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World Economic Outlook, Capital Markets Update

Growth Projections for 1999 Revised Downward, But Global Economic Situation Is Stabilizing

In view of the significant events affecting world capital markets and the global economy during much of August–November 1998, the IMF staff's projections for world growth in 1999 have been revised downward—although not substantially—to 2¼ percent in 1999 from the projections in the October 1998 *World Economic Outlook* of 2½ percent in 1999. (For 1998, the estimated growth has been revised up slightly.) These new projections, contained in an interim joint update of the IMF's latest regular reports on the *World Economic Outlook* (see *IMF Survey*, October 19, 1998, page 305) and *International Capital Markets* (see *IMF Survey*, September 28, 1998, page 290), underscore the continuing costs of the Asian crisis, its repercussions, and the crises that afflicted financial markets in 1998.

Describing the revised projections in a press briefing held on December 21, Michael Mussa, IMF Economic Counsellor and Director of the Research Department, said that the most serious downside risks to the global economy (Please turn to the following page)

IMF Research Department Director Michael Mussa (right) at press briefing, together with Flemming Larsen, Deputy Director of the Research Department.

EMU and the IMF

Camdessus Welcomes Successful Euro Launch; SDR Baskets Are Revised

The euro, a common currency for the 11 member countries of European Economic and Monetary Union (EMU), was launched on January 1, 1999. On January 6, IMF Managing Director Michel Camdessus welcomed the launch in a statement to the IMF's Executive Board. In anticipation of the introduction of the euro, the IMF, on December 31, 1998, announced the incorporation of the euro into its SDR valuation and interest rate baskets. On December 22, 1998, the IMF granted observer status to the European Central Bank (ECB). The text of Camdessus's remarks to the Board and other developments relating to the euro follow.

I would like to begin this, our first meeting of 1999, by welcoming the successful launch of the euro. This is an historic event—for Europe and for the international monetary system. I would like to congratulate our European colleagues on this collective achievement. Let me share some thoughts with you from the twin perspectives of Europe and the international monetary system.

First, the launch itself has been strikingly smooth. This is testament, indeed, to the vision, professionalism, and dedication of all those involved at both the EU [European Union] and national levels. It has also been a model of cooperation and partnership between public and private sectors.

The foundation for this success has, of course, been created by the impressive strengthening of macroeconomic policies in Europe in recent years. In crafting and implementing its monetary policy, the European System of Central Banks (ESCB) will be able to capitalize on the hard-won credibility earned by its member central banks. No less important is the stability-oriented framework established by the Maastricht Treaty and the Stability and Growth Pact. These (Continued on page 5)

Update on Capital Markets and Global Economy

(Continued from front page) that emerged as a result of the turbulence in global financial markets now seem to have subsided, and the relatively modest scale of the downward revisions to the global growth outlook since early September suggests that the situation may have begun to stabilize.

In addition to reassessing and updating the *World Economic Outlook*, the interim assessment sheds light on the sources and nature of the turbulence experienced in both mature and emerging financial markets and seeks to identify critical shortcomings in private and public risk-management systems.

Flemming Larsen. We certainly do not believe that we are completely out of the woods.

Projections and Risks

The effective devaluation and unilateral debt restructuring announced by Russia in mid-August triggered a series of sharp market corrections, Mussa explained at the press briefing. The tension and turbulence that developed in several financial markets initially forced a widening of interest rate spreads and cut off new credit flows to emerging market borrowers.

The turbulence then spread to the deepest and most liquid of the world's financial markets, producing sharp declines in industrial country equity prices, unusual volatility in the yields of highest-grade government debt, a general rush to safety and a drying up of liquidity, and sharp movements in key exchange rates. These developments, Mussa said, led the IMF staff to further revise their projections for world growth downward.

The interim assessment suggests that, despite the downward revisions in growth projections, the danger of a worldwide recession appears to have diminished. Conditions in financial markets have calmed down since early October, Mussa said, thanks in part to timely actions by monetary authorities in North America, Europe, and Asia to ease monetary conditions. In addition, the Asian economies most caught up in the recent crisis—notably, Korea and Thailand—are making substantial progress with their stabilization and reform efforts, as evidenced by the strengthening of their exchange rates and equity markets. Also, Brazil, with substantial support from the international community, has undertaken a forceful program to correct its chronic fiscal imbalances and thereby help stabilize its own economy and halt the spread of contagion (see *IMF Survey*, December 14, 1998, page 385).

Because of the calming in financial markets and the actions that helped bring it about, Mussa said, the IMF staff's assessment of the near-term prospects for the world economy are actually "little changed from the way we saw things in early September" when the previous *World Economic Outlook* draft was put together. Indeed, he said, the forecast for world growth in 1998 has been revised up ²⁄₁₀ of 1 percentage point, while that for 1999 has been revised down ³⁄₁₀ of 1 percentage point. The net change over the two years combined is thus only –¹⁄₁₀ of 1 percentage point.

A breakdown of the aggregate nevertheless reveals significant changes for individual countries, Mussa said. Among the industrial countries, most notably, the 1999 growth forecast for Japan has been revised down a full percentage point, standing now at –½ of 1 percent. Among the emerging market economies, the forecasts for Latin America have been revised down significantly, while that for China has been boosted somewhat.

As with any forecast, however, there are always risks, Mussa stressed, both on the upside—particularly in the United States where fourth-quarter growth may be stronger than forecast and in Asia where there is potential for a more rapid recovery than projected in the interim assessment—and on the downside—such as in Latin America, where the risks are still "modestly on the downside."

Revisions to World Growth Projections

World Economic Outlook	1997	1998	1999	2000
	(percent change in world real GDP)			
October 1997	4.2	4.3	4.4	4.6
December 1997	4.1	3.5	4.1	4.4
May 1998	4.1	3.1	3.7	3.8
October 1998	4.1	2.0	2.5	3.7
December 1998	4.2	2.2	2.2	3.5

Data: *World Economic Outlook and International Capital Markets: Interim Assessment*, December 1998

The "key message in the report is that the worst of this crisis is now behind us," Flemming Larsen, Deputy Director of the Research Department, said at the press briefing. He warned, however, that this judgment comes with "considerable caveats," and "we certainly do not believe that we are completely out of the woods." A number of risks and uncertainties remain, Larsen said:

• The speed of recovery of private capital flows to emerging markets may not be quite as rapid as assumed in the interim report's projections.

• The speed of recovery in Japan, which is dependent upon the implementation of necessary measures to stimu-

late the economy and speed up the restructuring and recapitalization of the banking system, is a key uncertainty.

• The uneven pattern of trade adjustment in the wake of large shifts to surpluses in the Asian crisis countries has given rise to concerns about the sustainability of the corresponding very large U.S. current account deficit, as well as about a resurgence in protectionist pressures.

• The strong recovery of stock markets, especially in the United States, may not be sustainable. The sustainability of the large imbalance that has built up in recent years between private saving and investment in the United States is a further cause for concern.

In response to questions about the significant downward revision for Japan despite the government's recent announcement of measures to help the economy, Larsen said that the downward revisions to the projections would have been even larger in the absence of the recent policy announcements. The current projection reflects very recent events, including the sharp appreciation of the yen in September, which has had a depressing influence on the economy and will require stronger domestic demand growth to offset it. On the plus side, the newly announced budget may well produce a different assessment of the fiscal stance, although it is still too early to say. A number of other measures are in the works, Larsen added, that could get the Japanese economy restarted during 1999.

Explaining the revisions in prospects for Latin America, Larsen said they reflected several factors, including international trade linkages, the projected slowdown in growth in the United States, and higher rates of interest and reduced availability of foreign financial flows. Although interest rates have come down significantly since September 1998, Larsen said, they remain much higher than they were before the Russian crisis in August. Recent developments in commodity prices, including oil markets, are also likely to have a depressing effect on domestic demand and the level of imports that can be sustained in several Latin American countries.

