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Unprecedented Rapid Response

IMF Board Approves Record $21 Billion Stand-By To Support Korea's Adjustment Program

On December 4, the IMF Executive Board approved a $21 billion stand-by credit for Korea in support of that country's economic adjustment program (see press release, page 388). This arrangement, which was negotiated with unprecedented speed, was the largest ever approved for an IMF member, exceeding the $17.8 billion credit approved for Mexico in February 1995 (see *IMF Survey*, February 20, 1995). It was part of a major international support package, involving also the World Bank and the Asian Development Bank, as well as bilateral lenders. The IMF's support for Korea's economic reform program marks the latest in the institution's continuing efforts to assist the beleaguered economies of East Asia. In August, the IMF approved a $3.9 billion package for Thailand supplemented by a $12.7 billion support package coordinated with other interested countries and multilateral institutions (see *IMF Survey*, September 17); and in November, the IMF approved a $10.1 billion stand-by credit for Indonesia as a major element in international assistance totaling some $23 billion (see *IMF Survey*, November 17).

IMF First Deputy Managing Director Stanley Fischer (right) responds to questions from reporters following press briefing.

As IMF First Deputy Managing Director Stanley Fischer said in a press briefing on December 5 (see page 386), the overwhelming speed and severity with which the financial crisis in Korea unfolded imparted a sense of urgency to the negotiations, which were completed in record time. Stanching the crisis and restoring market confidence required a tightening of policies and an unprecedentedly large, heavily front-loaded external financing package, with the first $5.6 billion being disbursed immediately, and a second disbursement of $3.6 billion, on December 18. Fischer noted that the successful outcome of the negotiations would not have been possible without the extraordinary efforts of the IMF staff team, led by Hubert Neiss and Bijan Aghevli, Director and Deputy Director, respectively, of the IMF's Asia and Pacific Department; and Tomás Baliño, Assistant Director in the IMF's Monetary and Exchange Affairs Department; as well as the personal involvement of IMF Managing Director Michel Camdessus on the last and unexpectedly long day of negotiations. He also commended the Korean authorities for the strong economic program they had put together, which, he said, justified the exceptional level of support provided by the IMF and the international community. ■

Executive Board Reviews Thai Program

On December 8, the IMF Executive Board reviewed the progress Thailand had made in implementing its economic program. Following the review, a further SDR 600 million (about $810 million) was made available to Thailand under the SDR 2.9 billion ($3.9 billion) stand-by credit approved in August. SDR 1.2 billion ($1.6 billion) had been made available earlier under the arrangement. In announcing the review, IMF Managing Director Michel Camdessus said that the Thai authorities had made solid progress in implementing their program more forcefully, especially in the key area of restructuring the country's financial sector.

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Fischer Press Conference

Aim of Korea Program Is to Stanch Immediate Crisis, Permit Return to Stability and Growth

Following are edited excerpts from a press conference given by IMF First Deputy Managing Director Stanley Fischer on December 5.

FISCHER: The crisis in Korea unfolded with overwhelming speed and severity. The negotiating team led by Mr. Neiss left Washington for Seoul only 10 days ago, and we have reached agreement with the Korean authorities on a strong program in record time. The agreement with IMF management and staff was reached in the early hours of December 3, two days ago. IMF Managing Director Michel Camdessus briefed the press in Seoul and, soon after, he briefed the IMF Executive Board on the agreement by a videoconference link.

The authorities' letter of intent and the staff report on the economic program were sent from Korea and issued to Executive Directors on December 3 and in the early morning of December 4, respectively—all these being unprecedentedly rapid speeds at which these complex documents were written and distributed.

These were very difficult negotiations, as the program required a quantum leap in policies that the authorities had been planning to implement gradually over a number of years. Their decision to join the Organization for Economic Cooperation and Development obviously implied that their capital markets would be opened and that a lot of the other structural measures now in the program would be implemented in due course—but they now have had to be implemented much more rapidly.

The drama of this negotiation resulted from the realization, when the mission arrived in Seoul on Wednesday, November 26, of the alarming state of the foreign reserves. As the Managing Director has said, when we were invited in, Korea was possibly 10 days away from a financial catastrophe, and the urgency to compress negotiations into one week required a ruthless concentration on priorities.

The heart of the program is in the area of financial restructuring.

We focus, naturally, on the difficulties confronting our staff, and they were formidable. The Korean authorities similarly operated under enormous difficulties. Their chief negotiator was the new deputy prime minister and finance minister, Lim Chang-yuel, who fortunately had been an Alternate Executive Director at the IMF and the World Bank in the 1980s, so he was familiar with these institutions. But he came in just over two weeks ago into a situation that must have been far worse than he could have imagined. He was a very tough negotiator—which is only to be expected—and I believe that the agreement reached shows a lot of courage and wisdom for the future of the Korean economy.

The program aims to stanch the crisis in the immediate run and permit a return of economic stability and growth over a longer period. The stanching of the crisis requires a tightening of policies and the provision of this unprecedentedly large external financing package, which together are aimed at restoring market confidence.

The early reactions have been promising. While these are welcome, they will be sustained only if the Korean economic program is rigorously implemented and is so perceived by the markets.

The heart of the program is in the area of financial restructuring. First, a series of financial sector reform bills submitted to the National Assembly are expected to be passed before the end of the year. These include a revised Bank of Korea Act, providing for central bank independence, and a bill to consolidate supervision of all of the banks, including specialized banks, merchant banks, and other financial institutions, in an agency with operational and financial autonomy and independence.

In addition, troubled financial institutions will be closed or, if deemed viable, restructured and/or recapitalized. The government has already suspended nine insolvent merchant banks. A credible and clearly defined exit strategy will include closures as well as mergers and acquisitions by domestic and foreign institutions. The disposal of nonperforming loans will be accelerated. There are also important reforms in the areas of corporate governance and trade liberalization.

This is a strong economic program that deserves the support of the international community and has obtained the support of the international community through the IMF and our sister organizations and in the expressions of bilateral support.

Given the level of support and the speed of the operation, we in the IMF are confident that the authorities will do their part by meeting their policy commitments. We should not forget that Korea has been through crises in the past, including in the 1980s, and has shown an ability to take very difficult measures quickly and to deal with crisis situations.

QUESTION: *What will the recommended economic restructuring do to the chaebol [conglomerate] system? Will the conglomerates simply be restructured, or will they be dissolved in time and replaced with a different system of corporate governance?*

FISCHER: I don't think we can tell at the moment whether the chaebol system will survive. What is clear

is that the transparency of the financial relations among the chaebols will be enhanced. Whether they survive as they are restructured is something that the market will decide. But it is clear that market forces—through the financial sector, banking, and equity markets—are going to be strengthened enormously.

Question: *Some observers have complained that the IMF is forcing Korea into recession by insisting that interest rates short-term be raised as much as they have. Could you address that?*
Fischer: The growth slowdown that Korea will experience now is a result of things that happened before the IMF was called onto the scene. Given the situation of the economy two weeks ago, there was no way that Korea could have avoided a significant period of growth slowdown and restructuring. Without our assistance, this would have been a much deeper recession.

Question: *IMF financial assistance goes to the treasury, into the reserves, but many of the big conglomerates may experience financial difficulty stemming from ambitious expansion plans. How do we know that money will not be used to shore up the finances of the conglomerates?*
Fischer: This money is intended to bolster reserves and to assist in restoring confidence. For the rest, there is a well-defined fiscal program that includes and defines whatever support—and it is practically nil—is to be given directly to the corporate sector.

Question: *Is it possible for Korea to reform the current system of industrial policy, or will it be necessary to dismantle it? What lessons does the Korean experience have to offer other countries to which East Asia has been held up as a model?*
Fischer: I don't think this restructuring would be possible within the Korean model. What has happened in Korea is a breakdown of economic relations caused by that system—the banks were being used to funnel money from abroad into corporations that were not being subjected to market discipline and whose financial structures were not clear.

The attempt to use the international economy without fully integrating into international capital markets is an important reason for the problems confronting Korea. One of the lessons is that as you modernize the economy and seek to reach the levels of an advanced industrial country—and Korea is well on its way—then, the sophistication of the industrial structure has to be matched by the sophistication of the financial system.

What are the other lessons? When this crisis began, the wisdom of opening capital markets was heavily questioned. It is significant that the country that was best known for not opening its capital markets has suffered as big a crisis as—if not bigger than—those that had opened their capital markets. This reinforces the IMF's general view that gradual capital market liberalization is a necessary part of economic development.

Question: *Over the next six weeks or so, Korea will be receiving $11 billion, which is 20 percent of what you have said are your reserves at the moment. Has the IMF got enough money?*
Fischer: After allowing for the amounts already committed, including for Korea, we have about $44 billion in uncommitted, usable resources in the General Resources Account of the IMF. We also have the ability

Hubert Neiss (left) and Stanley Fischer at press briefing. Without IMF assistance, the growth slowdown would have been much greater.

to access the General Agreements to Borrow (GAB) up to an amount of about $25 billion. And there is the prospect of the New Arrangements to Borrow coming into existence, which would double the resources available under the GAB. In the event of more major crises, we would have access to reasonable amounts of funding; but this would drive our liquidity position to very uncomfortable levels. That is why it is important that member countries agreed in Hong Kong at the 1997 Annual Meetings to increase IMF quotas by 45 percent.

