconomic policy and management capacity; fostering civil service reform and trade liberalization; supporting regional initiatives; and helping to attract foreign investors—in part, by disseminating information to potential investors on macroeconomic and financial developments and the business environment.

Social Objectives. Social issues are increasingly entering into our policy dialogue with member countries. Too often the criticism is voiced that structural adjustment is harming human development. But the evidence speaks for itself. Available data in 27 countries that have had SAF [Structural Adjustment Facility]- and ESAF-supported programs show that, on average, real spending on education and health increased by 5 percent and 7 ½ percent a year, respectively, although the range of experience across countries is considerable.

The IMF is giving more attention to helping countries improve the availability and analysis of data on government spending on health and education. Under the HIPC Initiative, for example, the aim is to incorporate such monitorable targets into IMF-supported programs.

Preserving the Environment. Macroeconomic stability enhances growth prospects, increases employment and incomes, and ensures that the right price incentives work to preserve the environment. IMF-supported programs often involve the adoption of "win-win" policies that benefit both the economy and the environment. Nonetheless, in certain countries, especially in the developing world, environmental issues—such as weak forestry management, poor management of coastal fisheries, and severe air and water pollution—can have significant macroeconomic implications.

In such cases, drawing on our close links to the World Bank, we have increasingly tried to integrate environmental concerns and natural resource issues into our policy dialogues.

Nongovernmental Organizations (NGOs). The IMF works closely with specialized NGOs, academics, professionals, and international organizations, whose primary focus is on sustainable development. We also encourage our resident representatives to meet regularly with members of civil society, and our staff missions to member countries increasingly include meetings with labor leaders, religious groups, and others.

Industrial countries should do more to open their markets to competitive African products.

What Industrial Countries And NGOs Need to Do

Industrial countries should do more to open their markets to products in which African countries have, or are likely to develop, a comparative advantage. They also need to phase out the subsidization of agricultural exports more quickly than currently planned.

Donor countries must strengthen their bilateral assistance to countries that have demonstrated a commitment to reform—particularly in areas where a bold approach might involve important, albeit transitional, revenue losses.

Industrial countries should consider adopting measures to help diversify the risk of private investment in Africa, including the provision of guarantees for foreign direct investment.

Finally, industrial and other economically more advanced countries must ensure that the multilateral institutions have the necessary resources to promote and support adjustment efforts and, in general, fulfill their increasingly complex tasks.

NGOs are in a unique position to help the process of developing a new global partnership:

- At the international level, they can play an influential role in donor policy debates—pushing for sound macroeconomic policies, an opening of industrial country markets to developing countries, a strengthening of bilateral assistance, sufficient resources for the multilateral institutions, and a guiding moral conscience.
- At the grassroots level, they can help mobilize civil society to have a voice in the economic policy debates, help explain the benefits and costs of various policy options, and offer firsthand experience and expertise in providing basic social services—such as primary education and health care—to the poor and disadvantaged. ■

The full text of Alassane Ouattara's address on The IMF and Sustainable Development is available on the IMF's web site. The address is: www.imf.org/EXTERNAL/NP/speeches/1997/082597.htm.

Transition Economies Need a Prudent Debt-Management Strategy

As the 15 transition economies comprising the Baltics, Russia, and the other countries of the former Soviet Union move toward integration with the global economy, their external financing—and, in particular, their increasing recourse to international capital markets—has taken on considerable importance. In an IMF Working Paper, Ishan Kapur and Emmanuel van der Mensbrugghe of the IMF's European II Department acknowledge the benefits that transition economies can realize from foreign borrowing. At the same time, they caution that the recent rapid increase in external debt among these countries calls for an awareness of the risks that can accompany an inappropriately high dependence on foreign saving, including the risk of postponing needed structural reforms.

Debt Profile Determined by Economic Progress

The 15 transition economies under review have all made considerable—but varying degrees of—progress toward macroeconomic stabilization. The different stages of transition they have reached and their relative success in achieving stabilization have largely determined the nature and amount of external financing they have received in the past five years to meet their external financing requirements. Substantial private capital inflows have gravitated toward those countries most advanced in the transition process, reflecting consistent and credible progress toward financial stabilization and the introduction of structural reforms. Countries less advanced in the transition process continue to rely much more heavily on official disbursements and grants.

Following the adoption by the Baltics and the countries of the former Soviet Union in 1992–93 of the "zero-option" agreement, under which Russia assumed the external assets and liabilities of the Soviet Union, most of the 15 countries were left with little or no external debt (except Russia, which inherited the external debt obligations of the Soviet Union). During 1993–96, these countries obtained an estimated $163 billion in total external financing, with Russia accounting

for three-quarters of the total. Largely owing to the substantial debt relief obtained by Russia (and Ukraine), debt rescheduling accounted for about 40 percent of the total, and official disbursements (excluding from the IMF) and grants accounted for an estimated 21 percent. With net disbursements of $16 billion, the IMF has been the single largest provider of new funds, representing 10 percent of total external financing received over the four-year period. Private capital, which has increased significantly over the last two years, accounted for 16 percent.

Common Features of the External Debt Burden

By the end of 1996, the combined external debt of the Baltics and the countries of the former Soviet Union had reached $150 billion (see chart). Four characteristics of this debt merit attention, according to the authors:

• At the end of 1996, the debt burden was not high in most of the countries, either in absolute terms or relative to other economies at similar income levels. Of the 15 countries, 7 (Armenia, Kyrgyz Republic, Moldova, Tajikistan, Georgia, Turkmenistan, and Russia) had external debt-to-GDP ratios in excess of 20 percent. Russia's ratio at end-1996 was 21 percent.

