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Managing Director's Visit to Asia

Indonesia Adopts Revised Reform Program; Korean Situation Eases

Continuing economic upheavals affecting east Asia in mid-January prompted another visit to the region by IMF Managing Director Michel Camdessus. A main objective of the trip—which included stops in Korea, Singapore, Indonesia, Malaysia, and China—was to obtain assurances from Indonesian President Suharto that his government would strengthen and reinforce the economic reform program agreed to under the country's three-year Stand-By Arrangement with the IMF, which was negotiated in November 1997 (see *IMF Survey,* November 17, 1997, and Indonesia story, below). Indonesian financial markets had declined sharply during the preceding week as investors expressed concern over the extent of the country's commitment to reform. *(Please turn to the following page)*

IMF Managing Director Camdessus meets President Suharto in Jakarta for discussions on Indonesia's economic program.

To Restore Confidence

IMF and Indonesia Agree on Accelerated Economic Reforms

On January 15, IMF Managing Director Michel Camdessus announced in Jakarta that the government of Indonesia and the IMF had agreed on a reinforced economic program for Indonesia. Following is the text of his remarks.

> The measures aim to restore confidence in the currency and the country. -Camdessus

As you know, an IMF staff team, together with Stanley Fischer [IMF First Deputy Managing Director] and myself, have over the last few days been discussing with the Indonesian authorities an acceleration and deepening of much-needed reforms agreed under the IMF-supported program.

This is why I am pleased today to announce that the government of Indonesia and the IMF have reached agreement on a much strengthened and reinforced economic program. Many of the measures in this program are new, others have been there from the beginning but are now being accelerated, but all have one common purpose: they aim to restore confidence in the currency and in the economy by demonstrating that the government recognizes the problems confronting the country and is prepared to take the necessary measures to overcome them, even if they are difficult and painful.

Let me summarize briefly the program that we have just agreed.

Broad Macroeconomic Framework. The program is designed to avoid a decline in output, while containing inflation to 20 percent this year, with the aim of bringing it back to the single-digit level next year, despite the sharp depreciation of the rupiah. At the *(Continued on page 19)*

(Continued from front page) ***Korea.*** Before arriving in Indonesia, Camdessus held discussions with Korean President-elect Kim Dae-jung, other senior government officials, and business community representatives on January 12 and 13. He also met with leaders of the country's main labor unions on January 13, at the request of President-elect Kim. It was subsequently announced that a tripartite labor reform council—consisting of representatives from unions, businesses, and government—would be established to consider the impact of the economic program on the country's labor force.

In a press briefing in Seoul on January 13, Camdessus said that Korea's financial situation had been improving since November and that support, including a willingness by banks to roll over short-term debt while working on a longer-term solution, was growing in the international financial community. He added that, along with funds already distributed from the IMF, the Asian Development Bank, and the World Bank, bilateral lenders were actively working on further assistance measures. Summing up, he said his overall impression of his two-day visit was "extremely encouraging," but he cautioned that Korea has "won its first battle, but not the whole war."

Stanley Fischer, the IMF's First Deputy Managing Director, answers questions from the press following discussions with the Indonesian authorities.

Indonesia. The Managing Director's visit to Jakarta on January 14–15 was preceded by that of First Deputy Managing Director Stanley Fischer, who met President Suharto on January 12 to discuss his country's economic program. Then, on January 15, President Suharto, in a meeting with Camdessus, signed a new letter of intent for Indonesia. This spelled out a revised reform program linked to the $43 billion financing program agreed with the IMF and other donors in November. The 15-minute signing ceremony was televised live from the presidential palace. In a press briefing, Camdessus welcomed the agreement, saying that it was "bold and far-reaching and deserves the full support of the international community." Subsequently in Kuala Lumpur, Camdessus observed that the Indonesian government and public had forged a common determination. This, together with the economic program, would restore confidence in the rupiah by demonstrating that the government recognizes the depth of the economic problems and is prepared to take the necessary measures, even if they are difficult or painful. In a further development, President Suharto announced the establishment of a board of economic ministers charged with ensuring that the program is fully implemented. In keeping with its intention to improve transparency under the revised terms of its agreement with the IMF, Indonesia stated it would release the text of the letter of intent.

Malaysia. During a two-day visit on January 15–16, Camdessus met with senior government and central bank officials, including Prime Minister Mahathir Mohamad and Finance Minister Anwar Ibrahim. Speaking to reporters after his meeting with the Malaysian premier, Camdessus said he welcomed the implementation of an economic reform package on December 5—developed in consultation with the IMF—that cut government spending and introduced steps to curb excessive credit growth. Noting that the country's fiscal situation was sufficiently strong, he explained that Malaysia had taken a number of important economic steps. "Malaysia is not facing a crisis," he said, "but I believe there is a need to continue strengthening policies, particularly monetary policies, to achieve a better policy mix and ensure a rapid return to exchange rate stability." While Malaysia did not require any financial support from the IMF, Camdessus said, it needed to raise interest rates in order to contain inflationary pressures arising from currency depreciation and an "exceedingly high" rate of credit growth.

Regional Issues. At his news conference in Malaysia, Camdessus also discussed the IMF's response to the economic trauma still rocking east Asia. He said the IMF emphasizes the important need to tighten monetary policy to halt the slide in regional currencies. Shoring up financial systems must also be a key plank in any stabilization program, highlighting the need for "immediate actions to correct weaknesses in the banking sector." The ultimate goal of the IMF's programs in Thailand, Indonesia, and Korea, Camdessus said, is to allow the countries "to resume rapid development"—although this process would not happen overnight.

In the course of his return to Washington, Camdessus stopped in Brussels for meetings with Philippe Maystadt, Belgian Finance Minister and Chairman of the Interim Committee of the Board of Governors; Yves-Thibault de Silguy, the European Monetary Affairs Commissioner; and the Development Committee of the European Parliament. Speaking to reporters in Brussels, he said that the Asian crisis

appeared to be stabilizing, but that this process could take some time. He explained to the Development Committee that Korea had been on the brink of a major crisis before the government adopted its program. The crisis had been averted, he said, by the government increasing transparency in public and private sector management and offering the unions an equal footing in negotiations. This was, he added, an example of the importance of increased transparency for good governance and confidence in public policies.

In other related developments:

• In the course of his visit to Indonesia, Camdessus also gave assurances that the IMF would be flexible in reviewing the $17.2 billion program for Thailand that had been negotiated in September 1997 (see *IMF Survey,* September 17, 1997, page 283). "We don't want to impose artificial constraints on the economy of Thailand. What we want is the success of the program," he said.

• IMF First Deputy Managing Director Fischer said in a January 20 television interview that the situation in Thailand had improved, but that in Indonesia more work would need to be done on restructuring the banking system. He explained that the Indonesian authorities, the IMF, the World Bank, and the Asian Development Bank were working on a program that would reassure depositors and stabilize the banking system. The IMF and the government were also developing plans to deal with the corporate debt problem in Indonesia, he added.

• Crédit Suisse and Union Bank of Switzerland announced on January 13 that they had agreed to postpone payments on Korea's debt following similar action by the Swiss Bank Corporation. It was also announced that officials from the world's largest banks would meet with high-level Korean officials in New York to seek agreement on a plan to postpone payment of as much as $35 billion in short-term debts owed by Korea and its banks. Such an agreement would give Korea time to fashion a long-term solution to its credit problems. In addition, on January 14, ten Japanese banks agreed to roll over their loans to Korean borrowers until the end of March.