Question: *During the whole postwar period, South Korea has had an extraordinarily close relationship with the United States. The United States is now unwilling to provide much bilateral assistance and is lending very little under this plan. Doesn't the United States have some special responsibility for the current crisis, because it seemed to be willing in the past to bail out South Korea no matter what happened?*
Fischer: First, the United States has committed $5 billion in bilateral support, which is still a lot of money by most people's reckoning. Second, the United States is the largest shareholder in the IMF and the World Bank, and the support that is being provided through these institutions is part of the international effort to assist South Korea. Further, in recent years, the United States has moved to the widely supported view that the purpose of the international financial institutions is to deal with these crises and that these institutions should constitute the first line of defense.

QUESTION: *How do you actually enforce this program? Some observers are saying that the IMF's stick—withholding further money—is too large to use, given the tenuous situation in Asia.*

FISCHER: The argument that the IMF would not use conditionality because it is too dangerous is not one we can accept. The stakes are high on both sides. If the program is not implemented, it will fail, and the cost to Korea and to the international system will be very severe. Under those conditions, if we had to use our conditionality, we would.

We in the IMF are confident that in a couple of years Asian growth will recover.

QUESTION: *This regional crisis started in July and has tumbled downhill since then. In the last five months, more than $100 billion has been poured into the region, but there are few signs that the rout has been contained, let alone reversed. Why have efforts so far failed to stop the crises?*

FISCHER: Crises don't end immediately or quickly. The Mexican crisis started in December 1994. Signs of confidence really only emerged in April. In East Asia, there has been a profound change in investors' views of what is happening, and it will take time for that to settle down. We in the IMF are confident that in a couple of years the Asian growth record will recover—perhaps not to the supernormal 9 percent and 8 percent of the past. But rates of 6–7 percent—which are also historically extraordinary—are well within reach for most of these economies.

QUESTION: *Is there any possibility of the IMF and Korea renegotiating the package?*

FISCHER: On renegotiation, let me be clear. IMF programs are continuously renegotiated in the sense that as circumstances change, we adjust the targets. If the assumptions made at the beginning of the program turn out to be wrong—and there is no guarantee during a time of extreme crisis of what will happen in the next six months—then the program will have to be adjusted accordingly. What I cannot imagine is that the major areas of structural reform would be renegotiated or taken off the table. Those are very firm commitments that are essential to the continuation of the program.

Press Release

IMF Approves Three-Year Stand-By Credit to Support Korea's Economic, Financial Program

Following is the text of IMF Press Release No. 97/55, dated December 5, on the Executive Board's approval of the Stand-By Arrangement for Korea.

The IMF approved Korea's request for a three-year stand-by credit equivalent to SDR 15.5 billion (about $21.0 billion) in support of the government's economic and financial program. Of the total, SDR 4.1 billion (about $5.6 billion) is available immediately. SDR 2.6 billion (about $3.6 billion) will be available December 18, following the first review under the program, and a further SDR 1.5 billion (about $2.0 billion) on January 8, 1998 following the second review. Subsequent disbursements will be made available subject to the attainment of performance targets and, in some cases, program reviews. The stand-by credit is equivalent to 1,939 percent of Korea's quota of SDR 799.6 million (about $1.1 billion) in the IMF.

In approving Korea's request for the stand-by credit, the IMF made use of the accelerated procedures established under the Emergency Financing Mechanism, which was adopted in September 1995. The Emergency Financing Mechanism strengthens the IMF's ability to respond swiftly in support of a member country facing an external financial crisis and seeking financial assistance from the IMF in support of a strong economic adjustment program.

Background

For the past several decades, the Korean economy has grown rapidly. With per capita GDP rising at an annual rate of nearly 7 percent, a once poor agrarian economy has been transformed into an advanced industrial economy. At the same time, in the process of development, the limitations of Korea's system of detailed government intervention at the micro level have become increasingly apparent. In particular, the legacy of intervention has left an inefficient financial sector, which has led to a highly leveraged corporate sector that lacks effective market discipline.

Until the present financial crisis, Korea's macroeconomic performance in 1997 was broadly favorable. Notwithstanding a sharp slowing of domestic demand, real GDP grew by 6 percent during the first three quarters and inflation declined slightly to 4 percent. Subdued import demand and rapid growth of exports caused the external current account deficit to narrow in the second quarter, and a current account deficit of 3 percent of GDP is expected in 1997. Fiscal policy remained prudent and, despite a large tax shortfall, expenditure cuts were made so as to ensure that the

consolidated central government accounts record only a small deficit for 1997.

However, since the beginning of the year, an unprecedented number of highly leveraged conglomerates (chaebols) have moved into bankruptcy. This reflected a number of factors, including excessive investment in certain sectors, such as steel and autos, and a weakening in the profitability associated with the cyclical downturn. The bankruptcies severely weakened the financial system and nonperforming loans rose sharply to the equivalent of 7½ percent of GDP. At the same time, the steep decline in stock prices has cut the value of banks' equity and further reduced their net worth. These developments exacerbated the existing weaknesses in the banking system caused by a lack of commercial orientation and limited experience in pricing and managing risk, combined with lax prudential supervision. The weak state of the banking sector has led to successive downgrades by international credit rating agencies and a sharp tightening in the availability of external finance.

Program Objectives

The macroeconomic objectives of the program include building the conditions for an early return of confidence so as to limit the unavoidable slowdown of GDP growth in 1998, followed by a recovery toward potential in 1999; containing inflation at or below 5 percent; and building international reserves to more than 2 months of imports by the end of 1998.

The government's program is built around a strong macroeconomic framework designed to continue the orderly reduction in the external current account deficit, build up international reserves, and contain inflationary pressures through a tighter monetary stance and significant fiscal adjustment; a comprehensive strategy to restructure and recapitalize the financial sector and make it more transparent, market-oriented, and better supervised; and measures to reduce the high degree of reliance of corporations and financial institutions on short-term debt and allow a better diversification of risk in the economy.

To demonstrate to markets the government's resolve to confront the present crisis, monetary policy is being tightened immediately to restore and sustain calm in the markets and contain the inflationary impact of the recent won depreciation. In line with this policy, the large liquidity injection in recent weeks is being reversed, and money market rates have been raised sharply and will be maintained at a high level as needed to stabilize markets. The day-to-day conduct of monetary policy will be guided by movements in the exchange rate and short-term interest rates that will be used as indicators of the tightness of monetary conditions. A flexible exchange rate policy will be maintained, with intervention limited to smoothing operations.

For 1998, fiscal policy will remain tight. Because of lower growth, a weaker exchange rate, and the cost of servicing public funds raised to recapitalize the banks, the budget would have shifted into a deficit. To offset this, and to alleviate the burden on monetary policy, additional fiscal measures of about 1½ percent of GDP will be put in place to achieve at least balance, or a small surplus, through both revenue and expenditure measures. These measures include increases in mineral oil taxes that have already gone into effect; a broadening of the value-added tax base and selective increases in income and corporate taxes; and cuts in current expenditures and, to a limited extent, in infrastructure and other capital expenditures.

Korea: Selected Economic Indicators

	1995	1996	1997	1998[1]
		(percent change)		
Real GDP growth	8.9	7.1	6.0	2.5
Consumer prices (end of period)	4.7	4.9	4.2	5.2
		(percent of GDP)		
Central government balance (billion US dollars)	0.3	0.3	-0.5	0.2
Current account balance	–8.9	–23.7	–13.8	–2.3
External debt	78.4	104.7	101.5	126.8

[1]Program.

Data: Korean authorities and IMF staff estimates

Financial Sector Restructuring

The centerpiece of the government's program is a comprehensive restructuring and strengthening of the financial system to make it sound, transparent, and more efficient. The strategy comprises three broad elements: a clear and firm exit policy, strong market and supervisory discipline, and increased competition.

The exit policy seeks to ensure the rapid resolution of troubled financial institutions in a manner that minimizes systemic distress and avoids moral hazard. The authorities have moved to suspend nine insolvent merchant banks. Those merchant banks that are unable to submit appropriate restructuring plans will have their licenses revoked. The authorities' policy involves the restructuring and recapitalization of all banks that fail to meet the Basle Committee capital standards. In addition to recapitalization by current owners, this policy will include mergers and acquisitions by domestic or foreign institutions. The supervisory authorities will review such mergers and acquisitions to ensure the new groupings are economically viable. This process will entail losses to shareholders.

The deposit guarantee currently in place is intended to facilitate an orderly restructuring of the financial system

in present circumstances. In order to enhance market discipline and minimize moral hazard problems, the government is committed to eliminate the guarantee by the end of 2000 and replace it by a regular deposit insurance system that will only protect small depositors and be financed solely by contributions from the financial sector.

In order to improve transparency in the financial sector and upgrade accounting and disclosure standards toward best international practice, large financial institutions will be required to have their financial statements audited by internationally recognized firms. Disclosure standards will require the publication of key data by financial institutions twice a year, including nonperforming loans, capital adequacy, and ownership structures and affiliations.

Korean Deputy Prime Minister and Finance Minister Lim Chang-yuel (left) and IMF Managing Director Michel Camdessus during the negotiations.

To strengthen financial sector supervision, the authorities will urgently request passage of a bill to set up an agency to consolidate the supervisory functions currently distributed among various agencies. The legislation will also allow prompt closure of insolvent financial institutions, the replacement of managements, and the dilution of shareholders equity when appropriate. The passage of early legislation will also be sought to make the Bank of Korea independent and with price stability as its overriding mandate.

To promote competition and efficiency in the financial sector, the authorities will allow foreigners to establish bank subsidiaries and brokerage houses by mid-1998.