• The rate of increase in debt has been extremely high in recent years. Reflecting the increase in the stock of external debt, the average debt service as a percent of exports for the 15 countries rose to 12 percent in 1996 from 4 percent in 1993, and to 5 percent of GDP from 1 percent over the same period.

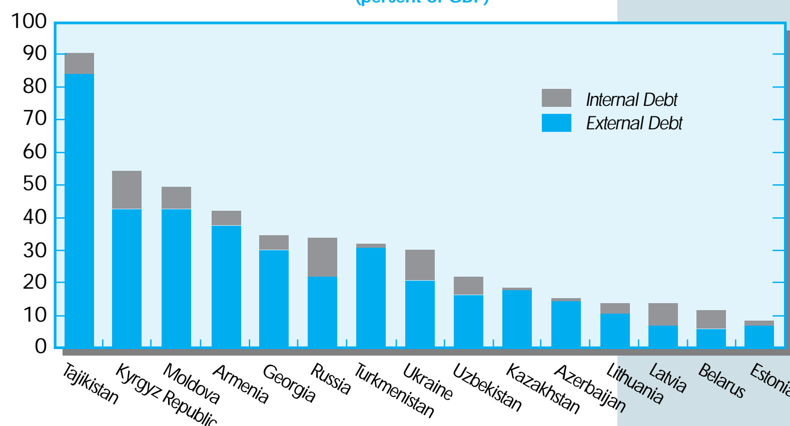
• In most of the 15 countries, the outstanding stock of debt is owed almost entirely by the government. Moreover, the composition of the official external debt is heavily weighted by debt to multilateral lending institutions, rather than to banks or foreign governments. This form of debt cannot normally be rescheduled, and much of it—in particular, to the IMF—begins falling due within the next five years.

• As overall debt levels have increased, the governments of many of these countries have recently shifted their external borrowing toward private markets, particularly through Eurobond issues.

Despite notable region-wide achievements over the past four years in generating growth and lowering inflation, the combined external current account deficit of the Baltics, Russia, and the other countries of the former Soviet Union has remained high—at about 9 percent of GDP. Given these current levels, the IMF study notes that the transition economies will continue to require significant levels of external financing for several years to come. A few of these countries will need to rely on concessional borrowing from official sources, but most of the remaining ones are likely to tap international capital markets for major portions of their external financing needs.

According to traditional debt indicators, the Baltics and the countries of the former Soviet Union do not face an immediate major debt problem. But tight demand management policies accompanied by relatively rapid export growth for several years will be necessary if they are to avoid any deterioration or realize a substantial medium-term improvement in their debt ratios. It is not obvious, however, according to the IMF study, that all the countries—and certainly some among them—can continue to expect the high and sustained export growth recorded during the past few years—20 percent in 1995 and 14 percent in 1994 (median growth rate)—unless structural reforms are speeded up and private sector investment accelerates.

Baltics, Russia, and Other Countries Of the Former Soviet Union: Total Debt, 1996
(percent of GDP)



Data: IMF, Working Paper 97/12, *External Borrowing by the Baltics, Russia, and Other Countries of the Former Soviet Union: Developments and Policy Issues*

To achieve enduring high rates of export and output growth, these countries will need to make vigorous efforts to improve productivity and increase investable resources. Structural reform—in particular, improving the performance of large and obsolescent state enterprises—could well cause external current account deficits to widen. But, the authors caution, recourse to external financing should not be used as a substitute for implementing the necessary structural reform. Governments need to concentrate on raising domestic saving rates and on implementing adjustment polices to generate the requisite saving rates, rather than depending excessively on additional external financing.

Debt-Management Policy Required

Although the 15 countries encompass a wide range of economic situations, their debt profiles share many elements, and they face similar risks. These include pressures on the budget, market risks, and a lack of strong financial institutions.

Budget. The ratio of debt service to both budgetary revenues and expenditures remains high in most of the

15 countries, with the exception of the Baltic states and Kazakhstan. Without a substantial pickup in revenues—which is more likely over the medium term than in the near future—external debt-service payments will continue to put pressure on budgetary policies; this will be worsened by the demands of domestic debt service and arrears reduction.

Almost all the external debt is either government debt with direct budgetary implications or is guaranteed by the government and therefore a contingent liability of the budget. In addition, government or government-guaranteed external debt to private lenders is growing rapidly in some of the larger countries. A major default by one of the governments on private external debt could raise borrowing costs substantially and possibly limit near-term access to international capital markets throughout the region.

The fiscal position of many transition economies will be under pressure for the foreseeable future.

The overwhelming bulk of the official borrowing has been used to finance current budgetary outlays—public consumption rather than investment. As a result, many of the 15 countries now have large amounts of short-term foreign debt that is not reflected in an increased capacity to repay. Moreover, in most of these countries, the pace of structural reforms—particularly privatization and enterprise reforms—has lagged behind financial stabilization.

These pressures on the budget are likely to be aggravated by the limited room for discretionary expenditure in many of these countries. In addition to low revenue levels, this limited flexibility results in part from large entitlement programs that reflect the lack of structural reforms in the budget as well as, in some cases, inappropriate subsidies to inefficient sectors. It is critical, the authors stress, that the transition countries focus their efforts on:

- enterprise and financial sector reforms to reduce the risks emanating from quasi-fiscal deficits or contingent liabilities of the budget; and
- the structure of the fiscal position itself to improve receipts and reduce nonessential demands on budget resources.

Despite considerable progress in macroeconomic stabilization, the fiscal position in many of the 15 transition economies will remain under substantial pressure for the foreseeable future. Given concerns about debt sustainability, primarily from the fiscal perspective, it is imperative that governments develop a comprehensive mechanism for monitoring debt and analyzing the capacity to service the debt.