Sources of Turbulence

The recent turbulence in global financial markets was unusual for a period characterized by relatively strong macroeconomic policies and conditions in many of the advanced economies, including, in particular, the United States, the interim assessment notes. The volatility reflected a sudden heightened perception of, and aversion to, risk following Russia's effective debt default in August and an associated flight to quality. Emerging markets were particularly affected, but the repercussions were not limited to these countries. The global flight to quality led to sharp increases in spreads on financial assets in some of the deepest capital markets in the world, especially in the United States, and to sharp volatility in the dollar-yen exchange rate.

The extraordinarily high degree of turbulence experienced in financial markets, Mussa said at the press briefing, appeared to be substantially out of proportion with the magnitude of the triggering events—the Russian crisis and the near-collapse and last-minute bailout of Long-Term Capital Management, a major U.S. hedge fund. This mismatch between apparent cause and effect is not only a mystery but a serious cause for concern, Mussa said. The massive turbulence in markets apparently grounded in sound fundamentals raises questions about the working and design of financial markets—questions about transparency, the internal risk management and control procedures of some of the largest internationally active financial institutions, and the adequacy of prudential supervision and systemic financial market surveillance.

Michael Mussa. The degree of turbulence in financial markets appeared out of proportion with the triggering events.

Charles Adams, Assistant Director in the Research Department, speaking at the press conference, mentioned that in the process of compiling the interim report, the IMF staff looked at the nature and sources of the turbulence to see what lessons could be drawn about policies and actions that could minimize the risk of future turbulence. For several years before the Asian crisis, there had been a repricing of risks, a narrowing of spreads, and, during 1998, a buildup of vulnerabilities—that is, a lot of positions based on risk spreads remaining low or continuing to narrow. The events in Russia triggered a global reassessment of the value of risk, Adams said, which set in motion a chain reaction of portfolio rebalancing and changing of positions that was exacerbated by a high degree of leverage in the system. Looking at the events in a broader context, Adams said, "we have identified serious shortcomings in three main lines of defense": private risk-management schemes of individual financial institutions, prudential oversight, and financial market supervision. "These systems," he said, "failed to prevent a buildup in leveraged positions, which crumbled after the Russian default, giving rise to the subsequent bout of severe turbulence."

Charles Adams. The events in Russia triggered a global reassessment of the value of risk.

In response to a question about appropriate defense measures, Mussa said that private sector financial insti-

tutions need to take a look at their own risk assessment and management systems. The private sector needs to concern itself with how key financial institutions that lent money to hedge funds and other speculative investors are assessing and managing the risks they are undertaking in their various financial operations, he said. As for appropriate action on the supervision and regulation side, Mussa said the Basle Committee on Banking Supervision has been looking carefully at the issue of capital adequacy standards, especially as they relate to banks' growing off-balance-sheet activity, which accounts for an increasing slice of their total earnings. A key issue, Mussa said, is how the capital and other standards coming out of the Basle Committee can be adapted to deal with the changing structure of the business of modern, large, internationally active commercial banks.

Garry Schinasi. There is a trend toward looking at risk-management systems.

Garry Schinasi, Chief of the Capital Markets and Financial Studies Division, said that among the reforms under consideration by the Basle Committee was a shift from rules-based to risk-focused capital standards. There is also, he said, a more general trend toward looking at risk-management systems and operational controls rather than trying to monitor every risk that a bank takes.

Responding to Risks

The interim update marks the second consecutive year that global economic developments have warranted a public update of the semiannual *World Economic Outlook*. At the press conference, Mussa was asked if the IMF was concerned about its credibility, given its prediction in December 1997 that the three Asian countries most affected by financial crisis that had received IMF support for their programs would not suffer recessions. Yet, all three had experienced massive recessions in the past year. Mussa agreed that the IMF, as indeed virtually all other forecasters, had underestimated the severity of the downturn. This underscored, he said, the importance of focusing not only on the central forecast but also on the potential for different outcomes.

One important lesson from the presence of risk, Mussa said, is that policy is not inert in the face of emerging developments in economies and financial markets. "We have seen a forceful indication of that in the past three months." If there had been no policy response to the conditions that were developing in world financial markets in September and early October, Mussa concluded, "this interim assessment of the world economic outlook and capital market developments would look considerably darker than it does today." ■

The *World Economic Outlook and International Capital Markets: Interim Assessment,* December 1998, will be available in January 1999 for $36.00 (academic rate: $25.00) from IMF Publication Services. See page 15 for ordering information.

In the News . . .

Since the last issue of the *IMF Survey* dated December 14, 1998, the IMF has released several news briefs describing current actions and activities. Following are a listing and brief description of these news briefs. Full texts are available on the IMF's website (www.imf.org).

News Brief 98/51, December 14. **New Financial Support for Poorest Countries Neighboring Russia.** The IMF and the World Bank hosted a special financing meeting to mobilize additional balance of payments support for the poorest countries neighboring Russia that have been hardest hit by the Russian crisis.

News Brief 98/52, December 14. **IMF Completes Review and Approves $1.0 Billion Credit Tranche for Korea.** IMF Deputy Managing Director Alassane D. Ouattara announced that, in support of the government's economic program, the IMF Executive Board approved completion of the fourth quarterly review under the stand-by credit and the release of SDR 725 million (about $1.0 billion).

News Brief 98/53, December 15. **IMF Executive Board Completes Fifth Review of Kazakhstan's Economic Program: Next Loan Tranche Approved.** IMF Deputy Managing Director Shigemitsu Sugisaki announced that the IMF Executive Board approved completion of the fifth review of Kazakhstan's three-year credit with the IMF and the release of SDR 154.7 million (about $217 million).

News Brief 98/54, December 15. **IMF Completes Review and Approves $140 Million Credit Tranche for Thailand.** IMF Managing Director Michel Camdessus announced that the IMF Executive Board approved the completion of the fifth review under the stand-by credit for Thailand.

News Brief 98/55, December 15. **IMF Completes Review and Approves $957 Million Credit Tranche for Indonesia.** IMF Deputy Managing Director Alassane D. Ouattara announced that, in support of the Indonesian government's economic program, the IMF Executive Board approved the completion of the third review under the Extended Fund Facility and the release of the next SDR 684.3 million (about $957 million) credit tranche.

News Brief 98/56, December 18. **IMF Engages Consultants to Assess External Communications.** The IMF has selected Edelman Public Relations Worldwide, together with Wirthlin Worldwide, to offer recommendations for improving the ways the IMF communicates to the public.

Introduction of the Euro

(Continued from front page) auger well for a euro that will command confidence.

EMU is a milestone in European economic integration and the capstone of decades of effort to establish—this time irrevocably—exchange rate stability within continental Europe. But challenges remain to be addressed if EMU is to realize its full promise. In the fiscal area, the task of bringing budgets into balance or small surplus is not yet complete. However, it is in structural reform that the greatest strides now need to be made. Improving the working of labor and product markets, reforming public spending programs, and lightening the burden of taxation—these are the key to realizing Europe's full potential for lasting job creation and growth.

A successful EMU holds great promise for the world economy. It can play a key role in fostering an open and stable international economic system. Moreover, it will bring a broader and deeper European capital market offering new opportunities to savers and borrowers the world over. The launch of the euro also offers new scope for global cooperation. We at the IMF look forward to playing a full part in this process—in our surveillance of euro-area policies and more generally in providing a forum in which the members of the euro area and their international partners can work together in the interest of a well-functioning international monetary system—surely the key purpose of the IMF.

The IMF's Executive Board noted the historic character of the event and endorsed the views expressed by the Managing Director.

SDR Valuation and Interest Rate Baskets

Following is an edited version of Press Release No. 98/64, December 22, 1998.

The IMF has replaced the currency amounts of deutsche mark and French francs in the SDR valuation basket with equivalent amounts of euros, based on the fixed conversion rates between the euro and the deutsche mark and French franc announced by the European Council. The currencies of Japan, the United Kingdom, and the United States remain in the basket. Effective January 1, 1999, the date of introduction of the single currency in the 11 countries initially participating in the EMU, the value of the SDR will be the sum of the values of the following amounts of each currency:

Euro (France)	0.1239
Euro (Germany)	0.2280
Japanese yen	27.200
Pound sterling	0.1050
U.S. dollar	0.5821

The currency amounts in the SDR basket have been rounded in line with the principles set out in the guidelines for the calculation of currency amounts in the SDR basket established by the IMF's Executive Board. The value of the SDR in terms of currencies is the same today under both the existing (with deutsche mark and French franc) and revised (with euro) valuation baskets.