Structural Policies

Although the government has undertaken substantial trade liberalization since the early 1980s, further liberalization will help enhance domestic competition. Therefore, a timetable will be set in line with World Trade Organization commitments to eliminate trade-related subsidies, restrictive import licensing, and the import diversification program. Steps will also be taken to streamline and improve the transparency of import certification procedures.

The government plans to substantially accelerate its ongoing capital account liberalization program. The ceiling on aggregate foreign ownership of listed Korean shares will be increased from 26 percent to 50 percent by the end of 1997, and to 55 percent by the end of 1998. The ceiling on foreign ownership will be increased from 7 percent to 50 percent by the end of 1997. By the end of February 1998, steps will be taken to liberalize other capital account transactions, including those restricting foreigners' access to domestic money market instruments and the corporate bond markets, and by further reducing restrictions on foreign direct investment by simplifying approval procedures. A timetable will be set by the end of February 1998 to eliminate restrictions on foreign borrowing by corporations.

To facilitate the ability of the Korean labor market to respond to changing economic conditions, labor market flexibility will be enhanced by easing dismissal restrictions under mergers and acquisitions and corporate restructuring, which continue to rely on time-consuming court rulings. To ease the burden of layoffs and to expedite re-employment, the employment insurance system will be strengthened and private job placement agencies and temporary employment agencies will be allowed to operate.

Financing Needs

In addition to the IMF funding of $21 billion, the President of the World Bank has indicated the Bank's readiness to provide up to $10 billion in support of specific structural reform programs, in accordance with Bank policy. Similarly, the President of the Asian Development Bank has indicated his readiness to recommend to his Board to provide up to $4 billion in support of policy and institutional reforms, within the framework of the Bank's policy. At the same time, a number of countries (Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States) have informed the IMF that they are prepared, in the event that unanticipated adverse external circumstances create the need for additional resources to supplement Korea's reserves and resources made available by the IMF and other international institutions, to consider—while Korea remains in compliance with the IMF credit arrangement—making available supplemental financing in support of Korea's program with the IMF. This second line of defense is expected to be in excess of $20 billion. ■

Photo Credits: Yun Suk-bong for REUTERS, page 390; all others, Denio Zara and Padraic Hughes for the IMF.

Address to World Confederation of Labor

Camdessus Calls for Actions to Make Globalization Work for Workers

Following are excerpts of an address by IMF Managing Director Michel Camdessus to the World Confederation of Labor in Bangkok on December 2.

Globalization is an issue on which many people disagree. Some believe that the opportunities that globalization can bring outweigh its risks; others see in globalization the undoing of all they are striving to achieve. But one thing is certain: we already live in a global economy, and it is becoming more closely integrated in terms of trade and financial flows every year. As the representatives of unions from all over the world, your task is to help your members understand and adapt successfully to the forces of globalization—to make globalization a positive development for them and, I hope, for all working people.

Concerns About Globalization

But many working people have concerns about global markets. In the advanced economies, many people worry about growing income inequalities between skilled and less skilled workers. The share of industrial jobs in total employment is declining in advanced economies, but for the most part, this is the natural consequence of technological progress and increased industrial productivity.

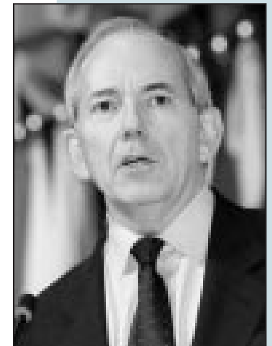
How can advanced economies cope with deindustrialization and widening income gaps? The answer is to provide workers with opportunities to adapt to the fundamental change that is occurring in all advanced economies: the shift from an economy that relies heavily on manufacturing to one that is based increasingly on services. This development should be greeted with attention to the opportunities to be seized. Contrary to popular misconceptions, many service sector jobs pay good salaries. But it does point to the need for more flexible labor markets so that workers can move easily from one job to another, carrying their pension rights with them. It also calls for better education and technical training, so that workers have the skills they need to fill better paying jobs. And it calls for a very proactive policy to be conceived and implemented in a tripartite context.

In emerging market economies, there are other concerns and, at times, tragedies. In Asia, for example, despite rapid growth in many countries, there are still nearly one billion people living in poverty. And even in the best of times, working conditions and labor rights in many countries fall short of what human dignity and ILO [International Labor Organization] conventions require. On the other hand, many workers in emerging market economies worry that protectionist pressures in advanced countries, often intensified by fears of globalization, could cause them to lose their jobs. And the Mexican and east Asian crises illustrate how vulnerable economies can be when economic policy mistakes result in large capital outflows.

But without the continued expansion of foreign trade and investment, and the jobs thereby created, there would be many more people living in desperate situations. Moreover, protectionism does not have a good record of improving labor conditions. Rather, it is more likely to cause many workers to lose their jobs and force them into the informal sector.

Strategy for Economic and Social Progress

The best strategy is for countries to improve the domestic environment for productive long-term investment and accelerate social progress.



The first requirement is to maintain sound macroeconomic policies, correct macroeconomic imbalances promptly when they arise, and continue with the structural changes needed to sustain macroeconomic stability and high-quality growth. This emphasis on prudent macroeconomic policies and supporting structural reform is the constant refrain of the IMF, but it should also be the theme of all those who really care for the most vulnerable in society, because reasonably stable prices and steady growth are so important—not just to reassure the financial markets but also to protect the poor. Indeed, it is the poor who are most likely to lose their livelihoods in economic downturns.

This also applies to many wrong-headed policies—sometimes pompously characterized as "a national way to development"—that the IMF opposes because they in no way serve the interests of the majority of citizens. Let me mention only a few examples:

- *monopolies and special protections for the benefit of the happy few*, with high costs for the ordinary people;
- *irresponsibly lax credit policies* that risk building a financial house of cards whose collapse, when market conditions tighten, imposes catastrophic costs;
- *financial institutions whose main purpose is to channel low-cost resources to cronies* while their losses would be absorbed by the national budget—that is, the people!
- *unproductive spending*—be it unnecessary military spending or white elephants—for the glory of the political regimes and of no real benefit for the people.

This sad list is long enough for you to understand why we press governments to adopt a "second generation" of reforms to ensure that the benefits of growth are more widely shared. Let me mention four important areas for reform:

- *Ensuring the rule of law, and making the judicial system independent, professional, and accessible to all.*

• *Dismantling monopolies and working energetically to establish simpler, more transparent regulatory systems* that are equitably enforced, provide equal access to markets, and thus, promote equality of economic opportunity. This is an important element of the program in Indonesia and the one we are negotiating with Korea.

• *Increasing transparency more generally.* This is essential with regard to banking systems—so frequently misused with a cynical disregard for their normal mission of promoting sound investment. Transparency also contributes to a more responsible use of public resources for the public good, reduces the opportunities for corruption, and facilitates the tripartite dialogue.

• *Improving the quality of public expenditure.* By this, I mean reducing outlays for unproductive purposes, such as military build-ups and large projects that only benefit a few, to make room in the national budget for spending on health, education, vocational training, and basic infrastructure; ensuring that essential public services are provided at reasonable cost, that they reach the intended beneficiaries, and that access to these services is equitable.

• *Labor market reform.* This is an area in which there has been relatively less progress in some countries in Latin America and Asia, which has had a dampening effect on social progress. Reducing poverty depends on expanding employment, particularly among the less skilled. And this, in turn, requires an adaptable labor market that encourages mobility and keeps labor costs in line with labor productivity, as well as sustained efforts to improve workers' skills.

But such reforms run counter to many vested interests, who will use all their means to discredit them, and, of course, with them, the IMF for daring to challenge these interests. Moreover, such reforms require governments to face the hard fact that not everything has been perfect so far. Thus, they meet with formidable resistance. But they cannot prevail unless governments give them their active support and explain them to workers. We would greatly welcome the active contribution of unions to these "second-generation" reforms, which are so crucial for the lasting generation of high-quality jobs. Indeed, I could say that this will not happen without your support.

Finally, let me turn to the concerns in the poorest countries. For them, globalization poses the very real threat of marginalization. The key to overcoming problems of the poorest countries is to help them attain stronger, higher quality growth. As in other countries, the strategy in the poorest countries must also begin with re-establishing basic macroeconomic equilibria and completing the structural reforms needed to improve resource allocation and spur growth.

All too often, people are disappointed by the results of their countries' initial stabilization and reform efforts. The problem is that many of the obstacles to private initiative, job creation, and foreign investment have been left in place. ■

IMF-AERC Seminar on Africa

Trade Liberalization, Regional Initiatives Explored

African cabinet ministers, academics, and senior officials from the IMF, African regional organizations, and donors gathered in Washington, on December 1–3 to explore trade liberalization and regional integration issues in Africa. The seminar, co-sponsored by the IMF and the African Economic Research Consortium (AERC) and organized by the IMF Institute, blended scholarly analysis and practical experience in a search for pragmatic solutions.

Alassane Ouattara (right) greets Benno Ndulu.

In his opening remarks, Alassane Ouattara, a Deputy Managing Director of the IMF, encouraged participants to take a comprehensive view of issues; examine the analytical basis for trade policy reforms and regional integration; and weigh goals and policy options. Benno Ndulu, Executive Director of the African Economic Research Consortium, wryly urged participants to take this "unique opportunity" to discuss the issues without the IMF's customary benchmarks in the context of negotiations.