Capital Markets. Recently, several countries have shown an interest in diversifying their sources and types of external financing—in particular, away from multilateral lending and toward international capital markets. Although such diversification is not inappropriate, it would subject the domestic economy to the scrutiny and discipline of the market. The judgments the market forms about the credibility of a borrowing country's policy performance will be critical in determining the availability of external financing. Although these developments are a normal consequence of the closer integration of the transition economies into the international economy, risks for individual countries can be made more manageable if the authorities carefully map out external borrowing strategies while maintaining a margin of prudence.

The fragile state of health of many financial institutions in all 15 countries poses substantial risks for the budget and debt servicing, particularly in those countries whose commercial banks have borrowed large amounts abroad through loans or lines of credit for onlending domestically. A narrowing of interest rate differentials between these countries and international markets may result in large capital outflows, which could jeopardize the external reserve position and place a tight squeeze on bank liquidity. The government budget and other borrowers face potential risk, including increased borrowing costs, from the failure of commercial banks or firms that either service foreign debt or have direct debt to nonresidents.

The ad hoc manner in which borrowers from the Baltics, Russia, and the other countries of the former Soviet Union have been entering the private capital markets in recent years is a source of concern, according to the authors, since such borrowing has often not been part of a coherent long-term strategy. Most of these countries need:

- well thought-out medium-term borrowing strategies;
- institutional structures to monitor both the borrowing and the debt service from the point of view of the budget; and
- strict limits on guarantees given by state or quasi-state entities for all external loans, but particularly those from the capital markets.

These external borrowing plans, the authors conclude, must be consistent with a country's medium-term fiscal adjustment strategy and be based on a careful, even conservative, assessment of the budget's capacity to repay. ■

Copies of IMF Working Paper 97/72, *External Borrowing by the Baltics, Russia, and Other Countries of the Former Soviet Union: Developments and Policy Issues*, by Ishan Kapur and Emmanuel van der Mensbrugghe, are available for $7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org. The full text is also available on the IMF's web site (http://www.imf.org/external/pubs/CAT/wp.cfm).

Peru Adopts Wide-Ranging Structural Reforms

(Continued from front page) economic adjustment program aimed at drastically reducing inflation, creating the conditions for sustained economic growth and a progressive return to external viability, while re-establishing relations with the international financial community. Peru was in arrears to most foreign creditors, and as the program called for a reduction in fiscal imbalances—while avoiding domestic financing—mobilization of external financing, particularly from multilateral institutions, was important to support fiscal adjustment.

A key step to Peru's securing renewed access to financing was the endorsement, in September 1991, by the IMF's Executive Board of the 15-month Rights Accumulation Program, under which Peru was to accumulate rights to draw SDR 624 million (about $854 million)—corresponding to the outstanding stock of arrears—upon observance of quarterly performance criteria. Under this program, and a subsequent Extended Fund Facility (EFF), Peru sought comprehensive rescheduling agreements with Paris Club official creditors. This fostered an environment for sustained growth and the resumption of private sector financing.

Structural Reforms Accompany Macroeconomic Stabilization

Under the Rights Accumulation Program, the main objective of monetary policy was to reduce inflation by keeping the growth of base money in line with the needs of the economy as determined by market forces. Monetary policy shifted away from the use of direct instruments, including credit allocation schemes and controlled interest rates, to indirect tools of monetary management. Inflation fell sharply to 57 percent in 1992 from over 7,600 percent in 1990. On the fiscal front, the authorities broadened the tax base and improved the overall efficiency of the tax system, while keeping expenditure growth under tight control. As a result, the combined public sector deficit fell to 2.8 percent of GDP in 1992 from about 6 percent in 1990. Following improvements in tax administration and the adoption of revenue-enhancing measures, central government current revenue rose to 11.4 percent of GDP in 1992 from 9.9 percent in 1990 (see chart, page 330).

Wide-ranging structural reforms accompanied economic stabilization. The Peruvian government eliminated several public sector monopolies and developed a plan to divest state holdings in public enterprises. The authorities also undertook reforms to strengthen the financial system; a new banking law was enacted in March 1991 that reinforced capitalization requirements and redefined the role of the Superintendency of Banks, and in 1992 all official development banks were liquidated. The authorities also reduced import tariffs and eliminated most restrictions on private sector current and capital transactions and limitations on remittances on direct investment income and capital. On the social front, the government implemented a series of reforms in 1990 aimed at reducing poverty, including through the launching of the Social Emergency Program to tackle urgent health and nutrition needs. The fight against poverty took on a larger dimension through the establishment in 1991 of the National Fund for Compensation and Development (FONCODES) to finance temporary employment generation projects, as well as health and education programs.