• Korea's top five business conglomerates (chaebols) said on January 14 they would draw up sweeping restructuring plans aimed at restoring foreign confidence.

• Chinese Deputy Prime Minister Zhu Rongji said on January 14 that the economic crisis would put pressure on China's exports and the country's capacity to attract foreign investment, but he reiterated that China would not devalue its currency. The Chinese government has full confidence in the yuan, he said. ■

Clarification

In the last issue of the *IMF Survey,* dated January 12, 1998, page 1, lead article, the second sentence should read: "This disbursement—part of Korea's three-year $21 billion stand-by credit, approved on December 4, 1997—represented an acceleration of the original phasing under the agreement."

Indonesia Commits to Accelerated Reforms

(Continued from front page) same time, the external current account balance is expected to move from a deficit into a sizable surplus, thereby generating additional foreign exchange to help the country repay its external debt.

Budget. The 1998/99 budget will be revised to accord with the newly agreed macroeconomic framework, while still adhering to Indonesia's long-standing balanced-budget principle. Based on the IMF presentation, this would imply that the budget would record a small deficit, of about 1 percent of GDP, a level that strikes an appropriate balance between the need to avoid an undue fiscal deterioration and the need to avoid an undue fiscal contraction that would further depress economic activity. Nevertheless, to achieve this objective, serious measures will still be required. In particular, action will need to be taken to curb energy subsidies, which have grown to unsustainable proportions as the rupiah's depreciation has pushed domestic prices far below world levels. Accordingly, the government will phase out subsidies gradually by raising both fuel and electricity prices in steps, except for those on kerosene and certain diesel fuels, where increases will be kept to a minimum, so as to protect the poor.

Fiscal Transparency. In order to ensure that the public is kept fully informed of all government activities, the accounts of the Reforestation and Investment Funds will be brought into the budget in 1998/99.

Public Sector Projects. Under current economic conditions, public spending must be limited only to those items that are of vital importance to the country. For this reason, the program envisages that development spending will be curtailed, including by canceling immediately the 12 infrastructure projects that were recently postponed or placed under review. Moreover, budgetary and extrabudgetary support and credit privileges granted to IPTN's airplane projects will be discontinued, effective immediately. In addition, all special tax, customs, and credit privileges for the National Car project will be revoked, effective immediately.

Monetary Policy. Monetary policy will need to be kept firm for a sustained period, until confidence in the currency is restored. To signal the government's commit-

ment to this stance, Bank Indonesia will be given full autonomy to conduct monetary policy, and start immediately to unilaterally decide interest rates on its SBI certificates. As the program measures take hold and confidence returns, market interest rates should gradually begin to fall, while capital that has moved overseas should return to the country, providing the banks with sufficient liquidity to resume their lending activity.

Bank and Corporate Sector Restructuring. It has become vitally important to restore the banking system to financial health and to alleviate the difficulties of the corporate sector. Specific plans to assist the banking system are now being formulated, which will be announced over the coming days.

Structural Reforms. The program envisages that virtually all of the restrictions that have been put in place will soon be swept away. For instance:

- From February 1, BULOG's monopoly will be limited solely to rice. This means its existing monopoly over the import and distribution of sugar as well as its monopoly over the distribution of wheat flour will be eliminated.
- To complement this action, domestic trade in all agricultural products will be fully deregulated, so traders will have the freedom to sell their goods wherever they want and to whom they want. The Clove Marketing Board will be eliminated by June 1998.
- As of February 1, all restrictive marketing arrangements will be abolished, leaving firms free to produce and export their products as they wish and as the market decides. Specifically, the cement, paper, and plywood cartels will be dissolved.
- Another pressing need in the current circumstances is to encourage foreign investment. Accordingly, for instance, by February 1, all formal and informal barriers to investment in palm oil plantation will be removed, while all restrictions on investment in wholesale and retail trade will be lifted.
- Measures are also being taken to alleviate the suffering caused by the current, severe drought. The program envisages that community-based work programs will soon be introduced to sustain the purchasing power of the poor. In addition, to ensure that adequate food supplies are available at more reasonable prices, effective February 1, tariffs on all food items will be cut to a maximum rate of just 5 percent, while tariff rates on nonfood agricultural products will be reduced by 5 percentage points.

Last, but not least, particular attention is being paid to the proper financing of small and mid-size enterprises and exporters. To make funds available for this purpose through the banking system, the Asian Development Bank is putting in place a program whose details will be announced shortly.

As you can see, this program has a very strong structural component in the financial sector as well as in the corporate sector. The intensive involvement of our friends from the World Bank and the Asian Development Bank is therefore crucial for successful implementation. I am pleased that the staffs of our international organizations are cooperating effectively, and I am also happy to tell you that [James] Wolfensohn, the President of the World Bank, will visit Indonesia shortly.

As President Suharto wishes to take personal responsibility for the quick and full implementation of the program, he has decided that the people of Indonesia must be fully informed of its content through the immediate publication of the Letter of Intent, which he has decided to sign personally. Moreover, he has decided that in order to ensure that the economic objectives are realized, he will appoint a high council of economic ministers—reporting directly to him—to oversee the implementation of the program.

In expressing my confidence in the success of this program, my thoughts go to those who may experience hardships—hopefully for only a short period of time—because of the very strength and rapidity of the adjustment process. The program provides for strengthened measures targeted to alleviating the plight of the most vulnerable people in the country. I would like the government of Indonesia to know that the management of the IMF is open to consider very favorably any adjustments of budgetary allocations in this domain, provided these are financed by a corresponding reduction of other budgetary expenditures of lesser priority, military or otherwise.

This revitalized program is bold and far-reaching, addressing all of the critical problem areas of the economy and deserving the full support of the international community. I am confident that, if this program is implemented with the determination and commitment that I myself have seen over the past two days, Indonesia should soon be able to begin to overcome its economic crisis.

Recent Use of IMF Credit
(million SDRs)

	December 1997	Jan.–Dec. 1997	Jan.–Dec. 1996
General Resources Account	9,013.27	16,112.86	5,270.96
Stand-By Arrangements	8,984.45	13,255.39	2,471.06
Of which: Supplemental Reserve Facility	4,100.00	4,100.00	0.00
EFF Arrangements	28.82	2,749.87	2,625.29
CCFF	0.00	107.60	174.62
SAF and ESAF Arrangements	92.87	730.59	708.64
Total	**9,106.14**	**16,843.45**	**5,979.60**

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.

Data: IMF Treasurer's Department

Address to Bankers' Forum

Fischer Presents IMF Perspective on Origins, Implications of Asian Crisis

Stanley Fischer, First Deputy Managing Director of the IMF, addressed the Midwinter Conference of the Bankers' Association for Foreign Trade on January 22, 1998 in Washington, D.C. on "The Asian Crisis: A View from the IMF." Following are edited excerpts of his remarks.

The crisis in Asia has occurred after several decades of outstanding economic performance. During the 30 years preceding the crisis, per capita income levels had increased tenfold in Korea, fivefold in Thailand, and fourfold in Malaysia. Moreover, per capita income levels in Hong Kong and Singapore now exceed those in some industrial countries. Until the current crisis, Asia attracted almost half of total capital inflows to developing countries—nearly $100 billion in 1996. In the last decade, the share of developing and emerging market economies of Asia in world exports has nearly doubled to almost one fifth of the total. This record growth and strong trade performance is unprecedented, a remarkable historical achievement. So what went wrong?