The realities of globalization provided the backdrop for the seminar. The role that trade, and trade liberalization, could play in the quest for higher growth and greater integration into the world economy was at the heart of much of the discussion. Presenters and participants generally agreed that sound macroeconomic policies were critical for greater openness. The debate had shifted from whether or not to liberalize to how to liberalize. The role that refocused regional arrangements could play in furthering liberalization and spurring greater foreign direct investment in sub-Saharan Africa also drew attention.

Lessons from Experience

Mohsin Khan, Director of the IMF Institute, opened the seminar with a review of the lessons gleaned from trade liberalization in developing countries. Presenting a paper prepared by Michael Mussa, head of the IMF's Research Department, he underscored the importance of complementary macroeconomic and structural reforms if trade is to be an "engine of growth." Bold and comprehensive trade liberalization strategies have proven more durable than hesitant measures, and

sound macroeconomic policies—especially maintenance of competitive exchange rates—are essential. The Mussa paper sketched out a sequencing of reforms that would over five years remove quantitative restrictions and limit tariffs to 30 percent as a first step, and then would further reduce tariffs to a maximum of 15 percent. Major trade reforms could be facilitated, if countries accompanied these efforts with a real exchange rate depreciation and an improvement in the fiscal position. Regional integration efforts should also be consistent with multilateral liberalization.

Distilling the experiences of regional organizations, Gary Hufbauer of the Council on Foreign Relations and Barbara Kotschwar of the Organization of American States suggested a checklist of ingredients crucial to the success of regional arrangements. An essential precondition, they argued, is a deep commitment to liberalization. Be mindful of geography—particularly transport costs—and be certain all national leaders are "on board" and committed to trade liberalization, they said. Tap the natural leadership capacity of larger member countries, but also safeguard the interests of smaller participants. Keep regional arrangements as simple as possible, and be aware that free trade arrangements will be easier to administer than customs unions. The private sector's active involvement will be vital and infrastructure development a key priority.

Global Considerations

Africa is already globalized, noted Paul Collier of Oxford University (and the incoming head of the World Bank's research department), but in the wrong way. Its trade has become more concentrated in primary products, and its integration into the global capital markets has been the result of an estimated 70 percent of Africa's private wealth being invested outside the continent.

Can Africa become an exporter of manufactured goods and attract foreign investment? Africa's chief constraint was its high transaction costs. It could export, Collier believed, if the high transaction costs arising from inadequate infrastructure could be addressed. Attracting foreign investment would require steps to diminish the perception of risk and reassure investors on the sustainability of its policies. Africa could benefit, he believed, from internal and external "agencies of restraint,"—which would make policy reversals more difficult, and thus less likely. Collier urged the creation of independent central banks, the use of cash budgets, the pursuit of capital account convertibility (after fiscal stability had been secured), and the development of regional arrangements that placed constraints on national policy makers.

Alan Winters of the World Bank presenting a paper coauthored with Zhen Kun Wang, noted that although Africa is perceived to have fared badly in the Uruguay Round, the evidence suggests Africa did not lose much, but neither did it offer much. With agriculture a principal topic in the next round, Africa stands to gain more from greater activism in the multilateral trade negotiations.

Why Is Trade Reform So Difficult?

Dani Rodrik of Harvard University argued that empirical evidence on the link between trade liberalization and growth is quite weak, but there are indisputable benefits from basic trade reforms, such as demonopolizing trade, streamlining import regimes, and replacing quantitative restrictions with tariffs. Trade reforms are a hard sell, he said, because powerful groups are often asked to give up a lot for a small overall benefit. To make this more palatable, Rodrik suggested packaging trade liberalization with other reforms (particularly in response to a crisis) and considering two-track reforms that allow some groups to retain their benefits while others gain from reforms. China and Mauritius have done this. Still, trade liberalization in Africa will be difficult: the political costs are likely to be high, the institutions are weak, and the informational issues are great.

Collier: Africa can benefit from "agencies of restraint."

Trade Reform Issues

Benno Ndulu of the AERC and Njuguna Ndung'u of the University of Nairobi, looking at trade and growth issues in sub-Saharan Africa, asked whether the data support two popular impressions of Africa: that it does not trade enough and is not open enough. Africa's share of world trade has declined—from 3 percent in the 1950s to 1 percent in the 1990s—but trade as a share of GDP has remained fairly constant, and effective tariff rates—based on actual tax collections—suggest a degree of openness comparable with Latin America. Outstanding issues remain, however—chiefly the sustainability of liberalization efforts and fiscal concerns.

Robert Sharer of the IMF reviewed the trade liberalization component in IMF-supported adjustment programs in sub-Saharan Africa from 1990 to 1996. Comparing 14 programs in Africa with 14 programs elsewhere, he concluded that quite a bit had been achieved in Africa. Fears that a reduction in tariff levels might trigger significant revenue declines may have been overstated, he said, but trade liberalization was best done within a set of comprehensive reforms, with early attention to removing nontariff barriers.

Reporting on an ongoing IMF study on the revenue implications of trade liberalization, Liam Ebrill stressed that the IMF's Fiscal Affairs Department believes administrative capacity drives tax policy. Africa still derives a large share of tax revenues from trade taxes. He advocated these not be lowered before alternatives—notably a value-added tax—are put in place. The sequence he recommended was a removal of quantitative restrictions, a simplification of the rate structure, a broadening of the tax base, and a reduction in average tariff levels.

How will Africa industrialize, asked Charles Soludo of the University of Nigeria, as the first region to do so without access to preferential trading arrangements? Africa has been hobbled, he believed, by high transaction costs and a preindustrial economy that features, among other things, high risk levels, defective markets, poor institutional capacity at the state level, and scarce entrepreneurial skills. Africa's industrialization would require a stable macroeconomic framework, efficient factor markets (especially a more efficient labor market), locational advantages to attract firms, and well-functioning capital markets. The private sector must play a key role; trade policy will need to be developed for industrialization; effective regionalism will need to attract investment and the international community should, he argued, return to project lending and give more attention to the costs of adjustment and supply-side constraints.

Charles Soludo (left) with G.E. Gondwe and Mohsin Khan of the IMF.

Africa's New Regionalism

Ibrahim Elbadawi of the AERC, presenting a paper by T. Ademola Oyejide of the University of Ibadan, noted scant evidence to date that regionalism has enhanced trade or investment. Oyejide argued for a refocusing of integration objectives to increase economic space and build strategic complementarities in the region. These arrangements should function as agents of restraint—conferring additional credibility on national policies and increasing the costs of reneging on commitments. Regional arrangements can support industrialization and structural transformation, but in newer, more indirect ways, and sustain the momentum of liberalization.

Christian François of the IMF argued that regional arrangements promote and enforce good policies; enhance the size (and thus the attractiveness) and credibility of markets; provide efficiency gains in areas such as education, energy, and telecommunications; leverage negotiating clout; and perhaps help resolve conflicts. But they are not without pitfalls. If these arrangements encourage overly ambitious goals, increase bureaucracy, or grow too numerous (and thus overlap), they will detract from the efficient use of scarce resources.

Ernest Aryeetey of the Institute of Social Sciences and Economic Research of the University of Ghana observed that early efforts at African regional integration had focused on boosting intraregional trade, industrialization, and import substitution. The failure of this goal diminished interest in regionalism until the 1990s when fear of marginalization in a global economy and regional developments elsewhere (notably in conjunction with ASEAN) rekindled interest in regional arrangements. This new regionalism has emphasized the key role played by appropriate macroeconomic frameworks, the importance of attracting capital flows, the need to cooperate on infrastructure development, and the importance of developing effective compensation mechanisms.

Elbadawi and Francis Mwega of the University of Nairobi concluded that Africa's failure to increase trade and investment was at least partially explained by the development strategy that had been adopted earlier. They suggested a more appropriate model for Africa's new regional integration might be the ASEAN strategy, which was not explicitly designed to create trade but did pursue greater national policy credibility and the more rapid accumulation of physical and human capital.

Papers by Charles Jebuni of the Center for Policy Analysis, Trudi Hartzenberg of the Southern African Research Institute for Policy Studies, and Louis Kasekende of the Central Bank of Uganda noted the mixed results of the various regional arrangements currently in place in sub-Saharan Africa.

Concluding Observations

In the final session Khan, Ndulu, Richard Eglin of the World Trade Organization, Edwin Barber of the U.S. Treasury, and Ernesto Hernández-Catá of the IMF addressed recurring themes and related topics. Khan was struck, he said, by the broad recognition of the importance of a bold, sustained, and well-sequenced trade liberalization within the context of comprehensive macroeconomic and structural reform. It was also clear, he said, that there was significant interest in a new regionalism with refocused objectives and that Collier's points on transaction costs and agencies of restraint had become the "touchstones" of the seminar.

For Ndulu, the seminar underscored the importance of reducing the costs of doing business in Africa and the need to use resources to maximize productivity. Both objectives would have to be pursued on a sustained basis if credibility were to be achieved and growth fostered. Eglin stressed the long-term gains for Africa from a more active participation in multilateral trade negotiations. On the benefits of regional integration, however, he remained "very skeptical." Barber, focusing on the U.S. government's Africa Initiative, believed that countries with the will to reform, build capacity, and strengthen governance would garner international support. Financing and debt relief would, he said, be key, and organizations like the IMF and the World Bank would have an important role in spurring the reallocation of resources toward investment and human resource development.