The financial instruments in the SDR interest rate basket—the market yield of three-month treasury bills for France, the United Kingdom, and the United States; the three-month interbank deposit rate for Germany; and the three-month rate on certificates of deposit in Japan—will remain unchanged, although the French and German instruments will be expressed in euros, effective January 1, 1999. The SDR interest rate is determined weekly as a weighted average of interest rates on these five instruments, with weights reflecting the values of the currency amounts shown above.

In line with the currently effective decision on the SDR valuation basket, the next revision of the SDR basket will take place not later than 2000, with any changes to take effect on January 1, 2001. The SDR interest rate basket will be revised at the same time.

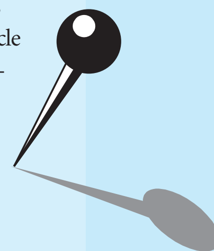
Further information on the SDR, its definition, valuation, interest rate, and exchange rates can be found on the IMF's Internet website (www.imf.org) under Fund Rates.

Observer Status

The IMF's Articles of Agreement extend membership solely to countries. The euro area is thus not able to appoint a Governor or appoint or elect Executive Directors to the IMF. On December 22, 1998, however, the IMF granted observer status to the ECB. Under this arrangement, the ECB will be invited to send a representative to Executive Board meetings on IMF surveillance over the common monetary and exchange rate policies of the euro area and over the policies of individual euro area members. The ECB representative will also be invited to attend Board discussions on the role of the euro in the international monetary system, the World Economic Outlook exercise, international capital markets reports, world economic and market developments, and other items recognized by the ECB and the IMF to be of mutual interest in the performance of their respective mandates. ■

Public Information Notices

Public 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



1998 **Colombia, No. 86, December 1**
Tajikistan, No. 87, December 21
Malawi, No. 88, December 30
1999 **Panama, No. 1, January 5**

Full texts are available on the IMF's worldwide website (www.imf.org/pins).

Fischer Address to Economic Forum

Frequency of Global Crises Highlights Need to Consider International Lender of Last Resort

Following is a summary of a paper given by IMF First Deputy Managing Director Stanley Fischer at the joint luncheon of the American Economic Association and the American Finance Association in New York on January 3. Mr. Fischer's views are his own and not necessarily those of the IMF. The full text is available on the IMF's website (www.imf.org).

Stanley Fischer

The frequency, virulence, and global spread of financial crises in emerging market countries in the last five years, coupled with the congressional debate in the United States over the increase in IMF quotas, have led to the most serious rethinking of the structure of the international financial system since the breakdown of the Bretton Woods system in 1971, Fischer said.

In the coming months and years, governments and international institutions will be putting in place a series of changes designed to strengthen the international financial system. The vision that underlies most proposals for reform of the international financial system is that the international capital markets should operate at least as well as the better domestic capital markets. To say this is to drive home the point that volatility and contagion cannot be banished, but we can surely do better in reducing the frequency and intensity of emerging market financial crises and the extent of contagion than we have in the last five years. It is urgent to start developing and implementing solutions.

Fischer began by reviewing the widely accepted case for a lender of last resort in the domestic economy and noted that the lender of last resort is not necessarily the central bank. He suggested that the international system also needs a lender of last resort and that the IMF, although it is not an international central bank, has undertaken certain important lender-of-last-resort functions, generally acting in concert with other official agencies. He concluded that this role can be made more effective in the context of some of the important reforms of the international financial system now under consideration.

Domestic Lender of Last Resort

The lender-of-last-resort role of the central bank is associated with the prevention and mitigation of financial crises—a sudden or potential breakdown of an important part of the credit system. These crises are associated with a loss of confidence in the standing of some financial institutions or assets and can spread rapidly through the financial system; if unchecked, they can have significant effects on the real economy.

The lender of last resort serves at least two functions: the crisis lender, which provides the financing to deal with a crisis; and the crisis manager, which assumes the responsibility for dealing with a crisis or a potential crisis. The central bank generally, but not always, carries out both functions. In a modern system, with a flexible exchange rate, the central bank is best placed to operate as lender of last resort, because it can create liquidity as needed. But this is not an essential prerequisite for a lender of last resort, particularly one acting as a crisis manager. It is possible, Fischer suggests, to set up an agency to deal with potential banking sector problems and endow it with sufficient funds to cover the anticipated costs of normal crises.

A well-functioning lender of last resort follows several guiding principles, many of them enumerated by the nineteenth-century U.K. economist Walter Bagehot. Fischer outlined these principles.

- The lender of last resort should always lend against collateral, and the test should be whether the collateral is good in normal (that is, noncrisis) times. The availability of collateral is a rough but robust test of whether the institution in trouble is likely to be solvent in normal times.
- A penalty rate is needed to limit the demand for credit by institutions that are not in trouble.
- The lender of last resort may, on occasion, have to lend to individual institutions, rather than only to the market, given the externalities that can follow from the failure of a large institution and the inherent uncertainties in the midst of a panic over market conditions following the panic.
- Although the lender of last resort will never be able to spell out precisely the circumstances under which it will fulfill its two functions, it should specify the general principles on which it will act.

As is the case with any insurance, last-resort lending creates the risk of moral hazard. According to Fischer, in the domestic economy, three weapons can be used to counter potential moral hazard: official regulation; encouragement for private sector monitoring and self-regulation; and imposition of costs on those who make mistakes, including, when appropriate, by enforcing bankruptcies.

International Lender of Last Resort

As important as a lender of last resort is to the domestic economy, Fischer maintained, there is a similar need in the international financial system for an independent agency that will act as lender of last resort for countries in crisis. This need arises both because international capital flows are not only extremely volatile but also contagious, exhibiting the classic signs of

financial panics, and because an international lender of last resort can help mitigate the effects of this instability, and perhaps the instability itself.

In important respects, Fischer said, the IMF is already playing the role of an international lender of last resort. The IMF has the capacity to act as both crisis lender and crisis manager in individual countries, even though it is not an international central bank. As suggested earlier, however, the domestic lender of last resort—whether as crisis lender or crisis manager—does not necessarily have to be the central bank. The IMF's financial structure is close to that of a credit union, and it has access to a pool of resources that it can onlend to member countries. It is able to assemble sizable financial packages in response to a crisis. In case of systemic problems, the IMF can borrow from the New Arrangements to Borrow or the General Arrangements to Borrow. As a crisis manager, the IMF has been assigned the lead in negotiating with member countries in a crisis, and it cooperates in arranging financing packages.

Although in recent years, the IMF has demonstrated the ability to move rapidly in the face of a crisis, the main constraint on its ability to act in time, Fischer said, is that governments delay too long in approaching the IMF.

Improving the International Lender-of-Last-Resort Function

Changes in the international system now under consideration could make it possible for the IMF to exercise both lender-of-last-resort functions more effectively. At the end of 1997, the IMF introduced the Supplemental Reserve Facility (SRF), which can make short-term loans in large amounts at penalty rates to countries in crisis, subject to policy conditionality. At present, Fischer said, the IMF Executive Board is considering the possibility of introducing a contingency or precautionary facility to supplement the reserves of countries threatened by but not yet in a crisis. The lending terms for the contingency facility would be similar to those for the SRF, but some thought is being given to the possibility that countries could prequalify for assistance.

Major reforms of the international system now on the agenda would have to be implemented for these lender-of-last-resort-like IMF facilities to operate effectively, Fischer said. These reforms, which would reduce the frequency and scale of crises, include

• the improvement and implementation of international standards, such as the banking standards defined by the Basle Committee on Banking Supervision, the IMF's Special Data Dissemination Standard, and other important standards already developed or in the process of development;

• changes to improve transparency and increase relevant information; and

• improved procedures to bail in the private sector.