Origins of the Crisis

The key domestic factors that led to the present difficulties appear to have been: first, the failure to dampen overheating pressures that had become increasingly evident in Thailand and many other countries in the region and were manifested in large external deficits and property and stock market bubbles; second, the maintenance of pegged exchange rate regimes for too long, which encouraged external borrowing and led to excessive exposure to foreign exchange risk in both the financial and corporate sectors; and third, lax prudential rules and financial oversight, which led to a sharp deterioration in the quality of banks' loan portfolios. As the crises unfolded, political uncertainties and doubts about the authorities' commitment and ability to implement the necessary adjustment and reforms exacerbated pressures on currencies and stock markets. Reluctance to tighten monetary conditions and to close insolvent financial institutions has clearly added to the turbulence in financial markets. Although the problems in these countries were mostly homegrown, developments in the advanced economies and global financial markets contributed significantly to the buildup of the imbalances that eventually led to the crises.

In many respects, Thailand, Indonesia, and Korea do face similar problems. They all have suffered a loss of confidence, and their currencies are deeply depreciated. Moreover, in each country, weak financial systems, excessive unhedged foreign borrowing by the domestic private sector, and a lack of transparency about the ties between government, business, and banks have both contributed to the crisis and complicated efforts to defuse it.

But the situations in these countries also differ in important ways. One notable difference is that Thailand was running an exceptionally large (8 percent of GDP) current account deficit, while Korea's was on a downward path, and Indonesia's was already at a more manageable level ($3\frac{1}{4}$ percent of GDP). These countries also called in the IMF at different stages of their crises. Thailand called on the IMF when the central bank had nearly run out of usable reserves. Korea came still closer to catastrophe, a situation which has improved following the election of Kim Dae-jung, the forceful implementation of the IMF-supported program even before he takes office, and the start of discussions with commercial banks on the rollover of Korea's short-term debt.

Indonesia, on the other hand, requested IMF assistance at an earlier stage, and at the start—in early November—the reform program seemed to be working well. But questions about the implementation of the program and the President's health, as well as contagion from Korea, all took their toll.

IMF-Supported Programs in Asia

The design of the IMF-supported programs in these countries reflects these similarities and differences. All three programs have called for a substantial rise in interest rates to attempt to halt the downward spiral of currency depreciation. And all three programs have called for forceful, up-front action to put the financial system on a sounder footing as soon as possible.

Some have argued that these programs are too tough, either in calling for higher interest rates, tightening government budget deficits, or closing down financial institutions. Let's take the question of interest rates first. By the time these countries approached the IMF, the value of their currencies was plummeting, and in the case of Thailand and Korea, reserves were perilously low. Thus, the first order of business was, and still is, to restore confidence in the currency. Here, I would like to dispel the notion that the deep currency depreciations seen in Asia in recent months have occurred by IMF design. On the contrary, as I noted a moment ago, we believe that currencies have depreciated far more than is warranted or desirable. Moreover, without IMF support as part of an international effort to stabilize these economies, it is likely that these currencies would have lost still more of their value.

Other observers have advocated more expansionary fiscal programs to offset the inevitable slowdown in economic growth. The balance here is a fine one. As already noted, at the outset of the crisis, countries need

to firm their fiscal positions, to deal both with the future costs of financial restructuring and—depending on the balance of payments situation—the need to reduce the current account deficit. Beyond that, if the economic situation worsens, the IMF generally agrees with the country to let automatic stabilizers work and the deficit to widen somewhat. However, we cannot remain indifferent to the level of the fiscal deficit.

Likewise, we have been urged not to recommend rapid action on banks. However, it would be a mistake to allow clearly bankrupt banks to remain open. The best course is to recapitalize or close insolvent banks, protect small depositors, and require shareholders to take their losses. At the same time, banking regulation and supervision must be improved.

The global interest lies in an economically strong Asia.
-Fischer

In short, the best approach is to effect a sharp, but temporary, increase in interest rates to stem the outflow of capital, while making a decisive start on the longer-term tasks of restructuring the financial sector, bringing financial sector regulation and supervision up to international standards, and increasing domestic competition and transparency. None of this will be easy, and unfortunately, the pace of economic activity in these economies will inevitably slow. But the slowdown would be much more dramatic, the costs to the general population much higher, and the risks to the international economy much greater without the assistance of the international community.

Moral Hazard

Of course, not everyone agrees with the international community's approach of trying to cushion the effects of such crises. Some say that it would be better simply to let the chips fall where they may, arguing that to come to the assistance of countries in crisis will only encourage more reckless behavior on the part of borrowers and lenders. I do not share the view that we should step aside in these cases. To begin with, the notion that the availability of IMF programs encourages reckless behavior by countries is far-fetched: no country would deliberately court such a crisis even if it thought international assistance would be forthcoming. The economic, financial, social, and political pain is simply too great; nor do countries show any great desire to enter IMF programs unless they absolutely have to.

On the side of the lenders, despite the constant talk of bailouts, most investors have made substantial losses in the crisis. With stock markets and exchange rates plunging, foreign equity investors have lost nearly three-quarters of the value of their equity holdings in some Asian markets. Many firms and financial institutions in these countries will go bankrupt, and their foreign and domestic lenders will share in the losses. International banks are also sharing in the cost of the crisis. Some lenders may be forced to write down their claims, especially against corporate borrowers. In addition, foreign commercial banks are having to roll over their loans at a time when they would not normally choose to do so. Overall, the Asian crisis has indeed been costly for foreign commercial banks.

In effect, we face a trade-off. Faced with a crisis, we could allow it to deepen and possibly teach international lenders a lesson in the process; alternatively, we can step in to do what we can to mitigate the effects of the crisis on the region and the world economy in a way that places some of the burden on borrowers and lenders, although possibly with some undesired side effects. The latter approach—doing what we can to mitigate the crisis—makes more sense. The global interest, and indeed the U.S. interest, lies in an economically strong Asia that imports as well as exports and thereby supports global growth.

Simply letting the chips fall where they may would surely cause more bankruptcies, larger layoffs, deeper recessions, and even deeper depreciations than would otherwise be necessary to put these economies back on a sound footing. The result would not be more prosperity, more open markets, and faster adjustment, but rather greater trade and payments restrictions, a more significant downturn in world trade, and slower world growth.

Role of the IMF

When crisis does strike, the IMF has been willing to act in accordance with its purposes to deal with major problems confronting the international economy. On numerous occasions, the IMF has helped provide the expertise and vision needed to come up with pragmatic solutions to important international monetary problems, and it has helped mobilize the international resources to make them work.

There is no denying that each of these crises has been difficult—especially for the IMF members most adversely affected. In each case we, the IMF and the international community as a whole, learned from our experiences. And in each case, it is clear that without Fund assistance, things would have been much worse.