Finally Hernández-Catá noted Africa had made considerable progress in trade liberalization, but its trade regimes were still restrictive and could benefit from further reform. In asking Africa to take bold and politically difficult steps, industrial countries should also take bold action, including unilaterally removing quota restrictions and tariffs on African cotton and coffee and eliminating subsidies on such products as beef and sugar. ■

Broad-Based Growth Is Key

IMF Policy Advice Helps Members Build Framework for Poverty Alleviation

The following article is based on a paper by the Expenditure Policy Division of the IMF's Fiscal Affairs Department, delivered at the Development Assistance Committee–Organization for Economic Cooperation and Development Seminar on Key Elements in Poverty Reduction Strategy, in Paris on December 4–5.

Since the late 1970s, the focus and scope of the IMF's work has broadened beyond managing aggregate demand and attaining macroeconomic stability to include a concern for high-quality growth—a key element of which is growth with enhanced equity and reduced poverty rates. The IMF's policy advice can have a positive impact on the poor through three channels: macroeconomic policies and structural reforms, social safety nets, and public expenditures.

Macroeconomic Policies and Structural Reform

A major objective of the IMF's advice is to promote sound monetary, fiscal, and exchange rate policies to achieve macroeconomic stability. In the short term, stability directly benefits the poor by reducing inflation and promoting realistic exchange rates. More important, over the long run, a sustainable macroeconomic framework is critical for achieving the broad-based growth necessary to alleviate poverty.

Failure to correct serious macroeconomic imbalances can have high social costs. High and variable inflation hurts the poor because they usually have limited access to mechanisms that protect consumption and real income levels in such an environment. High inflation can also erode the tax base—and consequently affect the government's ability to maintain social expenditures.

To the extent that inflation stems from monetizing government fiscal deficits, IMF policy advice calls for limiting government's access to bank credit to ensure that the private sector receives an adequate share of total credit. The quality of fiscal adjustment is also critical: changes in expenditures or tax policy should be sustainable and have a lasting impact on the fiscal balance over the medium term.

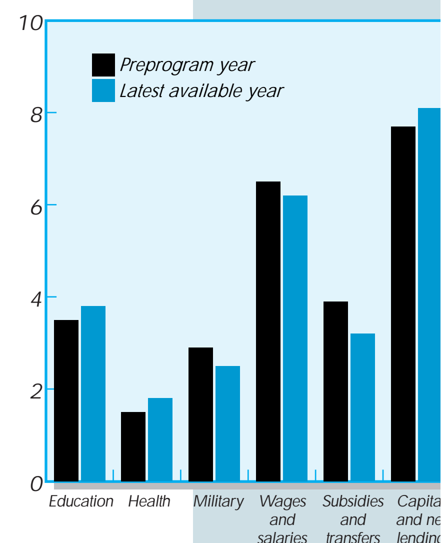
Exchange rate policy is another important element of the policy mix. An overvalued exchange rate is likely to have a negative effect on the incomes of the rural poor who depend on agricultural exports.

In addition, structural reforms designed to sustain growth by promoting efficient resource use and providing incentives for competition and private initiative are usually needed to create conditions for economic growth. These reforms include eliminating distortions in the fiscal system and liberalizing prices and interest rates.

Social Safety Nets

In the short term, some economic reforms aimed at removing impediments to long-term sustainable growth may hurt the poor. Removing generalized price subsidies on basic commodities, reducing budgetary subsidies to state enterprises, and lowering protection following trade liberalization can cause a decline in the real incomes of the poor and losses in employment. To limit these adverse short-term effects, many IMF-supported programs incorporate budget outlays on temporary social safety nets to transfer income or protect consumption (for example, targeted subsidies, cash compensation, and improved distribution of essential commodities, such as medicine). Safety nets can also enhance the political support for reforms. However, due regard needs to be paid to the cost-effectiveness and financial viability of these safety nets.

Government Spending in SAF/ESAF Countries
(percent of GDP)



Data: IMF staff estimates

Public Expenditures

Reallocating public expenditures can benefit the poor by shifting spending to outlays—on productive capital and basic education and health care—that enhance growth, increase equity, and alleviate poverty, away from "unproductive" public expenditures that can be reduced without affecting policy objectives—such as distortionary subsidies and excessive military outlays. In reorienting budgetary expenditures toward capital outlays, IMF-supported programs are designed to reflect realistic expectations of the countries' capacity to implement capital projects and available external financing. Because the productivity and benefit of education and health expenditures are highly dependent on how they are distributed, IMF policy advice has increasingly emphasized a shift in the pattern of spending toward higher spending on basic education and primary health care.

IMF-Supported Programs and the Poor

The IMF's Enhanced Structural Adjustment Facility (ESAF)—like its precursor, the Structural Adjustment Facility (SAF)—was established to provide longer-term concessional resources to low-income countries. A recent IMF review of 36 countries that have implemented structural adjustment policies under SAF/ESAF-supported programs during 1986–95 found substantial progress in creating the conditions for a stable macroeconomic environment and sustainable growth and in

improving the composition of public spending (see *IMF Survey*, November 3, pages 10–11). Overall, IMF-supported programs have been most successful in ending high-inflation episodes (inflation rates of over 40 percent), but have been less successful in achieving single-digit inflation. The review also examines the direct impact that IMF-supported programs have had on poverty rates and equity through the composition of expenditures and social safety nets.

Social Spending. Based on evidence for 23 countries, social spending in SAF/ESAF countries, on average, fared reasonably well during 1986–95, although substantially less so in CFA franc zone African countries. A comparison of the last year for which data are available and the preprogram period (an average of six years) shows that real public spending on education increased in 17 of the 23 countries, with per capita education spending increasing, on average, by nearly 4 percent a year, as education spending as a share of GDP increased by 0.3 percentage point (see chart, page 395). Health expenditures increased in real terms in 18 of the 23 countries, with per capita spending increasing, on average, by almost 6 percent a year. Health spending as a share of GDP increased on average by 0.3 percentage point since the start of the programs.

Increased spending on education and health care coincided with improvements in both education and health indicators. Although still high, the illiteracy rate was reduced by about 3 percent a year since the start of the first IMF-supported program. Access to health care increased from 46 percent to 64 percent of the population, and immunization rates and access to safe water and sanitation increased sharply. At the same time, life expectancy increased by 0.3 percent a year as infant mortality fell by 2.1 percent a year.

The impact of social expenditures in reducing poverty depends largely on how these outlays are allocated. For the countries whose situations during 1986–95 were reviewed, the IMF study shows that distribution of the benefits of education and health care spending still disproportionately favors higher-income groups. In the education sector, the percentage of benefits accruing to the poorest quintile of the population averaged 13 percent for a sample of eight SAF/ESAF countries, compared with 32 percent for the richest quintile. For the five SAF/ESAF countries for which health data are available, the poorest quintile received an average of just 12 percent of the benefits of total health care spending, compared with 30 percent for the richest 20 percent.

Although there is scope for improving the allocation of poverty-reducing social expenditures, poverty rates declined by an average of 20 percent under IMF-supported adjustment programs in seven SAF/ESAF countries for which data are available. For income inequality, data for the seven countries indicate that, on average the distribution of income improved.

Military Expenditure. Progress in reducing worldwide military outlays has been encouraging in recent years. In developing countries with IMF-supported programs, this decline has been even more rapid. In these countries, military expenditures fell, on average, by 3 percentage points of GDP between 1990 and 1995 (to a significant extent due to declines in transition economies), compared with 1.3 percentage points in nonprogram developing countries.

Other Aspects of Expenditure Composition. SAF/ESAF-supported programs have been successful in shifting the composition of expenditure toward capital spending, although by less than originally programmed. In the 36 countries reviewed in the IMF study, the share of outlays devoted to capital and net lending rose on average by about 2.5 percentage points during the program period, whereas the portion of expenditures absorbed by wages and salaries as well as by subsidies and transfers declined.

Social Safety Nets. During 1986–95, several countries in the sample improved the efficiency of outlays on subsidies and transfers by sharply reducing generalized subsidies and increasing targeted social safety nets. Partly as a result, spending on subsidies and transfers by the 36 SAF/ESAF countries as a share of total spending declined on average by almost 3 percentage points between the three-year preprogram average and the last year for which data are available.

Efforts to reform existing social assistance programs and implement new social safety nets have met with difficulties, however, including:

- Weak administrative structures and lack of appropriate social policy instruments have constrained implementation of cost-effective safety nets. Lack of data makes it difficult to assess the effectiveness of a social safety net in reaching its intended beneficiaries.
- In some countries undertaking structural adjustment, political support for reforming social safety nets has been insufficient, leading to the persistence of untargeted safety nets.
- The weakening of the revenue base for financing social benefits has limited the ability of some transition countries to provide adequate social benefits.

Future Challenges

The IMF's policy advice to member countries is centered on ensuring a sustainable macroeconomic framework that creates the conditions for growth and the reduction of poverty. Further research is needed on the linkages between social expenditures and social output indicators to provide guidance for better targeting of social expenditures. Programs can be strengthened by following up more systematically on the effectiveness of social safety nets and by improved monitoring of the composition of expenditures. The increased emphasis on second-generation reforms to foster high-quality growth will likely have an even greater impact on the poor than in the past, which underscores the need for more work in this area.