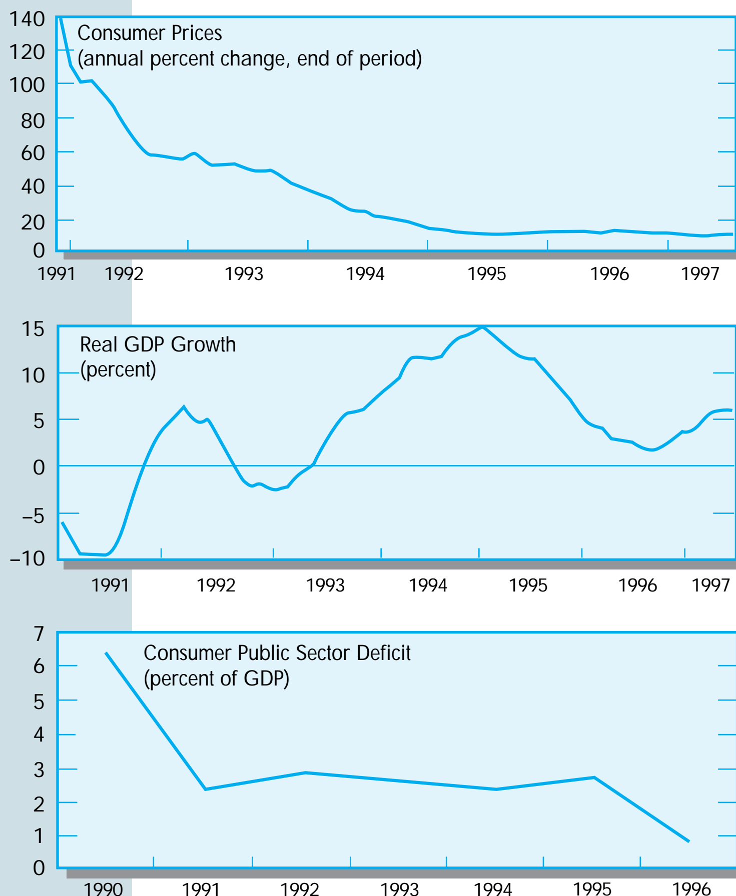
Private foreign capital inflows responded favorably to the reform efforts and to an easing of sociopolitical tensions. Inflows increased to an average of about $1.2 billion a year between 1991–92 from $0.1 billion in 1990. Net international reserves of the central reserve bank rose tenfold between 1990 and 1992; by the end of 1992, gross reserves (net of reserve requirements on foreign currency deposits) amounted to $1.4 billion, equivalent to about three months of imports.

Building on Improvements

After successfully completing the Rights Accumulation Program in December 1992, the Peruvian government adopted a comprehensive economic program covering 1993–95, supported by an EFF in an amount equivalent to SDR 1.0 billion (about $1.4 billion). Performance under this program was impressive: inflation fell to about 10 percent in 1995 from 39 1/2 percent at the end of 1993. And, after an initial period of slow growth, real GDP grew by an average of close to 9 percent a year during 1993–95. Gross international reserves of the central bank improved substantially, reaching nearly six months of imports by the end of 1995, reflecting continued large capital inflows, including from privatization. Nevertheless, the fiscal situation deteriorated in late 1994 and in the first half of 1995, largely because of outlays associated with a border conflict with Ecuador and the presidential and congressional elections. The external current account deficit widened to 7.3 percent of GDP from 5.3 percent in 1994, reflecting a strong increase in domestic expenditure, particularly in private investment.

Under the EFF, the authorities made further progress with structural reforms. The privatization process involved the sale of major assets in the telecommunications, transport, energy and mining, manufacturing, banking, and tourism sectors. During 1993–95, cash proceeds from privatization amounted to $3.4 billion, with investment commitments of close to $3 billion. The government issued a new labor code

and legislation changes aimed at enhancing flexibility in the labor market. In the banking sector, a modern central bank charter was enacted in December 1992, and the banking system's solvency indicators improved significantly during the period covered by the EFF.



Data: Peruvian authorities and IMF staff estimates

Ensuring a Return to External Viability

In July 1996, the IMF's Executive Board approved a follow-up EFF in an amount of SDR 248 million (about $339 million), in support of Peru's program for 1996–98. This program aims at consolidating the gains made under the previous arrangement and ensuring the return to external viability by the end of 1998. The program calls for an improvement in the overall position of the combined public sector, with further strengthening of tax administration and the continued implementation of tight expenditure policies.

In a determined effort to consolidate the fiscal position, the authorities successfully expanded the primary surplus of the combined public sector to 1.2 percent of GDP in 1996 from 0.4 percent in 1995. This improvement reflected mostly an increase in tax collections and higher nontax revenue of government agencies and local governments and operating profits of certain public enterprises.

The program for 1996 aimed at containing inflation and narrowing the current account deficit. Although inflation rose to 11.8 percent in 1996—owing in part to the lagged effect of a relaxation of policies during 1995 and higher international oil and cereal prices—it abated significantly to 8.2 percent in the year ended August 1997, following the tightening of financial policies and a decline in international cereal prices. Output growth slowed to 2.8 percent in 1996, partly the result of a slowdown in domestic demand associated with fiscal consolidation. But as activity gathered momentum, output rose by 5.7 percent during the year ended July 1997. During the first half of 1997, tax collections improved considerably, reflecting the recovery in economic activity, the successful implementation of the tax arrears regularization program initiated in November 1996, and improvements in the administration of the value-added tax.

The current account deficit decreased to 5.8 percent of GDP in 1996 from 7.3 percent in 1995, and the net international reserves of the central bank increased by $1.5 billion. This brought gross reserves to the equivalent of 7 ½ months of imports by the end of 1996. The reduction in the current account deficit resulted from both lower interest payments— stemming from the conclusion of debt reduction and rescheduling agreements with official and commercial creditors—and a narrowing of the trade deficit despite some deterioration in the terms of trade. Long-term capital inflows not only covered the current account deficit but also facilitated the further accumulation of international reserves. Sizable privatization receipts ($2 billion) and other foreign direct investment—about $1.9 billion, or 3.2 percent of GDP—demonstrate the renewed interest of investors in Peru. In the short run, the sharp increase in imports associated with this type of capital inflow has produced a widening in the current account deficit. As investment projects mature, however, they are expected to generate strong and sustained export growth, contributing gradually to the reduction of the current account deficit in the medium term.

Meeting Future Challenges

In February 1997, the IMF approved an augmentation of access of SDR 51.9 million (about $71 million) to support Peru's debt and debt-service reduction operation with its commercial creditors. The operation was closed in early March 1997, and the authorities have indicated that after the drawing for the operation, they intend to continue treating the IMF extended arrangement as precautionary (that is, they agree to meet the conditions applied to the use of the EFF but do not intend to draw on the available resources).