Measuring the SRF and the proposed contingent facility against the "Bagehot lessons" discussed earlier—that in a crisis the lender of last resort should lend freely, at a penalty rate, on good collateral, but that institutions that would be bankrupt in normal times should not be saved—Fischer suggested that the two IMF facilities either already incorporated many of these principles or could be adapted to do so. The SRF incorporates both the penalty rate and the notion of lending freely. Policy conditionality can be interpreted as a further element of the penalty. "Lending freely" in the international context could translate to the condition that the international lender of last resort should stand ready to lend early and in sufficient amounts to other countries that might be affected by contagion from the crisis. The IMF's capacity to do that has been enhanced by the agreement on the quota increase.

With regard to bankruptcy, private sector debtors in the crisis country should be covered by national bankruptcy laws. This is one of the reasons that a major effort is under way to strengthen these laws.

The Articles of Agreement permit the IMF to ask for collateral, but it has done so only once. In considering the explicit provision of collateral for IMF programs, it has been argued that there is a trade-off between the amount of policy conditionality that accompanies a loan and the amount of collateral—and that policy conditionality is more important. However, if the contingency facility moves in the direction of lending in anticipation of a crisis, there could be a greater reliance on collateral and somewhat lesser reliance on conditionality.

The moral hazard problem could be dealt with through the same channels as those suggested for the lender of last resort in the domestic context: official regulation, private sector monitoring and self-regulation, and the imposition of costs on those who make mistakes. The adoption of international standards would raise the quality of official regulation. Improvements in transparency and the provision of information by the public sector and improved regulation, together with bail-in procedures that set the right incentives, would encourage better monitoring and self-regulation by the private sector. And, finally, the charging of a penalty rate would discourage moral hazard, and the new procedures to bail in the private sector would greatly reduce investor moral hazard.

The lender of last resort does not have to be the central bank.

The nagging question remains, however, of how to provide incentives for countries to adopt the necessary international standards. Fischer suggested that only countries that meet specified standards would be eligible to borrow from the lender of last resort—that is, have access to, for example, the new contingency lending facility.

Development of the standards, and the international mechanisms to monitor them, will take time, Fischer acknowledged. It will take more time for countries to adopt and implement the standards. In the meantime, a transition process could be designed, in which countries can qualify for the new facility based on their making good-faith efforts to come closer to meeting the stan-

dards, possibly with an initial emphasis on the banking standard.

We should not underestimate the complexity of the task and the resources that would be required to improve standards in this way, Fischer said, but any cost-benefit analysis for the world economy of a successful effort to reduce the frequency and scale of crises would justify making the attempt.

These changes should *not* result in an increase in IMF lending, Fischer concluded. For if the reforms succeed, there will be fewer international crises, and fewer occasions for crisis lending. And that, surely, is a goal we all share. ■

Lessons from Argentina's 1995 Financial Crisis May Be Applicable to Other Countries

Argentina's 1995 banking crisis highlights the lessons for Japan and crisis countries in southeast Asia. In Working Paper 98/121, Capital Structures and Portfolio Composition During Banking Crisis: Lessons from Argentina 1995, *Alberto M. Ramos of the IMF's Western Hemisphere Department constructs a theoretical framework to explain how banks adjust to financial crises.*

Argentina's banking system did not escape the effects of the Mexican financial crisis of December 1994, which caused a lack of confidence to ripple through many emerging markets. In 1995, Argentina was in the throes of an economic recession, which, in conjunction with the expected growth in banks' share of nonperforming loans, led to a gradual deterioration of their capital-asset ratio in 1995 and 1996. Depositors panicked and subsequently became less tolerant of risk. They pressed banks to reduce default risk. Banks responded by contracting the share of loans in their portfolios, thus creating a credit "crunch."

There is evidence that, in the aftermath of the Mexican crisis, Argentine banks were particularly overexposed, with many experiencing substantial outflows of deposits and equity losses. The ensuing credit retrenchment lasted for six quarters—until the end of 1996 (see chart, page 9)—when banks showed the first signs of approaching their precrisis equilibrium levels of risk exposure and began to reconstruct their capital bases.

Lessons from Argentina

A chief finding of Ramos's study is that when banks sustain asset losses, their deposits are usually jeopardized. The best course of action, the author suggests, is to replenish, or reconstruct, the capital account immediately through an injection of new capital, which would immediately restore the security of deposits. With a higher capital ratio, banks are better able to withstand a deterioration of the value of their assets and to safeguard deposits. However, bank managers may instead elect to compensate depositors for the diminished safety by increasing liquidity and shedding lending risk. Why would banks opt for increased liquidity (forgoing the rents from lending) rather than for immediate recapitalization?

The study postulates that during and immediately after a banking crisis, the cost of raising equity is very high. Because the new capital required for reconstruction will be relatively expensive, shareholders will prefer to pay the opportunity cost of increased liquidity and postpone replenishment until capital is cheaper. In the meantime, depositors must somehow be reassured, implying that banks will have to shed risky assets and increase liquidity, which they are known to do after periods of financial distress. For instance, after the Great Depression and throughout the 1930s, commercial banks in the United States accumulated an unprecedented amount of liquid assets and substantially reduced the share of loans in their portfolios. This increased preference for liquid assets substitutes for inadequate bank capital, the author explains, and therefore functions as self-insurance.

The study concludes that, because of capital market imperfections, shocks to banks' capital base—or even their deposit base (through a bank run)—cannot be smoothly offset with other sources of funds and that, as a result, banks will alter their lending behavior. In the medium term, they will continue to liquidate old loans and stop extending new ones and will strive to increase the ratio of capital to assets mainly by retaining funds from their net profits. In the long run, when the memory of the distress episode fades, a period of rapid loan growth will ensue, accompanied by a shift to more robust capital ratios, where banks will again be able to raise fresh capital in the market.

The study also explores the dichotomy between domestic and foreign bank ownership and provides some revealing lessons. In Argentina, foreign banks as a group suffered much lower deposit withdrawal rates than domestic banks, adjusted immediately, and, during some critical phases of the panic, served as a stability anchor in the "flight to quality." Without a significant presence of foreign banks, capital is more likely to flee the country. In Japan, foreign banks currently hold less than 10 percent of the deposits and about 5 percent of the assets of the banking system. Hence, abolishing legal restrictions on foreign-owned institutions and giving them unrestricted access to the domestic market can help smooth shocks to the banking system.

Japan's Banking Crisis

In the aftermath of the recent financial market turmoil in southeast Asia and Japan, banking sector problems and the erosion of bank capital persist. Banks face substantial costs in reducing loans, and new nonperforming loans continue to accumulate because these econ-

omies have not yet recovered from their latest downturns. This has several implications:

- Given the rate at which banks need to provision against nonperforming loans, their capital will remain weak even if current profits are applied fully to provisioning activities.
- In light of the depressed state of many Asian stock markets and adverse investor perceptions of domestic banks, even large traditional bank franchises face a prohibitively high cost of raising external equity because they are not able to counter market stigma. As a result, fresh capital will have to be secured either from asset sales or from public funds.
- The majority of leading banks may have to reduce or even suspend dividend payments.

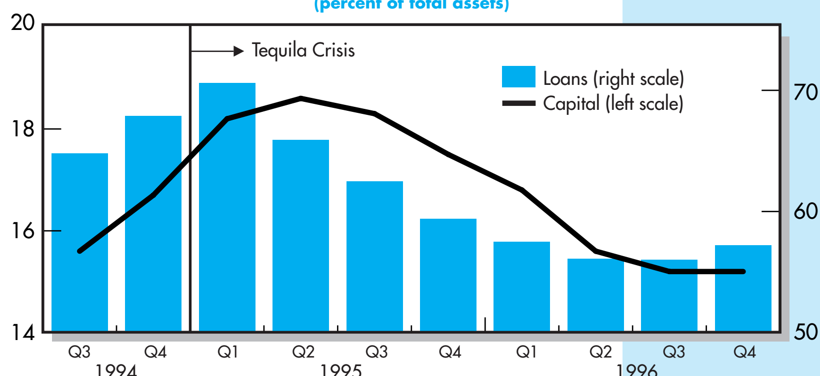
To halt the weakening of its ailing banking system and aid reconstruction, on October 13, Japan's lower house of parliament passed a ¥60 trillion rescue package, worth 10 percent of Japan's annual GDP, to inject public funds into the country's debt-laden banking system. A major purpose of the package is to revive bank lending and thereby alleviate the credit crunch that is deepening the economic recession. The banking bills make available ¥25 trillion ($210 billion) in public funds for recapitalizing weak but viable banks, ¥18 trillion for dealing with failed banks, and ¥17 trillion to strengthen the deposit insurance system. Similar programs have been established or are under study in other Asian countries.