Delineating Fiscal Responsibilities

Chinese Reforms Seek to Balance Revenue and Decentralization Goals

Ideally, fiscal decentralization promotes economic efficiency and budgetary discipline, but it does so best when certain conditions are in place—notably a clear and relatively stringent delineation of central and local government responsibilities. In a recent IMF Working Paper, *Intergovernmental Fiscal Relations: The Chinese System in Perspective,* authors Vivek B. Arora and John Norregaard examine the evolution of this relationship in China. The country's fiscal decentralization accelerated between 1978 and 1994, with local governments assuming greater control over taxation and with bargaining increasingly characterizing fiscal relations between central and local governments.

In the absence of clearly assigned revenue and expenditure responsibilities, China's fiscal decentralization has tended to spur the growth of off-budget activities and to constrain the central government's ability to use fiscal policy as a tool in furthering macroeconomic stability. Fundamental fiscal reform in 1994 addressed revenue concerns and succeeded in substantially raising—at least initially—central government revenue. Related reforms in expenditures and transfers—and the buoyancy of central government revenues—remain to be undertaken, however.

Decentralization in China

Alongside its rapid growth and transformation to a market economy after 1978, China experienced a steady evolution in its intergovernmental relations and a growing fiscal decentralization—most markedly on the revenue side. Before 1994, China had no centralized tax administration system. Local authorities carried out tax collection, with revenue distribution effected through an elaborate, and negotiated, system of revenue sharing.

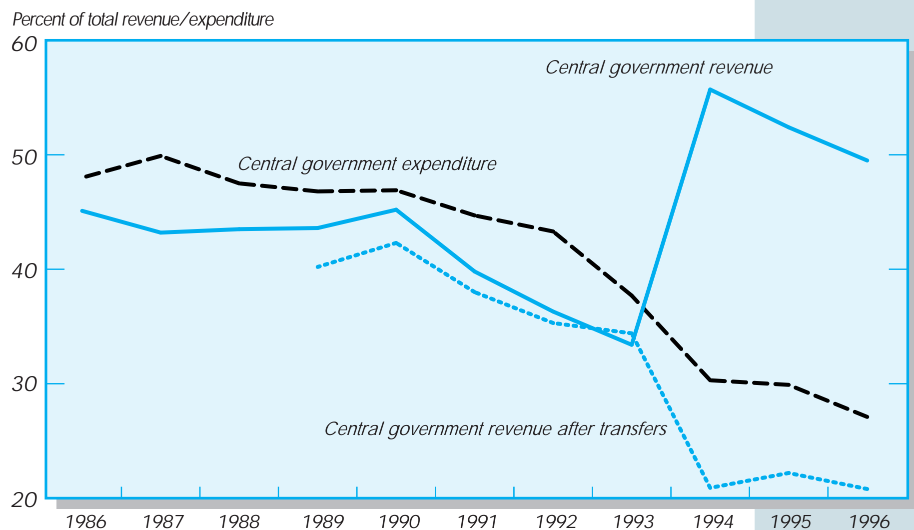
Expenditure responsibilities were not similarly decentralized. The central government assumed authority for capital outlays, national defense, and government debt servicing. And although local governments were responsible for social welfare, administration, agricultural development, and budgetary subsidies, the central government retained the authority to assign additional expenditure responsibilities. A key by-product of revenue decentralization and unpredictable expenditure responsibilities was a sharp increase in the growth of extrabudgetary funds. These off-budget funds largely comprised the retained earnings of local state-owned enterprises, public utilities surcharges, public housing rental fees, and ad hoc and social funds. Their size rose steadily in relation to budgeted funds. In 1992, for example, off-budget funds accounted for nearly 100 percent of revenues and 80 percent of expenditures.

The resulting system of intergovernmental relationships, the authors emphasize, was complex, heavily reliant on contracts, insufficiently supportive of macroeconomic stability, and sometimes the unwitting sponsor of perverse incentives to local governments. More specifically, the system prior to 1994 tended to:

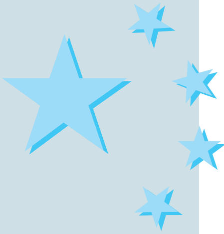
• *Undercut macroeconomic stability.* In periods of economic expansion, increased local revenues tended to promote increased expenditures rather than budgetary surpluses, since surpluses simply triggered larger remittances to the central government.

• *Weaken the central government's control over fiscal policy.* Contractual arrangements that required localities that performed well to remit more revenues to the central government encouraged local governments to shift their collection efforts away from shared revenue to revenue that would remain under local control. Tax concessions, exemptions, and refunds allowed local authorities to substantially raise the retained earnings of state-owned enterprises under their jurisdiction. The resultant loss in central government revenues con-

China: Central Government Revenue and Expenditure Shares



Data: IMF, *Intergovernmental Fiscal Relations: The Chinese System in Perspective* and *China Statistical Yearbook* (various issues)



strained the use of fiscal policy to maintain macroeconomic stability.

• *Leave regional fiscal disparities unaddressed.* A central government with weak revenues was effectively unable to transfer resources to ameliorate growing regional disparities.

• *Introduce inefficiencies in resource allocation.* The interest that local governments took in expanding local state-owned enterprises—and in expanding retained earnings—ultimately also encouraged regional protectionism. Governments adopted measures to protect these enterprises from competition. This regional protectionism also spawned inappropriate investments and the misallocation of resources.

1994 Reform and After

As part of its sweeping fiscal reforms in 1994, China crafted a transparent delineation of revenue sources for its central and local governments and for the first time established a National Tax Service to assume national tax-collection responsibilities. The reforms were designed to raise the central government's share of tax revenues (to about 60 percent over the medium term), strengthen the central government's ability to use fiscal policy as a macroeconomic tool, reduce regional disparities, and enhance the fiscal discipline of all levels of government. Under the new arrangements, taxes were classified as local, central, and shared. All were fixed, and not subject to bargaining. Local taxes were henceforth to be collected by local authorities, and central and shared taxes were to be collected by the new National Tax Service.

What did not change were expenditure and transfer arrangements. The central government's share remained around 40 percent of total expenditure, with the central government now expected to run a surplus. This surplus, in turn, was expected to provide the means to extend equalizing grants that would be awarded to regions on the basis of objective criteria such as per capita GDP, population, infrastructure, and incidence of natural disasters. A 1995 reform clarified budgetary procedures, insisted that local and central budgets be formulated within a consistent macroeconomic framework, and required local governments to run balanced budgets or use surpluses and extrabudgetary funds to finance deficits.

But after an initial boost that substantially raised its share of total revenue, central government revenues again began to decline relative to local government revenue. Local government resources, which relied on business and personal income taxes, proved more buoyant. The value-added tax—the chief revenue source for the central government, lost momentum. Off-budget funds and operations again escalated, prompting central government efforts to repeal unauthorized funds and fees and integrate extrabudgetary funds into the budgetary process.

China views its reform process as ongoing. The 1994 reforms principally addressed revenue needs and improved the central government's revenue position over previous years. But as the country continues to grow, the adequacy of central government revenues remains key to maintaining macroeconomic stability and addressing domestic issues, such as the economic disparities between inland and coastal regions. In the area of intergovernmental relations, important issues remain to be addressed, including:

Issues in Decentralization

An important and perhaps overriding reason for countries to embark on fiscal decentralization is to improve economic efficiency and budget discipline. Success in achieving these goals is often rooted in the ability to clearly assign revenues, expenditures, and transfers to the various levels of government in a rational, predictable, and enforceable manner. If the benefits are chiefly local—for example, for street lighting—it is both efficient and politically prudent to collect revenues and expend resources locally for that public good. Policies with national ramifications, such as macroeconomic stability or redistributive functions, are by extension best carried out by central governments.

In a decentralized fiscal system, it is essential for a central government to retain taxing powers consistent with its macroeconomic responsibilities. Lower levels of government should have well-defined authority to set tax rates, Arora and Norregaard note, but should not have the power to define tax bases. Ideally, local taxes should also not rely on a tax base that is mobile or unevenly distributed across jurisdictions. The impact of local taxes should be tangible at the local level, and their level should be sufficient to meet local needs. Property taxes and sales and excise taxes on the final sale to a consumer are typically best assigned to local governments, while payroll taxes, as well as value-added and corporate taxes, are better assigned to the central level.

Transfers of resources between levels of government are the third part of the fiscal equation. They function as levelers, ensuring that all local governments have, Arora and Norregaard observe, "equal opportunities to provide their constituencies with public services at a comparable tax price." Regional or local differences thus become a matter of preferences, not of factors beyond their control, such as income disparities or demographics. At their most effective, transfers are allocated according to well-defined formulas based on objective factors and are predictable, so that local governments can develop reasonable medium-term budgets. Ideally, transfers also do not provide perverse incentives and do, in fact, encourage sound management and balanced or surplus budgets.

• *Legal framework for subnational governmental activities.* The autonomy of local governments, particularly with regard to expenditure responsibilities, needs to be clearly and definitively delineated.

• *Extrabudgetary funds and operations.* Several of these continue to operate outside official budgets, complicating fiscal management and limiting the transparency of fiscal accounts.

• *Transfers.* Largely untouched by the 1994 reforms, transfers still contain elements of bargaining and unpredictability. China intends to reconfigure its transfer system toward equalization grants based on objective criteria.

• *Buoyancy of central government revenues.* While the 1994 reforms boosted revenue performance over previous years, the buoyancy of central government revenues remains relatively low. The authorities are attempting to strengthen these revenues by scaling back tax concessions. ■

Copies of IMF Working Paper 97/129, *Intergovernmental Fiscal Relations: The Chinese System in Perspective,* by Vivek B. Arora and John Norregaard, are available for $7.00 from IMF Publication Services.