We are deeply aware in the IMF that our support derives ultimately from the legislatures that vote to establish their countries' quotas—their deposits—in the IMF. We must justify that support. But it must also be recognized that contributions to the IMF are not fundamentally an expense to the taxpayer; rather, they are investments. They are an investment in the narrow sense that member countries earn interest on their deposits in the IMF. Far more important, they are also an investment in a broader sense, an investment in the stability and the prosperity of the world economy. ■

Georgetown University Address

Rubin Stresses IMF's Central Stabilizing Role, Need to Update Global Financial Structure

On January 21, at Georgetown University in Washington, D.C., U.S. Treasury Secretary Robert E. Rubin delivered an address on the Asian financial situation and the challenges posed to the international financial system. Excerpts from his remarks follow:

In the face of [the] challenge [of the Asian financial turmoil], our first job is clear: to help stabilize the immediate crisis. Yet, to make the most of the opportunities and limit the risks of the new global financial system and to have a viable situation for the years ahead, we must also modernize the architecture of the international financial markets that we helped create and that has served us so well for the last fifty years.

No single factor would likely have produced a financial crisis. While economies usually adjust in a relatively orderly fashion to market swings, in this case the combination of factors proved combustible. When these crises began, foreign investors started to withdraw capital, local companies sought to hedge hard currency exposures, exporters stopped bringing their export earnings home, and citizens moved their savings abroad. The international community has been involved in a major effort to focus countries on these underlying problems, and to assist them in addressing them. These issues have been a central focus of the IMF as well as of our interactions with these countries.

The program we have supported has focused on four key elements: supporting reform programs in individual nations; providing temporary financial assistance when needed; encouraging strong action by Japan and the other major economic powers to promote global growth; and fostering policies in other developing and emerging economies to reduce the risk of contagion.

First, and most importantly, our approach requires that these countries take the concrete steps necessary to reform their economies. These programs, which are designed with the IMF, address the specific causes of each nation's crisis and can be adapted as the situation changes. These are not austerity programs. These are primarily programs of structural and financial reform. It is the crisis and the ensuing loss of confidence—not the reform programs—that leads to economic hardships.

The second element of our approach is to support these programs of reform with temporary financial assistance. When a nation's financial stability is at risk, this money provides the breathing room for a nation to establish the conditions to restore economic confidence, attract private capital and resume growth.

The third element is to encourage the major industrial countries to act to strengthen their own economies and take the steps necessary to promote the strong economic and financial environment globally that can contribute to resolving the crisis in Asia.

Fourth, and finally, we have worked closely with the IMF to encourage other emerging markets to make policy adjustments to reduce their vulnerability to contagion from the countries now in crisis. The IMF is the right institution to be at the center of these support programs. With tremendous expertise and technical resources, the IMF has the ability to shape effective reform programs. As a multinational organization, it is able to require an economically distressed country to accept conditions that no contributing nation could require on its own. Finally—and critically important—the IMF internationalizes the burden during a global financial crisis by using its pool of capital.

The American people should also know this: over the past fifty years our contribution to the IMF has not cost the taxpayer one dime. When the IMF draws on our commitments, we receive a liquid, interest bearing offsetting claim on the IMF. There are no budget outlays. Our contribution does not increase the deficit, or divert resources from other spending priorities. Support for our periodic pledge to the IMF, and support for a new emergency fund, the New Arrangements to Borrow, which supplements the IMF's resources to deal with crises such as this one, is critical.

The financial instability in Asia involves enormously complicated problems and presents challenges the global financial system has never faced. I am confident that overall these are strong well-crafted programs and the best and probably the only viable way to help these countries re-establish stability and confidence.

The global economy needs architecture as modern as the markets. That is why, even as we have tried to confront the immediate crisis in the Asian region, we have also begun an intensive effort to improve the global financial system to both better prevent crises from occurring and better deal with them if they do occur.

To build on these efforts, we have begun an intensive internal effort with the [U.S.] Federal Reserve Board and others, to identify and analyze possible mechanisms for dealing with new challenges to the international financial system. This initiative will focus on four objectives: improving transparency and disclosure; strengthening the role of the international financial institutions in helping to continue to deal with the challenges of today's global markets; developing the role of the private sector in bearing an appropriate share of the burden in times of crisis; and strengthening the regulation of financial institution in emerging economies. ■

AEA Meeting

Presentations Spotlight U.S. Economic Issues, Transition Economies, and Financial Crises

What would prompt many of the top names in the economics profession to spend New Year's weekend in cold, slushy Chicago? A touch of "irrational exuberance" perhaps. Indeed, the coiner of that phrase, Alan Greenspan, Chairman of the U.S. Federal Reserve, was on hand to deliver the keynote address at the opening luncheon of the event—the annual meeting of the American Economic Association (AEA).

The four-day gathering traditionally serves as a major venue for introducing new research and typically features lively discussions of a wide range of economic topics. This year, major themes included the status of the U.S. economy and growth prospects for the Group of 7 countries, developments in Africa, Russia's future and the transition process worldwide, global monetary policies and financial crises in Asia, and sessions on trade, development, and technology.

U.S. Economic Issues. In his comments, Greenspan focused on recent statistical problems in the overestimation of the consumer price index (CPI) for the U.S. economy. Mismeasurement in and of itself, he said, does not injure a vibrant economy, as has been evidenced by the sustained good performance in the United States. "Overstating the CPI simply means that real growth and standards of living are understated." What did concern him is that biases in price measurement may begin to matter more when inflation is low. Echoing Milton Friedman, he said that "persistent *deflation* is, at its root, a monetary phenomenon." Moderate, ongoing deflation distorts the optimal allocation of resources just as persistent inflation does.

Finally, Greenspan pointed out that it is measures of individual prices—not their aggregation—that matter. Goods in the U.S. economy have been changing—in a qualitative sense—so rapidly in recent years that it is impossible to make basket comparisons that are meaningful over time. About one-half of the one percentage point overstatement in the U.S. CPI in recent years has been attributed empirically to failures to adjust for these qualitative changes, and the other half is due to problems in aggregation techniques. While Greenspan had no suggestions for how this mismeasurement would influence the conduct of monetary policy, he seemed to hint that the deflationary trend is more worrying to him that the measurement error.

African Prospects. Stanley Fischer, First Deputy Managing Director of the IMF, presented a paper coauthored with Mohsin Khan of the IMF Institute and Ernesto Hernández-Catá of the IMF African Department, entitled "Africa: Is This the Turning Point?" The paper argued that the current period will unavoidably mark a turning point for Africa because official development assistance is on a downward trend and globalization will exert its own pressures. Whether that turning point will pave the way for a stronger growth performance and a reduction in poverty will depend on the economic policies that the African countries pursue. Fischer noted the recent high positive average growth performance across 44 African countries and proposed various actions that could sustain this rate of growth into the medium term, such as improving investment by reducing risks, creating physical infrastructure, redirecting public spending toward health and education, and strengthening governance and the credibility of legal institutions.

Of course, all these measures must be undergirded by sound macroeconomic and structural policies over a sustained period, he said. The credibility of these measures must also be reinforced by externally monitored "restraint mechanisms," such as regional trade organizations, independent central banks, and investment guarantee agencies. Fischer also made the point that "Africa has two potential engines of growth—South Africa and Nigeria, which together comprise 60 percent of the total GDP of Africa." These two countries could, if they grew at their potential trend of 6–7 percent a year, act as locomotives for major regions of the continent.