Injections of public funds tend to dilute shareholders' interests or breach other funding covenants, but the key uncertainty of the banking package is whether banks will be willing to face public opprobrium and meet official conditions by applying for capital injections. This may discourage applications for funds and thus weaken, or even defeat, the impact of the recapitalization exercise. There is evidence that banks have been discouraged from applying—several major banks have turned instead to their corporate grouping, the *keiretsu*, for funds.

Japan's attempt to strengthen capital adequacy ratios through the program introduced on April 1—which requires banks to assess their nonperforming loans and hold adequate reserves against bad or doubtful debts—has prompted banks to take a cautious approach toward credit risk, calling in some outstanding loans and limiting the supply of new credit. The continuous erosion of bank capital resulting from increased provisioning requirements and declining equity prices has spawned a serious credit crunch and caused corporate bankruptcies to soar. With low equity valuations increasing the cost of raising private capital, banks opted instead to shrink their risk-weighted asset base to enhance capital adequacy, largely by cutting lending and investing in low-risk government bonds. Few doubt that the economy will remain overdependent on fiscal stimulus until active new credit creation is available to fuel increased personal consumption and higher levels of private capital investment. From a macroeconomic point of view, there is a serious risk that a scarcity of bank capital can further tighten the supply of credit and send the economy into a deflationary spiral.

In Japan, bank lending, which has been lackluster since late 1996, weakened significantly after the failures of a few sizable financial institutions in late 1997. By June 1998, outstanding bank loans hit a six-year low. Hence, the urgency to restore solvency and lending capacity to the core banking system is a strong reason to endorse public support for solvency in Japan and elsewhere.

Argentina: Capital and Loan Shares
1994:Q3–1996:Q4
(percent of total assets)



Data: IMF staff estimates

Conclusion

Uncertainty about the economic solvency of many banks creates a virtually insurmountable obstacle to securing voluntary injections of private capital in organizing mergers or takeovers. Given this uncertainty and the fact that private capital is not available, using public resources to support the equity base of the core banking system—and the economy as a whole—allows banks to focus on new businesses rather than on survival. Nevertheless, to minimize moral hazard, the terms of the government's capital subscription should be designed to ensure appropriate incentives to secure replacement of public capital with private capital as soon as feasible and should insist on aggressive loan-loss recognition coupled with financial and operational reorganization to improve the system's long-term profitability and competitiveness.

As Argentina's experience in the wake of the 1994 Mexican devaluation shows, portfolio composition decisions (loans versus liquid, less risky assets) are highly affected by banks' liability structure. The difficulty in reconstructing strong capital bases after a major financial crisis leads banks to self-insure, reducing their risk exposure by cutting risky assets, such as loans, and to offer a premium for liquid assets, such as cash and government securities. ■

Copies of IMF Working Paper 98/121, *Capital Structures and Portfolio Composition During Banking Crisis: Lessons from Argentina 1995*, by Alberto M. Ramos, are available for $7.00 from IMF Publication Services. See page 15 for ordering information.

Australian Reforms Accelerate Growth and Help Resist Contagion from Asian Crisis

Australia's economic performance in the 1990s has been impressive. The country has experienced healthy growth since the early years of the decade, with inflation averaging just 2½ percent over the same period. This strong showing has helped Australia resist contagion from the Asian crisis and maintain a relatively high growth rate. The recent performance contrasts sharply with the previous three decades, when falling productivity and rising inflation prompted Australia's per capita income to slip from one of the highest among Organization for Economic Cooperation and Development (OECD) countries.

How did Australia overcome several decades of lackluster performance? Beginning in the mid-1980s, the government embarked on two broad phases of reforms. In the first phase, the exchange rate was floated, exchange controls were dismantled, the market was allowed to determine interest rates, external tariffs were reduced, and competition was encouraged in a number of sheltered sectors. Moreover, public enterprises were corporatized or privatized, and the Reserve Bank adopted an inflation target. In the second phase, from 1996 onward, fiscal reforms were intensified to raise public saving, steps were taken to consolidate the credibility of monetary policy, and reforms were undertaken in the labor market and remaining sheltered product markets. As a result of these reforms, Australia's annual growth potential is estimated to have risen from 2½–3 percent in the late 1980s to about 3½ percent in the 1990s. (Potential growth rates provide economists with a measure of the rate of increase in the economy's productive capacity and may differ from actual growth rates over the economic cycle due to changes in the extent to which this capacity is used.)

But several problems persist. The unemployment rate remains stubbornly high, and national saving, relatively low. Continued structural reforms, particularly in labor and product markets, would help sustain high potential growth rates as well as Australia's resilience to external shocks.

Background

Based on GDP levels per capita, Australia was the third-richest OECD country in 1960, after the United States and Switzerland, and its per capita income was more than 50 percent higher than the OECD European average. Economic performance declined during the 1960s, however, as growth in the capital stock slowed and productivity dropped. Inflation also took hold. By the 1980s, Australia had slipped from near the top of OECD rankings in growth, productivity, and capital.

The factors underlying these trends were

- *Poor productivity*. Much of the poor productivity performance had its roots in the high external tariffs and extensive product market regulations that protected large sectors of the Australian economy for much of this period. In the mid-1960s, the average tariff on imports was 9½ percent, compared with 6 percent on average in the OECD countries. In the 1970s, when many OECD countries lowered tariffs, Australia's average import tariffs rose to more than 12 percent. The high tariffs damaged economic performance by diverting production away from areas of comparative advantage, thereby reducing productivity, and by raising the prices of imported and import-competing goods. Key sectors of the economy were also dominated by public enterprises, which in many cases had monopoly rights that enabled them to raise prices for their services above the level in other countries.
- *Inflexible labor market*. Traditionally, employment conditions have been governed by a large number of minimum wages and legally binding agreements specific to individual occupations or industries. While these arrangements were developed in response to social equity goals, they were not tailored to individual enterprises and slowed the economy's adjustment to the changing global economic environment.
- *High inflation*. In the 1970s and the 1980s, Australia's inflation was higher and less predictable than in most OECD countries, generating economic uncertainty and detracting from a macroeconomic framework conducive to growth.
- *Low saving*. Another problem that emerged during this period was low national saving, which declined from about 24 percent of GDP in the 1970s to 17 percent of GDP in the 1990s—among the lowest in the OECD. Saving has dropped in both the public and private sectors, leading to a structural deterioration in the current account deficit. This deterioration has raised Australia's external debt and liability ratios and potentially increased vulnerability to external shocks.

First Phase of Reform

The government moved across a wide front from the mid-1980s to the mid-1990s to strengthen economic performance—reducing trade barriers, liberalizing key areas of the economy, corporatizing or privatizing public enterprises, and adopting an inflation target.

Beginning in the late 1980s, the government carried out several rounds of unilateral tariff cuts; a maximum tariff of 5 percent now applies to most goods. Australia's Industry Commission estimates that, by 2000, the average tariff will be less than 3 percent.

The government also liberalized a number of key sectors. In the financial sector, it floated the exchange rate, dismantled exchange controls, and allowed the market to determine interest rates. The telecommunications and aviation sectors were liberalized, while the government moved to corporatize or privatize a number of public enterprises. Moreover, the Competition Policy Reform Act of 1995 set up a framework to extend competition to sectors that had remained relatively sheltered from the increased competitive pressures—notably, public enterprises, unincorporated businesses, and professions. Consistent with this process, the state governments began to break up the electricity and gas industries that had a monopoly. The benefits from the reforms have been clear and extensive at the microeconomic level, with prices having fallen in the electricity, telecommunications, and aviation sectors, and public enterprises having experienced a marked improvement in productivity.