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From the Executive Board

Following are excerpts of a recent IMF press release. The full text is available on the IMF's web site (http://www.imf.org/external/news.htm) or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Tanzania: ESAF

The IMF approved the second annual loan under the Enhanced Structural Adjustment Facility (ESAF), in an amount equivalent to SDR 71.4 million (about $97 million), to support Tanzania's economic program for 1997/98. The initial amount of SDR 51.41 million (about $69.8 million) has been increased by SDR 20 million (about $27.17 million) to assist Tanzania in dealing with the effects of drought. The loan is available in two equal semiannual installments, the first of which can be drawn on December 19, 1997. The three-year ESAF credit, equivalent to SDR 161.6 million (about $220 million) was approved on November 8, 1996 (see Press Release No. 96/55, *IMF Survey*, November 25, 1996).

Program for 1997/98

The key macroeconomic objectives of the 1997/98 program that the ESAF loan supports are to achieve a real GDP growth rate of 4.7 percent; reduce the inflation rate to no more than 13 percent; and limit the external current account deficit, excluding official transfers, to 14.4 percent of GDP. To achieve these objectives, fiscal policy targets a surplus on the current government budget of 1.1 percent of GDP (excluding grants and development expenditures), reflecting the rationalization of the structure of both revenues and expenditures. Preparations are under way for the introduction of a value-added tax in July 1998. Monetary policy under the program will be consistent with achieving the program's inflation and balance of payments objectives.

Structural Reforms

The government is continuing with reforms of the banking and the parastatal sectors, and with civil service reform. The scope of privatization has been widened to include the utilities and other core parastatals, and its pace is being accelerated.

Addressing Social Needs

Key steps being taken to strengthen the delivery of health and education services are devolution to local authorities to enhance community involvement, and a shift in resources to meet basic requirements, such as primary education and preventive health services. In addition, a National Poverty Eradication Strategy is also being drawn up.

Tanzania joined the IMF on September 10, 1962, and its quota is SDR 146.9 million (about $200 million). Its outstanding use of IMF financing currently totals SDR 150 million (about $204 million).

Press Release No. 97/54, December 4

Tanzania: Selected Economic Indicators

	1994/95	1995/96	1996/97	1997/98[1]	1998/99[1]
			(percent change)		
Real GDP	2.6	4.1	3.9	4.7	5.7
Consumer prices (annual average)	34.0	25.7	17.1	13.0	7.8
			(percent of GDP)		
Overall fiscal balance (including grants and development expenditures)	–3.9	–2.2	2.3	0.5	0.2
External current account balance (excluding official transfers)	–24.4	–16.0	–12.4	–14.4	–12.1
			(months of imports)		
Gross official reserves	1.6	1.4	2.6	2.9	3.7

[1] Projections.

Data: Tanzanian authorities and IMF staff estimates and projections

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
December 1	4.32	4.32	4.73
December 8	4.39	4.39	4.81

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

Members' Use of IMF Credit
(million SDRs)

	November 1997	Jan.–Nov. 1997	Jan.–Nov. 1996
General Resources Account	2,219.30	7,099.60	4,786.97
Stand-By Arrangements	2,210.30	4,270.94[1]	2,241.48
EFF Arrangements	9.00	2,721.05	2,370.88
CCFF	0.00	107.60	174.62
SAF and ESAF Arrangements	186.91	637.72	576.45
Total	**2,406.21**	**7,737.32[1]**	**5,363.42**

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.

[1]Reflects revised data from September.
Data: IMF Treasurer's Department

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:

Ghana No. 97/36, December 1

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

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			**12,839.90**	**8,443.85**
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
Indonesia	November 5, 1997	November 4, 2000	7,338.24	5,136.77
Latvia	October 10, 1996	April 9, 1999	33.00	33.00
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			**10,926.90**	**5,609.84**
Algeria	May 22, 1995	May 21, 1998	1,169.28	253.28
Azerbaijan	December 20, 1996	December 19, 1999	58.50	35.10
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
Moldova	May 20, 1996	May 19, 1999	135.00	97.50
Pakistan	October 20, 1997	October 19, 2000	454.92	417.01
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
Yemen	October 29, 1997	October 28, 2000	105.90	96.90
ESAF Arrangements			**4,189.23**	**2,164.58**
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	73.73
Georgia	February 28, 1996	February 27, 1999	166.50	55.50
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	36.37
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
Pakistan	October 20, 1997	October 19, 2000	682.38	568.65
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	November 10,1997	November 9, 2000	100.43	80.34
Yemen	October 29, 1997	October 28, 2000	264.75	220.75
Zambia	December 6, 1995	December 5, 1998	701.68	40.00
Total			**27,956.03**	**16,218.26**

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

Data: IMF Treasurer's Department

The IMF's financing is provided through both its general resources and its concessional financing facilities.

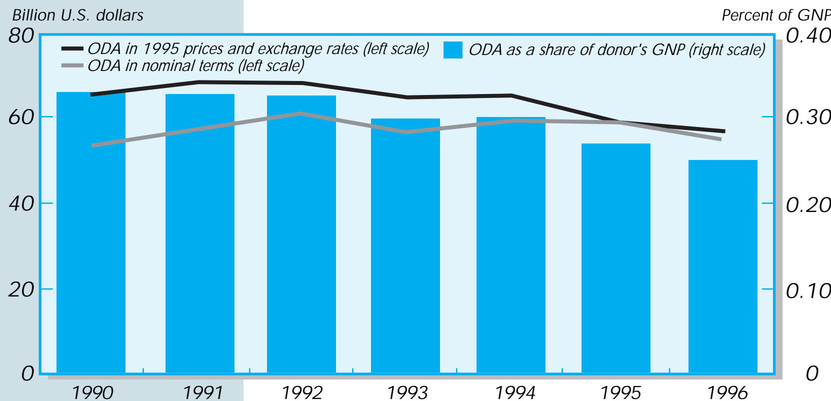
Financing for Developing Countries in 1996

Total Capital Flows Reach Record Levels, But Official Component Declines in Real Terms

Capital flows to developing countries surged to over $250 billion in 1996 from about $100 billion in 1990 and, in real terms, private flows are estimated to be higher now than at their previous peak in 1981. A sharp increase in private capital flows to emerging markets in Asia and Latin America and reforming transition economies in Eastern Europe—largely in the form of foreign direct investment—accounts for most of the growth in overall capital flows to developing countries. In contrast, official development finance—two-thirds of which is bilateral official development assistance in the form of concessional loans and grants—dropped by nearly 17 percent in real terms between 1990 and 1996, to its lowest level since 1980.

As pointed out by a staff team from the IMF's Policy Development and Review Department in *Official Financing for Developing Countries,* the recent decline in official development finance reflects fiscal consolidation and aid fatigue in many countries providing such resources, as well as competing demands from transition countries.

Official Development Assistance: Net Disbursements



Data: IMF, *Official Financing for Developing Countries* (1998, forthcoming)

Official Financing

Official Development Finance. Total official flows to developing countries excluding officially supported export credits (the latter are regarded as primarily trade-promoting rather than development-oriented). Comprises official development assistance and other official development finance flows.

Official Development Assistance. As defined by the Organization for Economic Cooperation and Development (OECD), flows of official financing meet the following criteria:

- its main objective is to promote the economic development and welfare of the developing countries, and
- it is concessional in character and contains a grant element of at least 25 percent (using a fixed discount rate of 10 percent).

Other Official Development Finance. Development-oriented official flows that do not qualify as official development assistance. Bilateral "other" official development finance includes mainly refinancing loans and the capitalization of interest in debt-restructuring agreements.

Strong Performance Attracts Capital

On a broader scale, the pattern of global capital flows reflects divergent economic trends that have emerged in the developing world, note the authors. The more developed countries have, for the most part, been able to integrate into global economic and financial markets, thereby gaining access to private capital markets. Other parts of the developing world have, however, made less progress in improving their policy environment and have yet to implement comprehensive reform strategies. Such countries, including many of the poorest countries in Africa, have little, if any, access to private flows and continue to rely on official sources of development finance.

This growing dependence has, however, been met with a weakening development assistance effort (see chart, this page), and there is little prospect of an early recovery in such flows. Furthermore, creditors have been providing development assistance more selectively based on countries' policy performance, poverty reduction, and social objectives. In 1996, for example, members of the OECD Development Assistance Committee adopted an ambitious strategy to focus their resources better on countries that undertake reform efforts. This strategy includes, for the first time, quantitative objectives for poverty alleviation, social development, and environmental sustainability, against which the success of development cooperation is to be measured.

Middle-income countries have attracted virtually all private capital flows in the 1990s, with the exception of sizable private flows to China and India. Most low-income countries—especially the heavily indebted poor countries (HIPCs)—have over the last 10–15 years become more dependent on official financing, including debt rescheduling. Only a few low-income countries—such as China and India—have avoided debt rescheduling and have been able to maintain access to private capital inflows. In light of the limited debt-servicing capacity of many low-income countries,

net bilateral loan disbursements to these countries have fallen to very low levels, and bilateral flows are often provided in the form of grants. Thus, multilateral institutions have become the main source of loan finance for most low-income countries, and they, too, have been lending on increasingly concessional terms.

