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Composition of Fiscal Adjustment Is Critical to Its Long-Term Success

Budget deficits and government debt rose sharply in most industrial countries during the 1980s and early 1990s, posing a potentially serious destabilizing and disruptive threat to the economy. And policymakers, worried about the effects of a cutback in spending on short-term growth, often delayed making the necessary adjustments. Experience over the past several years, however, has demonstrated that strong budget-reducing actions—sufficiently large and properly targeted and timed—can sometimes boost demand and growth, even during the fiscal consolidation.

The ingredients for successful fiscal adjustment are analyzed in two recent IMF Working Papers—*An Empirical Analysis of Fiscal Adjustment*, by C. John McDermott and Robert F. Wescott; and *Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects,* by Alberto Alesina and Roberto Perotti.

In their study, McDermott and Wescott use the fiscal expansion and consolidation experiences of the industrial countries during 1970–95 to examine the interplay between fiscal changes and economic performance. Their analysis attempts to find answers to the following questions:

• Can fiscal consolidations be good for growth?

• Does the composition of the fiscal consolidation influence the likelihood of success (where success is defined as putting a country's public-debt-to-GDP ratio on a sustained downward trajectory)?

• Does the world economic environment matter for the success or failure of fiscal consolidation? *(Please turn to page 24)*

Camdessus Cites Challenges Facing Germany and EU

While issues of the upcoming European economic and monetary union currently preoccupy Germany and Europe, globalization is simultaneously reshaping the world's economic and financial landscape. On January 10, in an address to the Christian Social Union at Wildbad Kreuth, Germany, IMF Managing Director Michel Camdessus outlined the challenges posed by globalization for Germany, Europe, and the IMF. The following summarizes his observations.

Camdessus: Globalization intensifies the need for Germany to address structural weaknesses.

Germany's success in meeting the economic challenges posed after World War II—the need to recreate a viable currency, the necessity of reestablishing economic and social order, and the prospect of rebuilding Europe—augurs well for its future response to globalization, according to Camdessus. Germany's example has helped make monetary stability the cornerstone of European economic policy. Its development of a competitive market economy, coupled with a unique social partnership, has brought years of economic prosperity and social peace, and its steadfast commitment to the construction of Europe has helped promote peace, stability, and economic progress across the continent.

Globalization now seems to pose a threat precisely *(Please turn to following page)*

because it appears to challenge these accomplishments. Efforts to create a strong euro are coming to fruition at a time when the power of global financial markets offers new challenges for authorities responsible for macroeconomic policy. Now that developed countries have become accustomed to extensive social protection, globalization demands increasing flexibility. And while European policymakers are absorbed with preparations for the economic and monetary union (EMU), the global economy continues to evolve in a less predictable way: competition in global markets is intensifying, and trade liberalization and expanding capital markets make it easier to shift production to lower-cost locations.

But a country's relative appeal to investors and producers derives from many factors other than wage levels, and clearly Germany's macroeconomic stability, predictable exchange rate, open trade regime and capital account, productive labor force, and transparent regulatory regime work in its favor. A tradition of macroeconomic stability and industrial excellence, however, has not been able to compensate for structural rigidities—notably in the labor market—that make it difficult for Germany to undertake the necessary adjustments to sectoral shifts in production and employment. These weaknesses are not the result of globalization, but globalization does expose and intensify the need to address structural weaknesses.

German labor productivity is high, but its relative wages are even higher. Hourly labor costs in manufacturing are not only sharply higher than developing country competitors but strikingly higher than the average found in the other Group of 7 industrial countries. Centralized bargaining has discouraged flexibility in wage setting and work practices, raised overhead costs, and compressed wage differentials between high- and low-skilled labor. Generous and lengthy unemployment benefits have discouraged job seeking, and the transfer of this system to eastern Germany has encouraged particularly high unemployment there. German employers, eager to remain profitable and competitive, have turned to capital-intensive technology and outsourcing to lower production costs, but with a resultant rise in Germany's structural unemployment that has compounded the country's fiscal burden and necessitated increases in already high tax rates.

How will Germany respond? Camdessus suggested three ways:

• *Introduce greater flexibility into wage determination and work rules.* Recent efforts to ease dismissal rules, promote part-time employment, and expand the use of fixed-term contracts have helped, but more needs to be done, particularly in bringing greater realism to wage negotiations and more flexibility into the centralized collective bargaining process. Wage levels should better reflect productivity, skill level differences, and conditions in individual firms.

• *Reduce employers' nonwage costs and disincentives for job seekers.* Germany's tax burden, according to Camdessus, is "simply too high," particularly its marginal tax rates. "Sweeping reforms are needed to broaden the tax base, flatten the steep marginal tax schedule, and lower the statutory corporate tax rate." This would make Germany's tax system more competitive and also set an example for other countries to follow. Camdessus expressed confidence that official commissions currently examining tax and pension issues will offer wise proposals in both areas.

• *Deregulate further.* Increased competition across borders and between German states in areas such as electricity, natural gas, trucking, and telecommunications would reduce input costs and improve competitiveness. More extensive deregulation of the financial sector will ensure that Germany's development as a world financial center is not held back by tax disincentives or cumbersome procedures.