Several other sessions were organized on specific policy and sectoral issues in Africa. Dhaneshwar Ghura of the IMF African Department presented a paper on "Determinants of Tax Revenue Performance in Sub-Saharan Africa." In the debate following the presentation, one participant questioned why the IMF tends to recommend raising tax rates in Africa. Ghura clarified the IMF's concerns, citing examples of several African countries that have much higher statutory tax rates than could be effectively collected. "The IMF does not advise countries to raise tax *rates* but rather tax *revenues,*" he said. In many cases this entails improving tax administration as the first step. Also on the side of public expenditure, the IMF does not recommend reducing fiscal deficits blindly. Rather, Ghura

Photo Credits: Enny Nuraheni for Reuters, page 17; Supri for Reuters, page 18; Denio Zara for the IMF, pages 21 and 23; and Susan J. Adams, page 25.

said, the IMF focuses on how "African countries should improve the efficiency or allocation of spending to redirect it toward human and capital infrastructure formation."

Russia's Future and the Transition Process. A second paper by Fischer—co-authored by Jorge Marquez-Ruarte of the European II Department—entitled "The Future of the Russian Economy" was presented by Fischer at a session attended by a standing-room-only crowd. Fischer emphasized that Russia has rapidly become a market economy, with 70 percent of economic activity generated by the private sector. Political achievements have been considerable, and the government has begun to design indirect instruments of macroeconomic control, under the aegis of a sophisticated and independent central bank.

In order to capitalize on the impressive progress in controlling inflation and the possibility of positive growth, Fischer noted that "the Russian government must now focus on fiscal performance and reform, as well as a number of structural reforms." Fellow presenter Padma Desai of Columbia University agreed with this assessment and predicted that Russia would begin to see improved economic growth once labor market and other structural issues were addressed. Responding to several Russian nationals in the audience who challenged his generally positive view of recent developments, Fischer expressed confidence in the reform efforts and the credibility of the Russian government.

Several other sessions surveyed the wider transition process in Eastern Europe, the former Soviet Union, and China. A number of speakers addressed institutional features and anecdotal evidence on the privatization process in individual countries, highlighting the problems of creating a suitable legal environment and financial system, as well as adequate physical infrastructure in transport and communications, to support newly privatized firms. Desai made the point that, "In Western countries, the economic and political institutions were developed first, and these paved the way for markets to work efficiently. The converse is true in many transition economies today: the development of private enterprises is goading the development of correct institutional structures."

In another session on policy issues in transition, Hernández-Catá made the point that "growth in the transition process is determined both by macroeconomic stabilization and by the extent of structural and institutional reforms." It was also pointed out, in a related session, that many transition economies are wrongly pursuing inflation-led growth, which can only backfire. In several empirical studies examining the growth-inflation relationship, it was found that, after a certain threshold, a negative partial correlation appears—in other words, the association between growth and inflation weakens as the inflation rate rises.

Monetary Policy. Alessandro Prati of the IMF Research Department chaired a session on monetary policy at which he also co-presented a paper (with Leonardo Bartolini, from the New York Federal Reserve) on "Reserve Requirements, Open Market Intervention, and the Intramonth Behavior of Money Markets." This paper used 12 years of daily interest and reserve data from the U.S. federal funds market to examine how reserve requirements—which are effectively taxes on bank credit—distort liquidity management in day-to-day operations. The paper concluded that better monetary policy decisions (that is, decisions that cause fewer liquidity distortions) could be made if the dynamic properties of the frequent time series were examined by monetary authorities.

Above, clockwise, Willem Bier displaying the IMF Institute's new CD-ROM on exchange rate analysis; Stanley Fischer (left) and Ernesto Hernández-Catá; and, at the podium, Ratna Sahay.

Financial and Currency Crises. Not surprisingly, several sessions were organized on topics pertaining to financial crises, particularly in Asia. A notable session examined possible causal links between banking and currency crises in Latin America and Asia. In a sweeping study of 102 financial crises across 20 countries during the past 20 years using the twin measures of degree of currency depreciation and percentage loss of reserves, panelists from the U.S. Federal Reserve Board and the Institute for International Finance noted that the Latin American currency crises in the early 1980s were about four times worse than the recent upheavals in Asia. Several participants noted that many countries, in the wake of financial market liberalization, experienced a proliferation of banking crises, which in turn led to currency crises. However, Victoria Miller of the University of Montreal presented empirical evidence of a "double drain," where

the causal links between banking crises and currency or balance of payments crises have been found to run both ways (in a Granger-causality sense). But panelist Graciela Kaminsky, an Argentinean economist at the U.S. Federal Reserve Board, observed that more recent Latin American currency crises have been less severe than those of the early 1980s, and the Asian markets appear to be taking lessons from the Latin American experiences. Kaminsky posed the provocative question: "Are Asians learning to tango?"

Ratna Sahay of the IMF Research Department served as a discussant at a session on capital movements and macroeconomic management in the Asia-Pacific region. In an indirect reply to the question posed by Kaminsky in the earlier session, Sahay noted that Latin American countries had previously used capital inflows for consumption, while Asian countries had been more interested in investment, and this could explain why the financial crises were delayed in Asia as compared to Latin America. Nonetheless, with the spate of short-term capital inflows in Asia in recent years, Sahay stated that "Asian central banks could have raised the marginal reserve requirements on dollar deposits, and should have invoked early warning signals to avoid the recent crises."

The association between growth and inflation weakens as the inflation rate rises.

Trade. Trade policy continued to dominate many of the AEA sessions this year. Numerous panels addressed themes of regional integration, trade liberalization, and the trade-offs between regional integration and multilateral trade arrangements. Phillip Swagel of the IMF Research Department provided technical commentary on a large empirical study prepared by the U.S. International Trade Commission on the effects of the North American Free Trade Agreement (NAFTA) on trade flows. This paper examined the bilateral trade flows between Mexico and the United States or Canada, using data on over three hundred specific industries during the post-NAFTA agreement period from 1994–97. It was found that no discernable trade flow increases occurred for over half of the industries studied. However, increases in trade flows did occur in a concentrated subsector of industries in the area of electronics and computer equipment.

Arms and Development. A lively session was held on trade in one particular commodity: military armaments. Nancy Happe, of the IMF Policy Development and Review Department, presented a paper on "Recent Trends in Arms Trade." At that same session, Professor Ronald Smith of the University of London presented a paper arguing that general industrial development (in products such as steel and autos) in Korea and Taiwan Province of China foreshadowed the development of their military production, and thus the basis of growth in those countries was not dependent on arms production as some scholars had previously claimed. There was also a discussion about how Brazil, Egypt, and South Africa developed entire defense platforms behind other trade impediments. This same theme was revisited in another session on "demilitarization in Africa," where the large volume of arms exports from South Africa to the rest of southern Africa was the focal point of discussion.

Technologies for Economists. Finally, in one of several sessions on new technologies for economists, Willem Bier of the IMF Institute presented a new product: a CD-ROM on exchange rate analysis, the final version of which will be ready at the end of February (for additional information, please e-mail: publications@imf.org). This session was packed with interested economists, who also got a taste of other new CD-ROMs and interactive technologies now coming on the market to teach basic macroeconomic and microeconomic theory. The days of students tediously drawing graphs of marginal cost curves by hand may be over. ■

Susan J. Adams
IMF Institute

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:

New Zealand, No. 98/1, January 12

Cameroon, No.98/2, January 21

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

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
January 12	4.21	4.21	4.61
January 19	4.24	4.24	4.65

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

Issue of Credibility

Making Currency Boards Operational Requires Wide Array of Technical Preparations

There has recently been a revival of interest in adopting currency board arrangements as a means of stabilizing exchange rates and establishing economic order when more conventional systems might be ineffective. A currency board is required to maintain the foreign exchange cover of designated domestic liabilities—that is, the authorities commit to issue domestic currency solely in exchange for a specified foreign currency at a fixed rate, limiting their discretion to create money by extending credits to the government or the banking system. In *Making a Currency Board Operational*, Charles Enoch and Anne-Marie Gulde of the IMF's Monetary and Exchange Affairs Department argue that a successful currency board arrangement requires, in addition to adopting appropriate macroeconomic policies, an early preparation of the legal and institutional aspects of the transition. The range of necessary preparations varies, but generally involves changing the central bank law, reorganizing the central bank, devising appropriate guidelines for reserve management, and adapting the government's cash and debt management activities.