Over the medium term, Peru's main challenge is to achieve a strong rate of real GDP growth while bringing inflation to industrial country levels and narrowing the external current account deficit. Peru's return to viability by the end of the current extended arrangement hinges on the continued implementation of cautious fiscal policies. A stronger fiscal position would lessen Peru's reliance on foreign savings and its vulnerability to external shocks.

Poverty alleviation is a central priority. To this end, the government has stepped up social spending to about $160 per capita in 1996 from $80 in 1992, and is targeting this spending on the most vulnerable sectors of society. The share of the population living in poverty has declined to 48 percent in 1994 from 55 percent in 1991, and extreme poverty dropped to 18 percent from 24 percent during the same period. The Peruvian government, however, seeks to halve extreme poverty by 2000 through the implementation of social safety nets and a concerted effort to improve the delivery of basic social services and the infrastructure.

Members' Use of IMF Credit
(million SDRs)

	September 1997	Jan.–Sept. 1997	Jan.–Sept. 1996
General Resources Account	820.2	4,851.0	4,270.4
Stand-By Arrangements	203.6	2,078.7	2,042.9
EFF Arrangements	616.6	2,664.8	2,052.9
CCFF	0.0	107.6	174.6
SAF and ESAF Arrangements	44.7	423.1	394.0
Total	864.8	5,274.1	4,664.4

Note: EFF = Extended Fund Facility
CCFF = Compensatory and Contingency Financing Facility
SAF = Structural Adjustment Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals shown owing to rounding.

Date: IMF Treasurer's Department

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
October 6	4.09	4.09	4.48
October 13	4.15	4.15	4.55

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

From the Executive Board

Latvia: Stand-By

The IMF approved an 18-month stand-by credit for the Republic of Latvia, in an amount equivalent to SDR 33 million (about $45 million), to support the government's 1997–99 economic program. The authorities have indicated their intention not to draw on the credit as was the case under the recently expired arrangement.

Latvia has completed the first phase of transition, as macroeconomic conditions have stabilized and economic growth has picked up. Following the banking crisis and fiscal slippage of 1995, the government made major strides in tightening fiscal policy, enhancing the soundness of the banking system, and moving forward with structural reforms. Considerable progress was made under the 1996/97 program supported by an IMF credit. Real GDP rose by 2.8 percent in 1996, led by strong performance in the transportation, communications, and construction sectors. While inflation declined to 13 percent, the current account deficit

Latvia: Selected Economic Indicators

	1994	1995	1996	1997[1]	1998[1]
	(percent change)				
Real GDP	2.0	0.0	2.8	4.0	5.0
Consumer prices (end of period)	26.0	23.0	13.0	9.0	7.0
	(percent change)				
Fiscal balance	–4.0	–3.3	–1.3	–0.9	–0.5
External current account balance (including official transfers)	–2.4	–3.4	–6.6	–6.1	–4.9
	(months of imports)				
Gross international reserves	4.5	3.0	2.9	2.7	2.7

[1]Program.

Data: Latvian authorities and IMF estimates

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:

Jamaica, No. 97/28, October 2

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

nearly doubled to 6.6 percent of GDP in 1996, reflecting a onetime increase in fuel imports in advance of preannounced excise tax increases, strong growth in imports of capital goods and other raw materials, and adverse external conditions for wood exports. Capital inflows more than compensated for this deficit and resulted in an overall balance of payments surplus for the year.

The 1997–99 Program

The macroeconomic objectives of Latvia's 1997–99 economic program are real GDP growth of 4 percent for 1997 and 5 percent for 1998, a reduction in the annual rate of inflation to 9 percent in 1997 and 7 percent in 1998, and a narrowing in the external current account deficit to 6.1 percent of GDP in 1997 and 4.9 percent in 1998. Gross international reserves will be tar-

Countries using ESAF resources must develop—with the help of both the IMF and the World Bank—a Policy Framework Paper for a three-year adjustment program.