The adoption of an inflation target was another important reform. After relatively high inflation in the 1970s and 1980s, inflation fell to low levels in the early 1990s mainly as a result of a sharp recession. The Reserve Bank moved swiftly to lock in low inflation, adopting in 1993 a target aimed at maintaining underlying inflation between 2 and 3 percent, on average, over the economic cycle. Under the inflation-targeting regime, the Reserve Bank acts preemptively to counter expected future demand pressures, yet it tolerates some short-term deviations of inflation from the target range to reduce fluctuations in real output. This approach has helped achieve average inflation of just 2¼ percent since the early 1990s. Moreover, a comparison of Australia's inflation and output performance with other inflation-targeting countries suggests that Australia's approach has produced superior results thus far.

New Phase of Reforms

By 1996, Australia had carried out widespread and—for the most part—successful reforms over the previous ten years. But several long-term structural problems remained. The country faced a stubbornly high unemployment rate of about 8½ percent and national saving had dropped to low levels. Recognizing that these problems needed to be addressed if Australia were to boost long-term growth further, the government launched a new phase of reforms. The objective was to raise public saving, consolidate the credibility of monetary policy, and carry out another crucial wave of reform aimed at the labor market as well as sheltered product markets in the nontraded sectors.

The government intensified fiscal reforms with a view to making a decisive difference in the public sector's contribution to national saving. The government announced in its 1996/97 budget a fiscal consolidation strategy to move the Commonwealth, or federal, budget sector from an underlying deficit of 2 percent of GDP to surpluses over the medium term. In addition, it adopted the Charter of Budget Honesty, underpinning the sound management of public finances by requiring greater public disclosure of budget information and observance of principles of responsible fiscal management.

Australia also introduced steps to consolidate the improved credibility of the inflation-targeting framework. In particular, the government formally endorsed the framework for the first time in 1996 in a joint statement by the Treasurer and the Governor of the Reserve Bank.

Over time, labor market reforms should enable the unemployment rate to fall.

The government also initiated reforms to the remaining sheltered product markets. The financial sector was reformed further in 1997 by, among other moves, liberalizing access to the clearing system and reorganizing the supervision of banks and nonbank financial institutions to increase the efficiency and effectiveness of prudential regulation. Other steps included further privatization of public enterprises (including the sale of one-third of Telstra, the public telecommunications company); the introduction of full and open competition in the telecommunications sector in 1997; and corporate law reform, with the aim of reducing transactions costs for firms and harmonizing Australia's regulations and laws with those applying in major world financial markets.

To address concerns about the comprehensiveness of earlier labor market reforms, especially their lack of success in reducing unemployment, Australia undertook additional reforms in 1996. These initiatives aim to reduce the reach of industry- and occupation-specific labor agreements and to tie enterprise-level wage bargaining more closely to productivity growth. Over time, these reforms should enable the unemployment rate to fall, and continued reforms would help achieve a decisive reduction in the structural unemployment rate.

Australia's program of reform has thus succeeded in accelerating not only actual growth but also productivity and potential growth. It has also been instrumental in maintaining Australia's impressive performance in the face of the financial crisis confronting its major Asian trading partners. The country appears to have shaken off the lackluster performance of the past several decades. Nevertheless, challenges remain. Vigorous pursuit of structural reforms will help sustain the recent high potential growth rates and cut unemployment. ■

Jeffrey Hayden
IMF External Relations Department

Copies of *Australia: Benefiting from Economic Reform*, by Anoop Singh, Josh Felman, Ray Brooks, Tim Callen, and Christian Thimann, are available for $25.00 each from IMF Publication Services. See page 15 for ordering details.

IMF Names New Administration Department Head

Brian Stuart, named Director of the IMF's Administration Department.

K. Burke Dillon, appointed Executive Vice-President of the Inter-American Development Bank.

On December 28, the IMF announced that IMF Managing Director Michel Camdessus has named Brian C. Stuart, a national of Canada, as Director of the IMF's Administration Department, effective January 4, 1999. Stuart succeeds K. Burke Dillon, who has been appointed Executive Vice-President of the Inter-American Development Bank.

Stuart was educated at the University of Calgary and Queen's College, Kingston, Ontario, and joined the IMF as an economist in 1973, holding various positions in the European, Exchange and Trade Relations (now Policy Development and Review), and Western Hemisphere Departments prior to his appointment as Assistant Director of the Exchange and Trade Relations Department in 1990. He was appointed a Senior Advisor in the Western Hemisphere Department in 1992, and Deputy Director of that department in 1995. Since 1995, Stuart has chaired the Interdepartmental Information Technology Policy Committee, which is helping to implement a strategic plan for information technology at the IMF. ■

Members' Use of IMF Credit

(million SDRs)

	Dec. 1998	Jan.–Dec. 1998	Jan.–Dec. 1997
General Resources Account	5,356.52	20,586.19	16,112.86
Stand-By Arrangements	4,517.52	12,098.01	13,255.39
SRF	3,601.31	8,726.31	4,100.00
EFF Arrangements	839.00	6,331.63	2,749.87
SRF	0.00	675.02	0.00
CCFF	0.00	2,156.55	107.60
ESAF Arrangements	155.44	895.96	730.59
Total	5,511.96	21,482.15	16,843.45

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

Data: IMF Treasurer's Department

Press Releases

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

St. Kitts and Nevis: Emergency Assistance

The IMF approved St. Kitts and Nevis's request for emergency financial assistance related to natural disasters. The assistance, equivalent to SDR 1.625 million (about $2.3 million), will support the government's economic recovery program and associated relief and rehabilitation efforts in the aftermath of Hurricane Georges.

The devastation caused by Hurricane Georges reflects damage to all major infrastructure services and tourism facilities, including several major hotels. About one-fourth of the nation's sugarcane crop may also have been destroyed, according to preliminary estimates. Current estimates by the authorities indicate hurricane damage overall amounted to about $400 million, or 150 percent of GDP in 1997. Real GDP growth is projected to slow to about 3.5 percent in 1998 and decelerate further to 2 percent in 1999, compared with recent pre-hurricane growth, which averaged about 5 percent a year.

St. Kitts and Nevis joined the IMF on August 15, 1984, and its quota is SDR 6.5 million (about $9.2 million).

Press Release No. 98/62, December 17

Malawi: ESAF

The IMF approved the third annual arrangement for Malawi under the Enhanced Structural Adjustment Facility (ESAF), providing assistance equivalent to SDR 20.4 million (about $27 million) in support of the government's program for 1998–99. The third annual loan, which has been augmented by SDR 5.15 million (about $7 million), is available in two equal semiannual installments, the first of which is available on December 30, 1998.

Medium-Term Strategy and 1998–99 Program

The government's medium-term development strategy aims to consolidate macroeconomic stability, attain sustainable economic growth that will reduce poverty, and raise the overall living standards of Malawi's population. The macroeconomic objectives for the medium term are to increase the rate of real GDP growth from about 3.5 percent in 1998 to 6 percent in 2001; reduce the average annual rate of inflation from about 27 percent in 1998 to about 5 percent in 2001; and strengthen further the balance of payments. For 1998–99, the principal macroeconomic objectives are to achieve

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
December 14	3.65	3.65	3.91
December 21	3.61	3.61	3.86
December 28	3.64	3.64	3.89
January 4, 1999	3.58	3.58	3.83

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (the U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 107 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

Malawi: Selected Economic and Financial Indicators

	1996	1997[1]	1998[2]	1999[2]	2000[3]	2001[3]
	(annual percent change)					
GDP at constant market prices	10.7	5.1	3.6	5.0	5.5	6.0
Consumer prices (end of period)	6.7	15.2	36.4	7.0	7.0	5.0
	(percent of GDP)					
Domestic primary balance (commitment basis)[4]	0.8	–4.5	–0.1	–1.2	–1.2	–1.1
Overall balance (excluding grants, commitment basis)	–7.7	–11.6	–14.8	–12.9	–12.1	–11.4
External current account (including official transfers)	–7.7	–9.3	–8.9	–8.8	–8.1	–6.8
External debt	95.0	90.4	140.7	166.5	162.5	154.2
	(months of imports of goods and nonfactor services)					
Gross official reserves	3.6	2.1	3.5	4.4	4.5	4.5

[1]Preliminary.
[2]Program.
[3]Projections.
[4]Fiscal year starting April 1 for 1996 and 1997, July 1 for 1998. Program targets for 1997 were calculated based on revised GDP.