Doubt about the soundness of the banking sector is among the greatest threats to the credibility of a currency board arrangement. Countries experiencing banking sector problems require additional measures before initiating a currency board, including broad-based restructuring or closure of banks that do not comply with established prudential standards. Unless these preparations are made in time and a coherent system is in place, the credibility of the currency board arrangement itself—and with it the entire range of economic benefits desired from the adoption of the arrangement—will be at stake.

Currency and Level of Peg

In establishing a currency board, the authorities must choose a foreign currency against which to peg the domestic currency. In their selection process, they must consider several variables, including the direction of trade flows, the denomination of imports and exports, and the denomination of international debt. The currency of the predominant trading partner is often an advisable peg, as it reduces exposure to swings in the import value of reserves. In this regard, the authorities should analyze prospective trade patterns rather than assume that historical patterns will characterize the future. The domestic acceptance of a currency may also need consideration. Widespread dollarization—replacing the domestic currency with the U.S. dollar—could, for example, be an argument in favor of the U.S. dollar, even in a country whose trade is not predominantly with the United States or is not U.S. dollar-denominated. In any case, the peg currency should be that of a country with reasonably deep financial markets, offering a range of financial instruments underwritten by domestic and foreign issuers.

The authorities must also determine at which level to peg. The most appreciated level that could be feasible is the rate at which the available foreign exchange reserves would just cover the specified domestic monetary liabilities. Calculating this rate requires a definition of available foreign exchange reserves and of specified domestic monetary liabilities. Foreign exchange reserves can, for example, be specified net or gross, and can include or exclude borrowings from the IMF and other long-term debt items. The specified domestic monetary liabilities can comprise reserve money or domestic liabilities of the central bank. In many countries, the authorities may see a need for excess coverage—implying a somewhat more depreciated exchange rate—to provide for future open market operations or a safety margin for banking sector support. The level of excess reserves would depend on the anticipated need for central bank intervention.

Changing the Law

Currency board arrangements are generally established by law, protecting their operations from political interference and manipulation by vested interests. As such, the authorities should attempt to establish a political consensus for introducing a currency board arrangement law. To be operational, the law must, at a minimum, specify the fixed exchange rate and require that foreign exchange reserves be sufficient to cover domestic liabilities. In some countries, the law identifies constraints on the operations of the currency board, such as the prohibition on central bank lending to government

Incentives for a Currency Board Arrangement

Currency board arrangements are especially attractive to three groups of countries: small open economies with limited central banking expertise and incipient financial markets; countries that wish to belong to a broader trade or currency area; and countries that wish to enhance the credibility of exchange-rate-based disinflation policies. In the first two instances, the incentives for establishing such arrangements include simplicity of operation and the strengthened credibility of sound monetary and fiscal policies. For countries in the third group, the main attraction of currency board arrangements has been transparency and the strict limits they place on the monetization of government deficits or the provision of credits to the banking sector. Such stringencies help to provide the essential preconditions for a subsequent rapid return of domestic interest rates to international levels in these countries.

and restrictions on central bank monetary operations. While this approach contributes to the transparency of a currency board and, hence, its credibility, excessive legal prescription can reduce the authorities' ability to manage the currency board arrangement flexibly, which may, in turn, reduce confidence in the sustainability of the arrangement and adversely affect its credibility.

Reorganizing the Central Bank

As mentioned earlier, a currency board is designed to maintain the foreign exchange cover of designated domestic liabilities. The balance sheet of the central bank must therefore be re-specified so that assets and liabilities of the currency board can be separately identified. The authorities have the choice of:

When members draw on the IMF, they "purchase" other members' currencies, or SDRs, with an equivalent amount of their own currency.

Stand-By, EFF, and ESAF Arrangements as of December 31, 1997

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			**28,284.52**	**14,952.82**
Argentina	April 12, 1996	January 11, 1998	720.00	107.00
Bulgaria	April 11, 1997	June 10, 1998	371.90	124.30
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
Estonia	December 17, 1997	March 16, 1999	16.10	16.10
Hungary	March 15, 1996	February 14, 1998	264.18	264.18
Indonesia	November 5, 1997	November 4, 2000	7,338.24	5,136.77
Korea [1]	December 4, 1997	December 3, 2000	15,500.00	7,300.00
Latvia	October 10, 1997	April 9, 1999	33.00	33.00
Romania	April 22, 1997	May 21, 1998	301.50	180.90
Thailand	August 20, 1997	June 19, 2000	2,900.00	1,100.00
Ukraine	August 25, 1997	August 24, 1998	398.92	253.86
Uruguay	June 20, 1997	March 19, 1999	125.00	125.00
EFF Arrangements			**11,046.90**	**5,701.02**
Algeria	May 22, 1995	May 21, 1998	1,169.28	253.28
Azerbaijan	December 20, 1996	December 19, 1999	58.50	33.35
Croatia, Republic of	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	59.18
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
Panama	December 10, 1997	December 9, 2000	120.00	110.00
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Philippines	June 24, 1994	January 31, 1998	791.20	245.95
Russian Federation	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**	**2,071.71**
Armenia	February 14, 1996	February 13, 1999	101.25	50.63
Azerbaijan	December 20, 1996	December 19, 1999	93.60	38.02
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	0.00
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	0.00
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	20.67
Mauritania	January 25, 1995	July 13, 1998	42.75	0.00
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	0.00
Sierra Leone	March 28, 1994	May 4, 1998	101.90	5.06
Tanzania	November 8, 1996	November 7, 1999	161.59	74.47
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			**43,520.65**	**22,725.55**

[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

• establishing the currency board as a mere accounting element within the central bank;

• identifying these assets and liabilities in a separate department within the central bank;

• or taking the currency board functions out of the central bank into a separate institution.

The second option has been favored in most recent currency board arrangements: it maintains the synergies arising from the various central bank functions conducted within a single institution but at the same time makes visible the functions related to the currency board.

The authorities also need to decide to what extent the noncore functions of the central bank should be retained within the same institution. Among these, the most important are the banking supervision and the fiscal agency functions. The main argument for retaining these functions is the synergy of skills and resources. The argument for separating them is the need to improve transparency and avoid conflict of interest.

Managing Foreign Exchange Reserves

Under a currency board, the central bank stands ready to exchange unlimited amounts of domestic liabilities for the designated peg currency; it is legally required to have sufficient coverage of foreign exchange reserves, measured in terms of the designated peg currency, to meet designated domestic liabilities. These obligations are most easily met by maintaining the country's foreign exchange reserves in the designated peg currency. Conversely, the currency board will be more difficult to operate, the greater the proportion of the coverage of domestic liabilities held in assets that have significant fluctuations against the designated peg currency. This implies that in many countries the desired composition of reserves under a currency board will differ from that existing at the time when the country decides to adopt a currency board. For instance, a country deciding to peg a European currency may at the outset have a high share of its reserves in dollars. Even more important, it may have significant gold holdings in its reserves. The more a country is constrained by the full coverage requirement—the lower the level of foreign reserves over the coverage requirement—the more carefully its reserves will have to be managed.