Multilateral Lending Is Increasingly Concessional

Total multilateral lending to all developing countries fell in 1996 to a gross of $42 billion, after reaching a record high level of gross $60 billion in 1995, which reflected exceptionally large IMF lending in support of Mexico and Russia. After growing steadily over the last decade, multilateral lending to all developing countries—in gross terms—has reached nearly double the size of official bilateral lending. As noted above, for low-income countries, and HIPCs in particular, multilateral flows have become the largest source of public borrowing in net terms, while middle-income countries have increasingly been relying on borrowing from private sources. Nonetheless, middle-income countries received about half of net multilateral disbursements in 1996. Concessional lending increased to close to 28 percent of gross multilateral disbursements to all developing countries in 1996. For the HIPCs, over 80 percent of gross disbursements were on concessional terms in 1996, and concessional resources have been used to repay nonconcessional debt in the 1990s. As a result, the multilateral debt-service ratio of developing countries declined gradually from 4½ percent of exports in the first half of the 1990s to 3 percent in 1996—for the HIPCs, from 8½ percent to 7 percent (see chart, this page). Recent changes in the regional allocation of multilateral flows reflected the exceptional lending patterns of 1995, the authors note. Over the past decade, lending to transition economies in Eastern Europe surged, while the share of loans to countries in Latin America and South Asia fell sharply, reflecting both their increasing access to financial markets and recent net payments from India to the IMF.

The share of multilateral debt in the total debt of developing countries increased modestly by 3 percentage points during the first half of the 1990s to reach 26 percent at the end of 1996. For the HIPCs, the share reached 34 percent at the end of 1996, up from 26 percent at the end of 1990, reflecting in part continued support from multilaterals; bilateral debt forgiveness—particularly of official development assistance claims; increasing use by bilaterals of grant (rather than loan) finance; and a withdrawal by private creditors. In contrast, for middle-income countries, the share of multilateral debt remained largely unchanged at about 20 percent during the first half of the 1990s. For all developing countries, the share of concessional debt in total multilateral debt has risen by 6 percentage points over the past decade to reach 36 percent at the end of 1996; for the HIPCs, the share has risen from less than one-half to more than three-fourths over the same period.

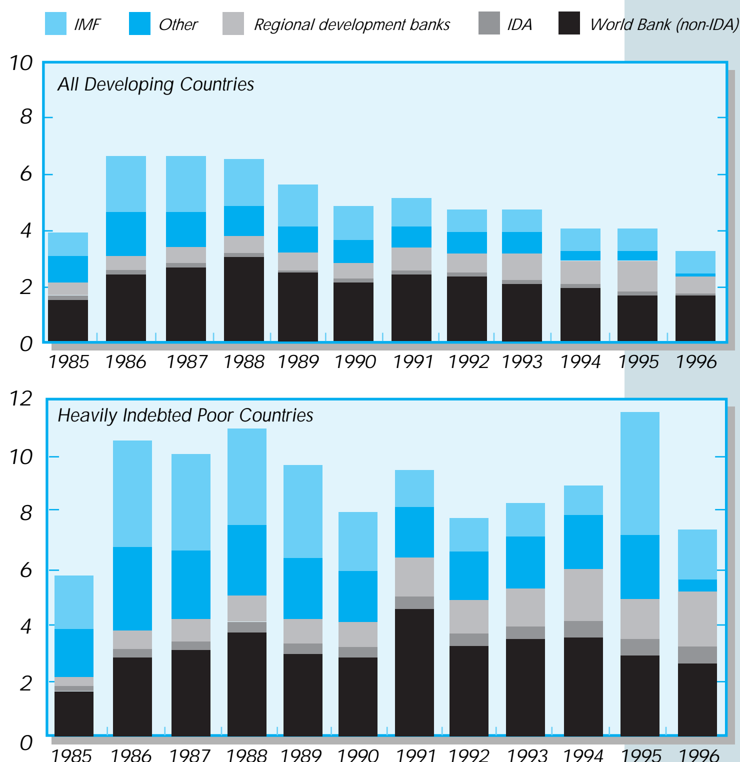
Export Credits Decline Marginally

Official bilateral support in the form of export credit represents a large share of the external debt of developing countries and economies in transition, accounting for more than 24 percent of their total indebtedness in 1996. For several countries—including Algeria, Islamic Republic of Iran, and Nigeria—export credits have been the main source of foreign finance in the past, representing about two-thirds or more of their external debt. For other countries with a more diversified base of foreign financing—such as Brazil, India, and Mexico—exports credits represented less than 20 percent of their external debts.

Export credit flows are highly concentrated in countries with positive market assessments—the top 10 countries received 66 percent of new commitments in 1996 (see chart, page 404). While six Asian economies (China, Hong Kong Special Administrative Region, Indonesia, Malaysia, Philippines, and Thailand) continued to receive

Developing Countries: Debt-Service Payments on Multilateral Debt[1]

(percent of exports of goods and services)



[1]Figures for 1996 are provisional.

Data: World Bank Debtor Reporting System; IMF, Treasurer's Department

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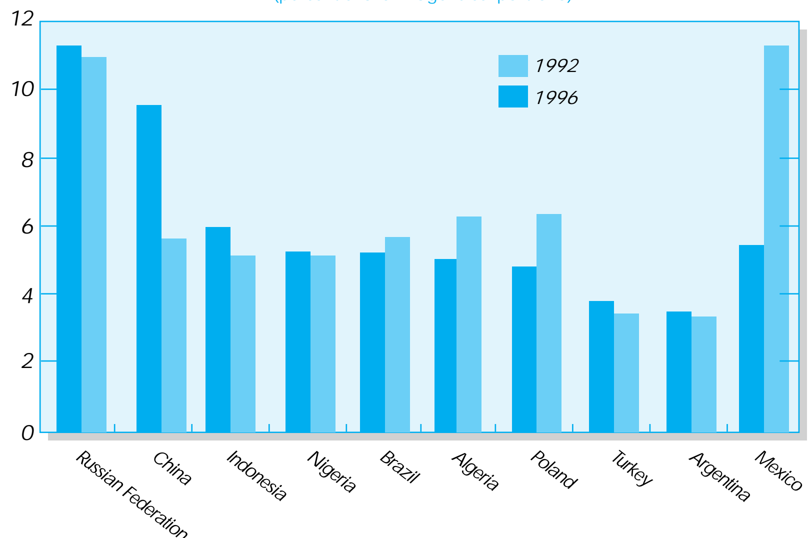
the bulk of new export commitments in 1996, all but Hong Kong Special Administrative Region showed substantial decreases from 1995. In general, the slower growth in new export credit commitments represented some slowing down of project financing, and in part, growing concerns about macroeconomic imbalances in some Asian countries and the ability of the debtor countries to assimilate previous amounts of export finance. Nonetheless, new commitments to some countries increased in 1996, particularly to South Africa, which accounted for less than 2 percent of agencies' existing exposure, but received over 7 percent of all new commitments in 1996 following the strengthening of economic performance in the 1995.



Data: Berne Union, and IMF staff estimates

HIPC Initiative Is Integral to Debt Relief

The international community has recognized the heavy debt burden of low-income countries as a solvency, rather than a liquidity, problem. Bilateral creditors have rescheduled the debts of low-income countries on increasingly concessional terms since late 1988, and the reduction granted in the net present value of rescheduled debt has reached as high as 67 percent since the end of 1994. Commercial creditors have also restructured their claims on many developing countries, often through debt buybacks at high discounts, especially for the poorest countries. These mechanisms have already allowed, or are expected to allow, most countries to resolve their external debt problems and graduate from the rescheduling process.

For a number of countries, however, such traditional debt-relief mechanisms are not enough—even if the countries undertake strong reform policies—to make their external debt burdens sustainable. To assist these countries, the HIPC Initiative was adopted in the fall of 1996 on the basis of joint proposals by the IMF and the World Bank (see *IMF Survey*, January 27, page 20). It is designed to assist eligible HIPCs to lower their external public debt to sustainable levels through concerted action by all creditors, including, for the first time, multilateral creditors, after these countries have established a strong track record of adjustment and reform. The HIPC Initiative thus completes the array of instruments available to the international financial community for dealing with the debt problems of low-income countries. It allows those countries that pursue appropriate adjustment and reform policies to exit from the rescheduling process and should eliminate external debt as an impediment to economic development and growth, thereby enabling HIPC governments to focus on the difficult policies and reforms necessary to achieve sustainable development.

The dichotomy between middle- and low-income countries is clear in terms of their debt-restructuring status. Most middle-income countries have already exited from the Paris Club rescheduling process or are expected to graduate after the end of their current consolidation periods. In contrast, less than one-fourth of low-income countries have exited—although their number has doubled over the last two years. All low-income rescheduling countries over the last two years have received Naples terms for relief, involving a 67 percent debt reduction (except for Cameroon, Guinea, and Honduras, where the net present value reduction was 50 percent; also, Ghana requested only a limited nonconcessional deferral of certain arrears). Six countries—Benin, Bolivia, Burkina Faso, Guyana, Mali, and Uganda—have received comprehensive stock-of-debt operations, all involving a 67 percent net present value debt reduction, and 13 other countries have received flow rescheduling over the last two years. These measures, combined with the HIPC Initiative, enhance these countries' prospects for exiting from the rescheduling process. ■

The next issue of the *IMF Survey* will be published on January 12, 1998.

Official Financing for Developing Countries, by a staff team led by Anthony Boote, Division Chief, and Doris Ross, Deputy Division Chief, of the Official Financing Operations Division of the IMF's Policy Development and Review Department, is part of the IMF's World Economic and Financial Surveys series. Copies will be available in February and may be purchased for $20.00 (academic rate: $12.00) each from IMF Publication Services.