Data: Malawian authorities and IMF staff estimates and projections

average real GDP growth of at least 3.6 percent in 1998 and 5 percent in 1999; a 12-month inflation rate of 36 percent by end-1998 and 7 percent by end-1999; a small domestic primary deficit for 1998–99; and a recovery in gross international reserves to more than four months of imports. The monetary program for 1998–99 is aimed at lowering the inflation rate substantially and restoring conditions conducive to the maintenance of a stable exchange rate.

Structural Reforms

The government's agenda of structural reforms is designed to support the goal of pursuing widespread poverty reduction and an improvement in living standards.The authorities are also continuing with the privatization program.

Social Issues

The government's medium-term development strategy since 1994 has been to achieve accelerated economic growth, lower inequality, and generate a broad-based improvement in living standards. Malawi is a poor country; nominal per capita GNP in 1997 was only $220—less than half the sub-Saharan average; and income inequality is perhaps the highest in Africa. In the education sector, the government introduced universal free primary education in 1994 and is now directing its efforts toward improving the quality of education.

Malawi joined the IMF on July 19, 1965. Its quota is SDR 50.9 million (about $72 million). Malawi's outstanding use of IMF financing currently totals SDR 59.8 million (about $84 million).

Press Release No. 98/63, December 18

Armenia: ESAF

The IMF has approved the third annual loan for Armenia under the Enhanced Structural Adjustment Facility (ESAF), which has been increased by SDR 8.1 million (about $11 million) to SDR 41.85 million (about $59 million), in support of the government's program for 1999. The loan is available in two equal semiannual installments of SDR 20.925 million (about $29 million), the first of which is available at the end of December. The total commitment under the three-year loan is thus increased to the equivalent of SDR 109.35 million (about $154 million).

Program for 1999

The key objectives of Armenia's development strategy are to address the spillover effects of the Russian crisis while trying to move forward in consolidating the gains achieved so far in stabilization and deepening structural reform. The authorities intend to take measures that would help Armenia absorb at least half of the external shock. The balance would be met through a concerted international donor effort to assist Armenia, as well as neighboring ESAF transition countries, to address the balance of payments difficulties resulting from the Russian crisis. It is anticipated that the steadfast implementation of these measures would provide the conditions to maintain real annual GDP growth of at least 5.5 percent in 1998 and 4.0 percent in 1999, in spite of the unfavorable external environment. End-period inflation is targeted at single digits in both 1998 and 1999, and the current account deficit is targeted to decline from a projected 24 percent of GDP in 1998 to about 22 percent in 1999. To achieve these macroeconomic objectives, the program calls for maintaining a tight fiscal policy stance, with a state government budget deficit of about 5.5 percent of GDP in 1998 and about 6 percent in 1999. On the monetary side, tight monetary and credit policies will continue to be implemented.

Structural Reforms

The government will deepen reforms in the areas of privatization and banking. The Central Bank of Armenia will seek to bolster the soundness of the commercial banks by introducing stricter prudential regulations and by strengthening supervision. The government is also committed to implementing the revised strategy to rehabilitate the energy sector. Armenia assigns high priority to raising productivity in the civil service and to increasing the real wages of public servants. Such efforts will be framed in the context of a comprehensive strategy.

Armenia: Basic Economic Indicators

	1996	1997[1]	1998[2]	1999[3]
	(annual percent change)			
Real GDP growth (percent change)[1]	5.8	3.1	5.5	4.0
Inflation (end of period)	5.8	21.9	3.8	9.9
	(percent of GDP)			
State budget balance[4]	–9.3	–5.9	–5.6	–6.1
Current account balance	–27.9	–27.8	–23.7	–21.8
Total external debt	38.0	48.3	43.0	44.1
	(months of imports of goods and nonfactor services)			
Gross official international reserves	2.2	5.1	3.6	3.6

[1]Preliminary.
[2]Projections.
[3]Program.
[4]Deficit as measured by revenues minus expenditures, including contingent expenditures in 1999.

Data: Armenian authorities and IMF staff estimates

Social Issues

The authorities are conscious that the process of transition may have some adverse consequences for the most vulnerable groups of the population; therefore, their program attaches particular importance to developing and implementing a well-targeted, means-based, and cost-effective social safety net, as well as reforming those sectors with the greatest social incidence, including education, health, and the pension system.

Armenia joined the IMF on May 28, 1992. Its quota is SDR 67.5 million (about $95 million). Its outstanding use of IMF resources currently totals SDR 114 million (about $161 million).

Press Release No. 98/65, December 22

Rwanda: Article VIII

The government of Rwanda has notified the IMF that it has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the IMF Articles of Agreement, with effect from December 10, 1998. IMF members accepting the obligations of Article VIII undertake to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in discriminatory currency arrangements or multiple currency practices without IMF approval. A total of 147 countries have now assumed Article VIII status.

Rwanda joined the IMF on September 30, 1963. Its quota is SDR 59.5 million (about $84 million).

Press Release No. 99/1, January 4

The Extended Fund Facility provides assistance for adjustment programs over larger amounts of financing than under Stand-By Arrangements.

Stand-By, EFF, and ESAF Arrangements as of December 31

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			**32,858.97**	**12,613.64**
Bosnia and Herzegovina	May 29, 1998	May 28, 1999	60.60	36.36
Brazil[1]	December 2, 1998	December 1, 2001	13,0224.80	9,605.79
Cape Verde	February 20, 1998	April 19, 1999	2.10	2.10
Djibouti	April 15, 1996	March 31, 1999	8.25	1.95
El Salvador	September 23, 1998	February 22, 2000	37.68	37.68
Estonia	December 17, 1997	March 16, 1999	16.10	16.10
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	2,175.00
Latvia	October 10, 1997	April 9, 1999	33.00	33.00
Philippines	April 1, 1998	March 31, 2000	1,020.79	823.42
Thailand	August 20, 1997	June 19, 2000	2,900.00	700.00
Uruguay	June 20, 1997	March 19, 1999	125.00	125.00
Zimbabwe	June 1, 1998	June 30, 1999	130.65	91.45
EFF Arrangements			**24,414.26**	**14,697.23**
Argentina	February 4, 1998	February 3, 2001	2,080.00	2,080.00
Azerbaijan	December 20, 1996	December 19, 1999	58.50	17.56
Bulgaria	September 25, 1998	September 24, 2001	627.62	523.02
Croatia, Republic of	March 12, 1997	March 11, 2000	353.16	324.38
Gabon	November 8, 1995	March 7, 1999	110.30	49.63
Indonesia	August 25, 1998	November 5, 2000	4,669.10	2,566.70
Jordan	February 9, 1996	February 8, 1999	238.04	35.52
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	398.06
Panama	December 10, 1997	December 9, 2000	120.00	80.00
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Russian Federation[1]	March 26, 1996	March 25, 2000	13,206.57	7,426.86
Ukraine	September 4, 1998	September 3, 2001	1,645.55	1,400.00
Yemen	October 29, 1997	October 28, 2000	105.90	87.90
ESAF Arrangements			**3,896.85**	**2,123.11**
Albania	May 13, 1998	May 12, 2001	35.30	29.42
Armenia	February 14, 1996	Sept 14, 1999	109.35	20.92
Azerbaijan	December 20, 1996	December 19, 1999	93.60	23.40
Benin	August 28, 1996	August 27, 1999	27.18	18.12
Bolivia	September 18, 1998	September 17, 2001	100.96	84.13
Burkina Faso	June 14, 1996	September 13, 1999	39.78	6.63
Cameroon	August 20, 1997	August 19, 2000	162.12	81.06
Central African Republic	July 20, 1998	July 19, 2001	49.44	41.20
Chad	September 1, 1995	April 28, 1999	49.56	8.26
Congo, Republic of	June 28, 1996	June 27, 1999	69.48	55.58
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Ethiopia	October 11, 1996	October 22, 1999	88.47	58.98
The Gambia	June 29, 1998	June 28, 2001	20.61	17.18
Georgia	February 28, 1996	Jule 26, 1999	166.50	27.75
Ghana	June 30, 1995	June 29, 1999	164.40	27.40
Guinea	January 13, 1997	January 12, 2000	70.80	23.60
Guyana	July 15, 1998	July 14, 2001	53.76	44.80
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	June 26, 1998	June 25, 2001	64.50	53.75
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	27.28
Madagascar	November 27, 1996	November 26, 1999	81.36	54.24
Malawi	October 18, 1995	December 16, 1999	50.96	7.63
Mali	April 10, 1996	August 5, 1999	62.01	10.34
Mongolia	July 30, 1997	July 29, 2000	33.39	27.83
Mozambique	June 21, 1996	August 24, 1999	75.60	12.60
Nicaragua	March 18, 1998	March 17, 2001	100.91	84.09
Niger	June 12, 1996	September 1, 1999	57.96	9.66
Pakistan	October 20, 1997	October 19, 2000	682.38	454.92
Rwanda	June 24, 1998	June 23, 2001	71.40	59.50
Senegal	April 20, 1998	April 19, 2001	107.01	71.34
Tajikistan	June 24, 1998	June 23, 2001	100.30	60.00
Tanzania	November 8, 1996	November 7, 1999	161.59	38.76
Uganda	November 10, 1997	November 9, 2000	100.43	43.52
Yemen	October 29, 1997	October 28, 2000	264.75	176.75
Zambia	December 6, 1995	December 5, 1998	701.68	40.00
Total			**61,170.08**	**29,433.98**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility
ESAF = Enhanced Structural Adjustment Facility
Figures may not add to totals owing to rounding.