Adapting Cash and Debt Management

A currency board's credibility would be seriously jeopardized if a shortage of banknotes were to prevent the central bank from being able to honor its commitment to supply unlimited amounts of the designated peg currency against domestic liabilities. As such, the success of a currency board calls for an adequate supply of banknotes denominated in the peg currency. At the same time, in the event of excess demand for domestic currency and deposits, the authorities should arrange for the repaid transmittal of peg currency notes abroad, so that the amounts can be invested as quickly as possible.

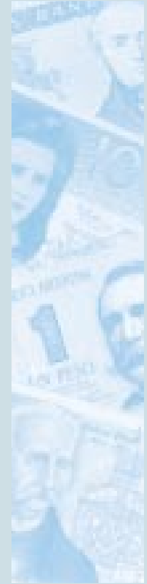
The credibility of a currency board is enhanced if it operates an exchange window at the central bank itself, where the public at large can undertake cash exchanges. The operation of this window requires a decision whether or not there should be a trading spread—that is, a higher exchange rate for buying foreign exchange than for selling the same amount. In deciding for or against a spread, the central bank has to weigh considerations of cost recovery and supporting a foreign exchange market outside of the central bank—which all argue in favor of a spread—against transparency and credibility, which are best maintained if the central bank buys and sells the anchor currency at exactly the official peg rate.

Many central banks are extensively involved in government debt markets, often in operations that include the issuance and marketing of treasury bills, as well as the provision of various debt management services to the government. Under a currency board, the role of the central bank in this area is curtailed in that it will no longer be able to acquire government paper for its own portfolio, nor to influence monetary conditions through large-scale open market operations or primary auction issues. To avoid any potential conflict between debt management and the operations of the currency board, it may be best for the fiscal authorities to take over both debt management and the organization of the primary treasury auctions. Such a separation, if combined with a move of the government's operations account to a commercial bank, would ensure that treasury bill auctions and repayments do not change the outstanding stock of reserve money and, hence, do not affect the currency board.

Timing and Announcing the Transition

A time frame for the introduction of the currency board, once announced, should be binding: delay could cause uncertainty and speculation against the currency. Since speculation in the run-up to a currency board could be destabilizing and lead to self-fulfilling prophecies, the authorities may opt to announce the exchange rate at an early date. While this would place constraints on exchange rate management until the currency board is in place, markets would assist in moving the rate toward the announced level. An advance announcement should set a rate that can be maintained with reasonable certainty; a devaluation prior to the introduction of the currency board, while feasible, might have significant costs in terms of credibility. ■

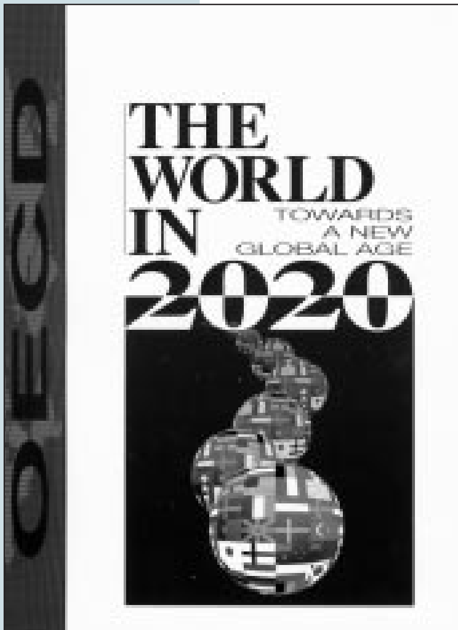
Making a Currency Board Operational, by Charles Enoch and Anne-Marie Gulde, is published as IMF Paper on Policy Analysis and Assessment 97/10. Copies are available for $7.00 each from Publication Services. See ordering information on page 31.



OECD Scenarios

Global Integration Is Key to Prosperity in Twenty-First Century

Over the past decade, the process of global integration, which effectively began over a century ago, has picked up speed. The globalizing world economy, according to the Organization for Economic Cooperation and Development (OECD), in *The World in 2020: Towards a New Global Age*, provides a "historic coincidence of interests" for OECD and non-OECD countries (see box, page 31). Closer linkages between these economies are beneficial for sustaining economic growth. There is now a "window of opportunity" for improving living standards, eliminating poverty, promoting environmental sustainability, and moving along an accelerated path toward sustainable development in all areas of the world by shifting economies onto a higher performance growth path.



Several major challenges need to be met, however, to achieve these goals, including:

• further progress in liberalizing trade, investment, and financial flows, and in strengthening multilateral systems, to facilitate deeper economic integration among the world's economies;

• domestic policy reforms to counteract the backlash in some OECD countries against globalization, which is sometimes blamed for persistent unemployment, widening income inequality, and deindustrialization;

• the need for some dynamic and emerging economies to open their markets further to imports from both industrial countries and the lower-cost developing countries;

• far-reaching policy changes in non-OECD countries, particularly those where the transition from a developing to a more advanced economic structure has just begun (in particular, sub-Saharan Africa).

The OECD study presents two alternative visions of the world economy in 2020: a slow-track reform and adjustment scenario ("business as usual") and a high-performance vision ("the new global age"). The high-performance vision is not a forecast, the OECD study cautions, but an attempt to lay out a plausible scenario for the world economy if governments undertake a wide range of necessary reforms.

World in 2020

Trends in population and technological change will clearly mark the future, according to the OECD report. World population is expected to increase to about 8 billion in 2020 from 5 billion in 1990. The non-OECD area, especially in Africa and parts of south Asia, will account for virtually all of this increase. The defining demographic characteristic in most OECD countries (particularly Japan), in contrast, is population aging, reflecting the end of the baby boom, falling fertility rates, and increased life spans. At the same time, improvements in information technology and biotechnology and the development of advanced materials, alternative energy sources, and improved transport, along with deeper integration among the world's economies and improvements in human capital, will provide the potential for continued growth in world prosperity.

Fully realizing the potential benefits of these developments over the next 25 years will depend in large part on government policies. If governments make only slow progress in international trade and finance liberalization, fiscal consolidation, and product and labor market reform, productivity performance in OECD countries might continue to stagnate—as it has for the past 25 years in many OECD countries—and growth could fall to about 2 percent, compared with an average of 3 percent over the past 25 years. For many non-OECD countries, poverty and marginalization could remain a major problem, unless they develop the necessary capacity for development through an appropriate policy framework, governance systems, and social, human, and physical capital.

Under the high-growth scenario, however, where governments move toward global free trade and capital movements and undertake the necessary reforms, world prosperity could grow. In broad terms, according to the OECD study:

Organization for Economic Cooperation and Development

Established in 1961, the OECD's original membership included Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. The following countries have joined the OECD since 1964 (in chronological order): Japan, Finland, Australia, New Zealand, Mexico, the Czech Republic, Hungary, Poland, and Korea.

• Real GDP per capita in the OECD area would be 80 percent higher in 2020 than in 1995 (compared with 50 percent higher under the low-growth scenario); in the non-OECD world, progress would be far more dramatic, given the lower current level of development, with real GDP per capita at about 270 percent above 1995 levels (compared with about 100 percent under the low-growth scenario).