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

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			**5,468.66**	**3,274.08**
Argentina	April 12, 1996	January 11, 1998	720.00	107.00
Bulgaria	April 11, 1997	June 10, 1998	371.90	186.50
Djibouti	April 15, 1996	March 31, 1998	6.60	2.63
Egypt	October 11, 1996	September 30, 1998	271.40	271.40
El Salvador	February 28, 1997	April 27, 1998	37.68	37.68
Hungary	March 15, 1996	February 14, 1998	264.18	264.18
Papua New Guinea	July 14, 1995	December 15, 1997	71.48	36.14
Romania	April 22, 1997	May 21, 1998	301.50	180.90
Thailand	August 20, 1997	June 19, 2000	2,900.00	1,700.00
Ukraine	August 25, 1997	August 24, 1998	398.92	362.65
Uruguay	June 20, 1997	March 19, 1999	125.00	125.00
EFF Arrangements			**10,500.63**	**5,105.29**
Algeria	May 22, 1995	May 21, 1998	1,169.28	253.28
Azerbaijan	December 20, 1996	December 19, 1999	58.50	44.46
Croatia	March 12, 1997	March 11, 2000	353.16	324.38
Gabon	November 8, 1995	November 7, 1998	110.30	49.63
Jordan	February 9, 1996	February 8, 1999	238.04	76.25
Kazakhstan	July 17, 1996	July 16, 1999	309.40	309.40
Lithuania	October 24, 1994	October 23, 1997	134.55	—
Moldova	May 20, 1996	May 19, 1999	135.00	97.50
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Philippines	June 24, 1994	December 31, 1997	791.20	245.95
Russia	March 26, 1996	March 25, 1999	6,901.00	3,564.74
ESAF Arrangements			**3,624.59**	**1,452.48**
Armenia	February 14, 1996	February 13, 1999	101.25	50.63
Azerbaijan	December 20, 1996	December 19, 1999	93.60	52.64
Benin	August 28, 1996	August 27, 1999	27.18	18.12
Bolivia	December 19, 1994	September 9, 1998	100.96	16.82
Burkina Faso	June 14, 1996	June 13, 1999	39.78	19.89
Cameroon	August 20, 1997	August 19, 2000	162.12	135.10
Chad	September 1, 1995	August 31, 1998	49.56	16.52
Congo, Republic of	June 28, 1996	June 27, 1999	69.48	55.58
Ethiopia	October 11, 1996	October 10, 1999	88.47	73.72
Georgia	February 28, 1996	February 27, 1999	166.50	83.25
Ghana	June 30, 1995	June 29, 1998	164.40	109.60
Guinea	January 13, 1997	January 12, 2000	70.80	47.20
Guinea-Bissau	January 18, 1995	July 24, 1998	10.50	2.36
Guyana	July 20, 1994	April 17, 1998	53.76	8.96
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	July 20, 1994	March 31, 1998	88.15	16.13
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	45.47
Madagascar	November 27, 1996	November 26, 1999	81.36	54.24
Malawi	October 18, 1995	October 17, 1998	45.81	15.27
Mali	April 10, 1996	April 9, 1999	62.01	31.01
Mauritania	January 25, 1995	July 13, 1998	42.75	7.13
Mongolia	July 30, 1997	July 29, 2000	33.39	27.83
Mozambique	June 21, 1996	June 20, 1999	75.60	37.80
Niger	June 12, 1996	June 11, 1999	57.96	28.98
Senegal	August 29, 1994	January 12, 1998	130.79	—
Sierra Leone	March 28, 1994	May 4, 1998	101.90	5.06
Tanzania	November 8, 1996	November 7, 1999	161.59	110.18
Togo	September 16, 1994	June 29, 1998	65.16	21.72
Uganda	September 6, 1994	November 17, 1997	120.51	—
Vietnam	November 11, 1994	November 10, 1997	362.40	120.80
Zambia	December 6, 1995	December 5, 1998	701.68	40.00
Total			**19,593.88**	**9,831.87**

EFF = Extended Fund Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

geted at the equivalent of approximately three months of imports for 1997 and 1998.

To these ends, Latvia is continuing the previous macroeconomic strategy, with the exchange rate peg to the SDR remaining its focus, underpinned by fiscal and credit restraint. In the fiscal area, the general government fiscal deficit will be reduced to 0.9 percent of GDP in 1997 and 0.5 percent in 1998 from 3.3 in 1995 and 1.3 percent in 1996. This improved fiscal position reflects both improved revenue performance and overall expenditure restraint, despite increased spending on investment largely for infrastructure.

Structural Reforms

The program will emphasize the acceleration of structural reforms, including the completion of enterprise privatization and the strengthening and extension of private property rights, which will firmly establish Latvia as a market economy, encourage restructuring, and stimulate savings and domestic and foreign investment. Virtually all remaining state-owned enterprises, including large companies, will be privatized by mid-1998. In this context, steps are being taken to resolve the issue of consumer arrears and to ensure that energy tariffs are set on a cost-recovery basis. Other structural reforms, including land registration and a reduction in the number of business regulations, will also advance under the program. Trade liberalization is to continue, and legislation will be submitted to parliament by mid-1998 for further substantial reduction in agricultural tariffs.

Addressing Social Costs

Measures to improve tax administration and expenditure productivity, including through civil service reform, will make possible increased expenditures on social services and infrastructure. The government is also taking steps to improve the efficiency of social spending, including through a reform of the national health insurance system. The authorities recognize the importance of increasing productivity and protecting the needy as reductions in agricultural tariffs are implemented in connection with trade liberalization efforts.

The Challenge Ahead

Further progress and consistent implementation of structural reforms, together with continued fiscal discipline, are crucial for sustained economic growth to take hold. These steps will facilitate Latvia's objective of accession to the European Union.

The Republic of Latvia joined the IMF on May 19, 1992, and its quota is SDR 91.5 million (about $126 million). Its outstanding use of IMF credit currently totals SDR 69 million (about $94 million).

Press Release No. 97/46, October 10

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Policy Coordination, Labor Market Flexibility Crucial To EMU's Success

In May 1998, European Union (EU) leaders will decide which countries will participate in European economic and monetary union (EMU) from its outset, following the design agreed at Maastricht in December 1991. The establishment of EMU, scheduled for January 1999, will constitute an unparalleled development in the history of the international monetary system. The replacement of the national currencies of a number of highly developed economies in the EU by a single common currency—the euro—will be the culmination of over 40 years of progress in strengthening economic, monetary, and political ties. How will monetary and fiscal policies be conducted in the euro area? How will participating economies adjust to diverse developments in the absence of exchange rate flexibility and national monetary policy? And how critical are labor market reforms for EMU's success? These are among several questions addressed in the October 1997 World Economic Outlook *and in a recent IMF Working Paper on the EMU.*

The EU's current monetary system, established in 1979 with the aim of providing a zone of monetary stability, has at its core an exchange rate mechanism (ERM). The anchor role of the deutsche mark under the ERM has meant that the Bundesbank's policy—aimed at price stability in Germany and set primarily on the basis of domestic considerations—has had a dominant influence on monetary policy. By contrast, under EMU, the scope for national monetary policy—and the Bundesbank's dominant influence—will disappear. Monetary policy will be the exclusive preserve of the European System of Central Banks (ESCB), comprising the European Central Bank (ECB) and the national central banks. The ESCB's primary objective will be to maintain price stability.

Fashioning a Common Monetary Policy

The prospect of a common monetary policy in EMU has given rise to several operational issues, including the independence and accountability of the ESCB, the strategy and intermediate targets to be used by the ECB in pursuit of its objectives, and the differences among member countries in how monetary policy instruments are transmitted to the real economy.