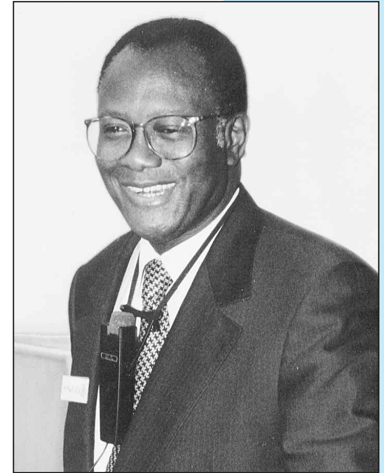
Data: IMF Treasurer's Department

Policy Dialogue

Africa Needs to Attract More Private Capital to Achieve Integration into the Global Economy

The Development Policy Forum of the German Foundation for International Development hosted an international policy dialogue entitled "Opening and Liberalizing Markets in Africa—A Response to Globalization?" at Villa Borsig, Berlin, on December 1–3, 1998. The discussion brought together a small circle of key decision makers from Africa (including the finance ministers of Nigeria and South Africa, the minister of justice of Zambia, and the governor of the Central Bank of Kenya), from international organizations (including the IMF, the World Bank, and the African Development Bank), and from Germany's public and private sectors. The purpose of the dialogue was to reflect on how Africa should respond to the challenges of globalization, to exchange experiences, and to draw up concrete recommendations that would feed into the formulation of national and regional economic policies in Africa. IMF Deputy Managing Director Alassane D. Ouattara delivered a keynote address. (The full text of the address is available on the IMF's website: www.imf.org.)

Several overarching themes emerged during the course of the dialogue. There was general agreement that Africa had no alternative to full integration into the global economy, given its pressing need for accelerated growth and poverty reduction and that it would have to attract a substantially greater share of the world's private capital in order to catch up with other regions. Regional integration was considered a useful intermediate step toward, though not a substitute for, global integration. It can also contribute to the requisite stability and predictability of macroeconomic policy. Promoting private sector investment also required an adequate economic infrastructure and the development of national human resources, as well as a conducive regulatory framework. This argues for a carefully redefined role of the state and a constructive partnership between public and private sectors. Policy



Alassane D. Ouattara delivered keynote address at the conference.

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98/161: *Inflation, Uncertainty, and Growth in Colombia*, Henry Ma. Analyzes the behavior of inflation in Colombia from the 1950s and its effect on growth.

98/162: *The Impact of Human Capital on Growth: Evidence from West Africa*, Emilio Sacerdoti and others. Analyzes the impact of human capital on growth, using a growth-accounting methodology.

98/163: *The Volatility of the Relative Price of Commodities in Terms of Manufactures Across Exchange Regimes: A Theoretical Model*, Hong Liang. Investigates the relationship between the nominal exchange rate regime and the volatility of relative commodity prices.

98/164: *The Quality of Governance: "Second-Generation" Civil Service Reform in Africa*, Nadeem Ul Haque and Jahangir Aziz. Argues that human capital development in the public sector is an important ingredient in "second-generation" reform in Africa.

98/165: *Migration and Pension*, Assasf Razin and Efraim Sadka. Shows that because of their positive influence on the pension system, migrants could be beneficial to all income and age groups.

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reforms should be framed within a comprehensive policy approach, and policies should be well explained to the population to foster understanding and acceptance. Transparency and accountability of the government, open and participatory democratic institutions, and an efficient civil service are the key building blocks of a national consensus in favor of the reform effort.

Trevor Manuel, South African Minister of Finance (left), Alassane D. Ouattara, and Landing Savané, Senegalese Member of Parliament, during the discussions.

Responding to the Challenges of Globalization

The dialogue was organized around five policy areas considered critical for a successful response to the challenges of globalization: regional integration; trade liberalization and enhancing export competitiveness; financial sector reform; monetary policy in the context of capital mobility; and fostering economic security and good governance.

Discussants agreed on the advantages of *regional integration* for Africa, noting the need for strong regional institutions but cautioning against a multiplicity of regional arrangements with uncoordinated and possibly inconsistent objectives. They also noted that economic convergence should be accompanied by convergence of democratic institutions and practices of good governance, and that the private sector, parliaments, and other representatives of civil society should be closely involved in the formulation of the common objectives.

There was general agreement on the need for an acceleration of *trade liberalization* in Africa, supported by other enabling macroeconomic and structural policies, in order to enhance export competitiveness. A regional approach could be a useful instrument in this regard. There was a broad consensus that preferential access to markets had not led to the expected expansion of trade and that open access to industrial markets was essential—African countries as a group should therefore take the initiative in upcoming trade discussions to push more aggressively for the removal of barriers to market access and for reciprocity in their trade relations.

Banking sector weakness in Africa had contributed to lower growth and development, and *financial sector reform* was therefore a priority for most countries. However, commercial banks needed to be complemented by more diversified financial market forms, and new financial instruments and institutions should be developed, particularly with a view to mobilizing long-term savings and financing investment, including in the widespread informal sector.

With modern information technology and the emergence of large institutional investors, market scrutiny of the economic policies of individual countries had become much more intense, and policy mistakes could more easily result in destabilizing capital flows. Particular care was necessary in fixed exchange rate regimes, which demanded solid macroeconomic fundamentals, very prudent management of the external debt, and low fiscal deficits, in order to avoid the buildup of pressure against the currency. These tenets applied to all countries, although the primary challenge of *monetary policy* in Africa was not to prevent capital outflows but to promote foreign direct investment and to encourage the repatriation of flight capital. Temporary controls on short-term capital inflows could play a role in limiting risk and giving countries time to make necessary policy adjustments. However, the general view was that there was no choice on whether to liberalize the capital account—only on when and how. Africa should liberalize gradually, in step with reforms of the financial sector and only in relation to the stability of domestic macroeconomic conditions.

The explicit consideration of the *political dimensions of economic reforms* was also required to ensure the success of the adjustment and reform process in African countries. Successful economic reform also required that governments have the capacity to absorb and reflect the opinions and needs of the population. It was thus critical to build an understanding of the reform process by closely involving civil society. There should be full respect for the rule of law, underpinned by strong institutions, and high standards of professionalism and ethics in the civil service and no tolerance for corruption. External support for the democratic process could range from assistance in developing the necessary institutions to specific political conditions for the disbursement of aid. ■

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