• As the gap in development levels between OECD and non-OECD countries continued to narrow, global economic weight could shift substantially, with the non-OECD share of world GDP rising to 67 percent in 2020, from 44 percent in 1995, and the non-OECD share of world trade increasing from one-third at present to one-half in 2020.

Responding to Policy Challenges

Within and among all countries, there is a need to find new balances between the roles of the state and other public and private actors, the OECD study states. Stable and sustainable macroeconomic policy is another precondition for taking full advantage of the opportunities provided by globalization. This is particularly true for non-OECD countries with a history of macroeconomic instability.

Specific policy responses necessary to realize the new global age vision for 2020 include:

• *Strengthening the multilateral system.* Creation of the World Trade Organization has provided the legal basis for a multilateral trading system and has established clear authority to negotiate and manage a com-

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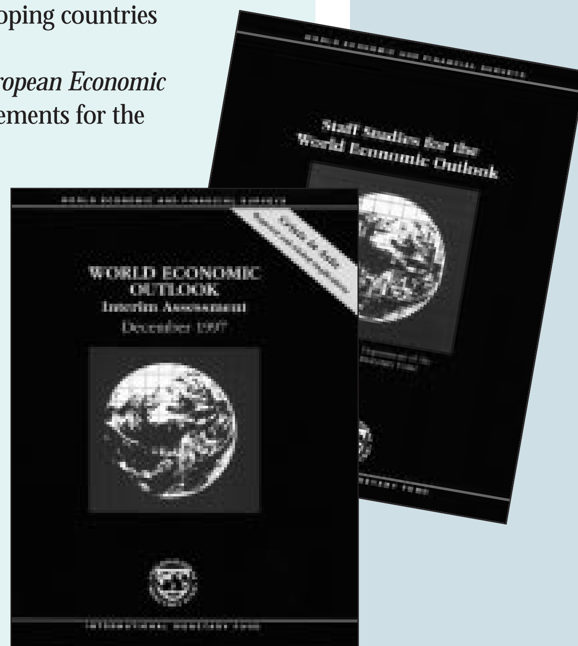
97/178: *Some Issues in the Design of Monetary Instruments for the Operation of European Economic and Monetary Union,* Charles Enoch and others. Briefly summarizes the arrangements for the monetary policy operation in Stage 3 of European Economic and Monetary Union and identifies some areas in which important decisions still have to be made or refinementsintroduced.

97/179: *A Decade of Civil Service Reform in Sub-Saharan Africa*, Ian Lienert and Jitendra Modi. Assesses a decade of experience in civil service reform in a sample of 32 sub-Saharan African countries.

97/180: *Evolution of Monetary Policy Instruments in Russia,* by Tomás J. T. Baliño, David S. Hoelscher, and Jakob Horder. Analyzes the evolution of monetary policy in Russia—particularly the period January 1992–December 1995—with special attention to the role of monetary policy instruments.

97/181: *Empirical Determinants of Household Saving—Evidence from OECD Countries,* by Tim Callen and Christian Thimann. Investigates the empirical determinants of household saving from data from 21 OECD countries, with a particular focus on the impact of tax and social security systems on household saving.



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prehensive set of rules for international trade in goods and services. However, difficult border barriers remain in OECD countries in such areas as agriculture, while barriers to trade and capital movements are generally higher in non-OECD countries. Also, protectionist pressures will continue to be a threat, accentuated by growing competition as service sectors become increasingly internationalized and electronic commerce and cheaper transportation tighten the linkages between economies.

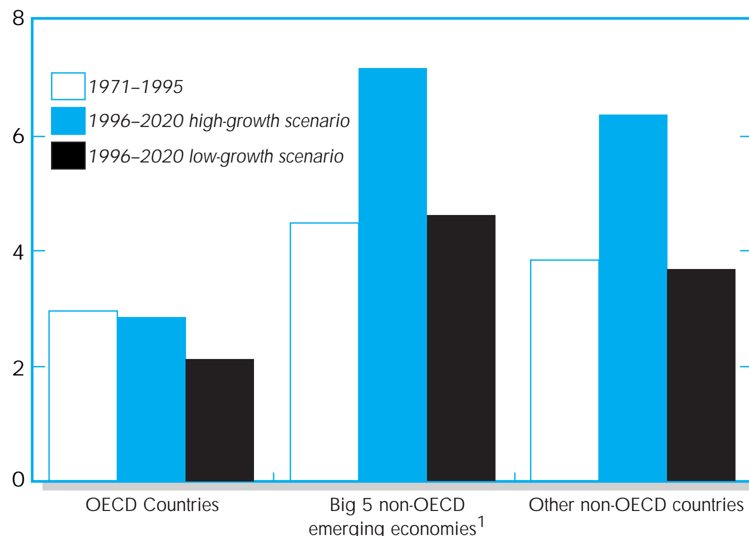
In the financial markets, the desire for broad portfolio diversification will help forge close financial linkages between OECD and non-OECD economies. But the process will need to be supported by appropriate policies, especially in non-OECD countries, such as the removal of capital controls, liberalization of cross-border financial services, and the abolition of restrictions to market access by foreign investors and institutions. In addition, all countries need to step up efforts to modernize their financial structures and upgrade their regulatory and supervisory frameworks.

• *Policy challenges in OECD countries.* Over the past decade and a half, according to the OECD study, it has become increasingly clear that key macroeconomic problems—notably high unemployment and slow growth—are largely of a structural nature. Although price stability has been largely achieved, fiscal positions are now generally worse than in the late 1970s, and unemployment remains high. Significant progress has been made in the financial sector and international trade, but reform has lagged in other areas, particularly labor and product markets.

OECD countries face a demanding structural reform agenda, including product market deregulation, social security issues, labor market flexibility, and policies to cope with population aging.

• *Policy challenges for non-OECD countries.* Despite some successes over the 25-year period ending in 1995, only a handful of non-OECD countries have sustained high GDP growth rates—averaging 5 percent a year—according to the OECD study. Also, despite some progress with poverty reduction, the latest estimates suggest a world total of some 1.3 billion people in poverty—roughly 30 percent of the world's population. Faster growth, such as that associated with the OECD study's high-growth scenario, would substantially reduce these numbers.

A major challenge to non-OECD countries is preventing the marginalization of poor countries and poor people occurring as a consequence of globalization. Important policy efforts include:



[1]Brazil, China (including Hong Kong SAR), India, Indonesia, and Russia.

Data: OECD estimates

• an effective governance system under the rule of law, an active civil society, and a capacity to manage internal conflicts;

• human capital development through investment in education and health and the enhanced participation of all people—notably women—in economic and political life;

• adequate infrastructure for energy, transport, and communications, extending to more backward areas and linking them more closely to national and international markets; and

• easier access—particularly for the poor—to productive assets and financing, through, for example, encouragement of micro investment lending institutions.

Looking toward 2020, the OECD study concludes, one of the central challenges will be to facilitate and consolidate the integration of non-OECD economies into the global economy. Active participation in the global economy depends fundamentally on the strengthening or creation of effective economic, human, social, and institutional capacities. Privatization, a legal framework for enterprises, regulatory reform, and taxation and competition policy are all important areas requiring reform, together with strong macroeconomic policies and financial management. ■

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