Independence and Accountability. The independence of the ESCB is well safeguarded, as various Maastricht Treaty provisions insulate it from political influence, notes the *World Economic Outlook.* The treaty precludes member governments from influencing ECB decisions and prohibits ESCB financing of government deficits or

EU institutions assuming the commitments of governments. Moreover, while the EU's Council of Ministers has the right to enter into formal agreements relating to exchange rate arrangements for the euro or to formulate general orientations for the exchange rate, the rules concerning the exercise of these rights help protect against the possibility that the ECB might have to take measures jeopardizing its own objectives. A Council decision on a formal exchange rate arrangement would have to be unanimous, made on a recommendation from the ECB or the European Commission; and in the case of the latter, after consultation with the ECB in an endeavor to reach consensus consistent with the objective of price stability. Moreover, the ECB will not be obliged to follow general orientations specified by the Council if it believes them incompatible with price stability.

Closely related to the question of its independence is the ESCB's accountability. This is important not least

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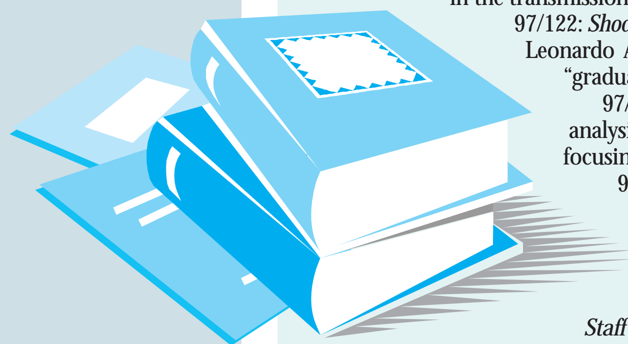

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because its success in delivering low inflation will depend partly—as with any central bank—on the public's support for that objective. Thus, mechanisms to ensure broad public understanding of monetary policy decisions will be essential. The transparency of the ESCB's policy decisions can also help assure the markets of the ESCB's commitment to the anti-inflation mandate, particularly until it has fully established its credibility. As David Begg points out in an IMF Working Paper entitled *The Design of EMU*, "transparency has two virtues: it prevents temporary accommodation being misinterpreted as permanent relaxation, and it facilitates the ease and reliability of verifying the true intentions of the ECB."

Strategy and Intermediate Targets. Preparatory work has ruled out exchange rate targeting as a viable nominal anchor. According to the *World Economic Outlook*, this seems appropriate, given the much smaller importance of international trade for the euro area as a whole than for individual EU countries, and hence of the exchange rate as an influence on domestic inflation. The euro area will in this respect resemble the economies of Japan and the United States, where monetary policy decisions are based primarily on domestic considerations.

The ECB is thus faced with two monetary policy strategy options: targeting inflation or targeting a monetary aggregate. The latter would provide continuity of the framework used by the dominant central bank of the ERM—the Bundesbank—and might thereby facilitate the transfer of credibility. In addition, the public could monitor the effects of the ECB's actions on a timely basis, rather than with a significant lag, as would be the case with an inflation target. Monetary targeting, however, is the exception rather than the rule among the central banks of advanced economies. The stability of the demand for money relationships needed for successful monetary targeting has been questioned, in light of rapid financial innovation. Therefore, monetary aggregates are unlikely to provide an adequate guide for monetary policy on their own, particularly at the outset of EMU when the restructuring of financial markets will make the demand for money especially uncertain. The recent experience of a number of countries that have successfully targeted inflation after abandoning their exchange rate and monetary anchors strengthens the case for inflation targeting. However, uncertainties about methods for forecasting inflation and predicting the effects on inflation of changes in monetary policy would also complicate the use of a fully specified inflation targeting approach at the start of EMU. According to the *World Economic Outlook*, it is unlikely that the ECB will be able to rely solely on a single strategy when EMU begins. More likely, it will have to use a high degree of discretion in conducting monetary policy, based on monitoring a variety of indicators in which monetary aggregates are apt to play a significant role.

Transmission Mechanism. In EU countries, changes in monetary policy are transmitted to the real economy in different ways. Consequently, output and inflation in some countries are more sensitive to changes in short-term interest rates than in others. These differences will complicate the task of the ESCB but should not pose a threat to EMU, according to the *World Economic Outlook*. Furthermore, a common monetary policy and the creation of a single financial market are likely to lead to greater harmonization in the transmission mechanism in the euro area. Any problems relating to differences in the transmission mechanism are most likely to be transitory.

No Central Fiscal Function

Unlike most monetary areas, EMU will not include a central fiscal authority. Spending and taxation decisions will remain almost exclusively the province of member states, although subject to EU surveillance. The absence of a central fiscal function complicates the task of ensuring an appropriate fiscal policy for the euro area as a whole, notes the *World Economic Outlook*. A successful monetary and fiscal policy mix will require avoiding pressures on monetary policy that would result from inadequate fiscal discipline. To promote fiscal discipline, the Maastricht Treaty introduced the "excessive deficit exercise," whereby a country is deemed to have an excessive deficit if its general government deficit exceeds 3 percent of GDP or its general government gross debt exceeds 60 percent of GDP. Some exceptions are allowed for, however, notably where the breach of the 3 percent reference value for the deficit is small, temporary, and due to exceptional circumstances, or a debt exceeding the 60 percent reference value is judged to be declining at a sufficiently fast pace. Not being subject to an excessive deficit finding is one of the Treaty's convergence criteria to be used in judging a country's eligibility to participate in monetary union. Once monetary union commences, participating countries that do not correct excessive deficits quickly enough will be subject to financial sanctions. Avoiding excessive deficits will not on its own ensure an appropriate policy mix, however.

For EMU to function successfully, participating economies will need to meet a number of additional macroeconomic convergence criteria. EU countries have made considerable progress on this front—substantial fiscal consolidation has accompanied continued convergence of inflation since the Maastricht Treaty was signed (see chart, page 336). The general government deficit has narrowed steadily since 1993, and the *World Economic Outlook* projects an EU-wide general government deficit of 2 ¾ percent of GDP for 1997—about 3 ½ percentage points lower than its peak in 1993, with average consumer price infla-

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tion for the EU as a whole falling to 2 percent—less than half of what it was in 1991.

On a broader scale, attempts at policy coordination have, since 1993, included general guidelines for the economic policies of EU members, issued annually by the EU's Council of Ministers. How effective these can be in calibrating the euro area's fiscal stance, and its allocation among members, is not clear. In June 1997, the European Council requested that the European Commission and the Council of Ministers study how the coordination of economic policies could be strengthened in EMU.

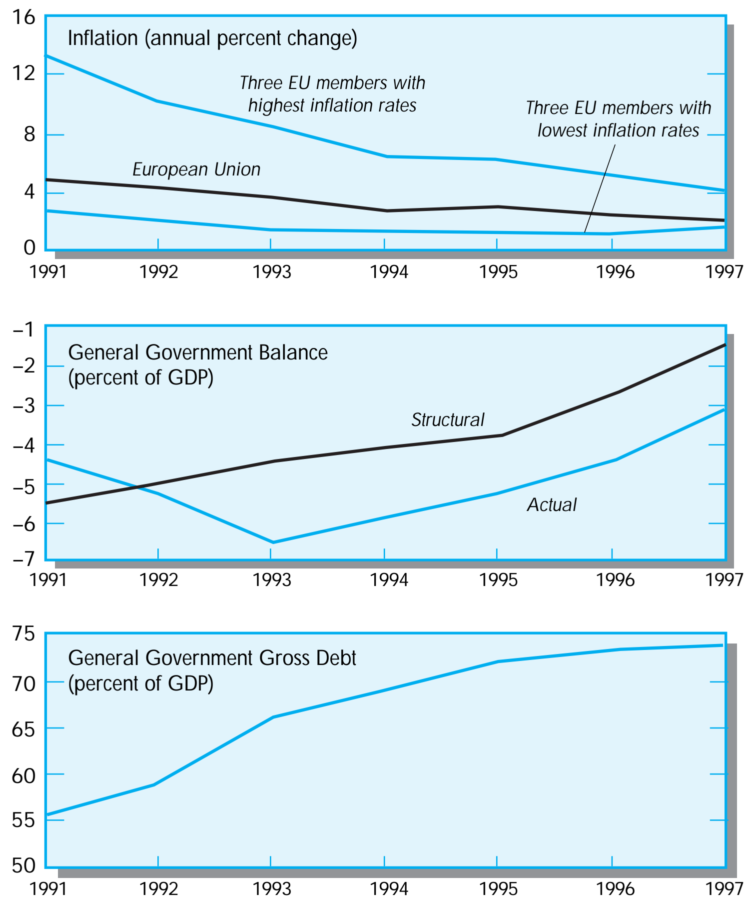
Labor Flexibility Key to Absorbing Shocks

With its monetary and fiscal policy frameworks designed to foster price stability and fiscal sustainability, a key question is how well equipped EMU will be to absorb and adjust to economic shocks, especially asymmetric shocks that have differential effects across countries. If shocks are symmetrically distributed across EU countries, the loss of independent exchange rate or monetary policies at the national level should not impede the ability of countries to adjust to them. In the event of asymmetric shocks, however, the loss of independent monetary and exchange rate policies will be more constraining, and common policy responses are more likely to be ineffective. In the case of temporary shocks, EU countries have typically not used monetary and exchange rate flexibility as a means of adjustment. And under EMU, the scope for fiscal stabilization should not be any less than in the past, according to the *World Economic Outlook*. In the case of longer-lasting asymmetric developments, the role of fiscal policy is necessarily more limited, since adjustment—rather than financing—is required. In such circumstances, exchange rate changes have provided an important tool of adjustment for EU countries.

With the possibility of exchange rate changes among countries no longer available under EMU, adjustments in wages and labor mobility will have to play a larger role. This underscores the need, which already exists given Europe's high levels of unemployment, for the EU to reform labor markets to enhance flexibility, notes the *World Economic Outlook*. In June 1997, in recognition of the lack of progress in solving the EU's labor market problems, EU leaders included procedures for the surveillance of employment policies in the Treaty of Amsterdam and also agreed on a Resolution on Growth and Employment. While this may strengthen the framework at the EU level, the reluctance of many EU member countries to embark on fundamental labor market reforms needs to be overcome.

Measures to promote labor market flexibility need to be pursued as a matter of urgency, emphasizes Begg. Greater labor market flexibility not only allows different countries to cope more easily with idiosyncratic shocks but also, by reducing the period for which any recession will be protracted, diminishes the pressure on European policymakers to succumb to the inflation bias in an attempt to avoid recessions at the EMU level. According to the *World Economic Outlook*, EMU itself may help in this regard, since with the exchange rate no longer available as an instrument of adjustment at the national level, policymakers will recognize the importance of flexible markets to help in adjusting to shocks and make their economies more efficient. ■

European Union: Selected Economic Indicators



Data: IMF, *World Economic Outlook*, October 1997

Copies of the fall edition of the *World Economic Outlook* ($35.00; academic rate: $24.00); IMF Working Paper 97/99, *The Design of EMU*, by David Begg ($7.00); and *EMU and the International Monetary System*, edited by Paul R. Masson and others ($35.00) are available from Publications Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.