Making substantial progress in these areas, while maintaining macroeconomic stability, would place Germany in a strong competitive position vis-à-vis the global markets. The rewards would be high in terms of new investment, new jobs, and stronger growth. There would be short-term costs, as well, Camdessus noted, and the government and its social partners would need to take measures to ease the pain of adjustment for affected sectors and segments of the population. These steps should not, however, protect those with jobs at the expense of those searching for jobs.

For Europe, the potential benefits from globalization parallel those European Union (EU) members are already deriving from European integration—increased trade (from reduced barriers to trade) and deeper and broader markets. The challenges facing Germany are a microcosm of those facing Europe. Macroeconomic and monetary stability is essential, and timely and full completion of the Maastricht process is a "must." Camdessus welcomed the stability and growth pact proposed by Germany, noting that it seemed to strike a reasonable balance between the need to penalize lax policies and the desire to build in sufficient flexibility to deal with unforeseen developments.

The EU's ECOFIN Council of Ministers should undertake a major effort to agree on rules for fiscal transparency and rectitude, suggested Camdessus, to ensure that the same exemplary methods apply to the public sectors of all EU members. This would not only deepen mutual trust but also help strengthen fiscal discipline and enhance the transparency of fiscal policy by reducing off-budget transactions and quasi-fiscal deficits.

But a strong euro and macroeconomic stability are not sufficient in themselves, Camdessus stressed. Struc-

tural reforms are also essential. Demographic changes will require a restructuring of social security regimes, and more flexible labor markets will be needed if the EU is to adjust to changes in the world economy, raise its potential rate of output growth, and take advantage of emerging opportunities in global markets.

Camdessus cautioned that continuing labor market rigidities were impeding adjustment and driving up unemployment. He warned that the problem could intensify with the completion of the monetary union, since exchange rate changes would no longer provide a means of dealing with excessive wage increases or other disturbances. In the absence of a flexible labor market, pockets of high unemployment could result, with unwelcome fiscal and social effects that in turn could fuel protectionist pressures and undermine the credibility of monetary policy.

By contrast, an EU that remains open and adaptable can be strong and competitive, with "the potential to create a financial system that is as deep and efficient as that of the United States." Such a scenario offers greater opportunities for growth, a larger international role for the new euro, and expanded influence in world affairs. The extent to which, and the speed with which, the euro becomes a key currency will depend in large measure on the support provided by fiscal and structural policies. With the stability and growth pact in place, Camdessus emphasized, attention must now shift to needed structural reforms. And as the prosperity of Europe becomes more and more intertwined with the stability and strength of the global economy, Europe will have to participate more and more in the global community effort—within the framework of the world financial institutions—to counter the risks of global instability and the marginalization of the poorest in the globalization process.

Stand-By, EFF, and ESAF Arrangements as of December 31, 1996

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-by arrangements			**16,803.29**	**6,203.13**
Argentina	April 12, 1996	January 11, 1998	720.00	428.00
Bulgaria	July 19, 1996	March 18, 1998	400.00	320.00
Costa Rica	November 29, 1995	February 28, 1997	52.00	52.00
Djibouti	April 15, 1996	June 14, 1997	4.60	1.73
Egypt	October 11, 1996	September 30, 1998	271.40	271.40
Estonia	July 29, 1996	August 28, 1997	13.95	13.95
Hungary	March 15, 1996	February 14, 1998	264.18	264.18
Latvia	May 24, 1996	August 23, 1997	30.00	30.00
Lesotho	September 23, 1996	September 22, 1997	7.17	7.17
Mexico	February 1, 1995	February 15, 1997	12,070.20	3,312.18
Pakistan	December 13, 1995	September 30,1997	562.59	321.48
Panama	November 29, 1995	March 31, 1997	84.30	23.20
Papua New Guinea	July 14, 1995	December 15, 1997	71.48	36.14
Romania	May 11, 1994	April 24, 1997	320.50	226.23
Ukraine	May 10, 1996	February 9, 1997	598.20	62.20
Uruguay	March 1, 1996	March 31, 1997	100.00	100.00
Uzbekistan	December 18, 1995	March 17, 1997	124.70	59.25
Venezuela	July 12, 1996	July 11, 1997	975.65	625.65
Yemen	March 20, 1996	June 19, 1997	132.38	48.38
EFF arrangements			**9,741.63**	**7,011.07**
Algeria	May 22, 1995	May 21, 1998	1,169.28	590.88
Azerbaijan	December 20, 1996	December 19, 1999	58.50	53.82
Gabon	November 8, 1995	November 7, 1998	110.30	66.18
Jordan	February 9, 1996	February 8, 1999	200.80	118.60
Kazakstan	July 17, 1996	July 16, 1999	309.40	309.40
Lithuania	October 24, 1994	October 23, 1997	134.55	41.40
Moldova	May 20, 1996	May 19, 1999	135.00	112.50
Peru	July 1, 1996	March 31, 1999	248.30	248.30
Philippines	June 24, 1994	June 23, 1997	474.50	438.00
Russia	March 26, 1996	March 25, 1999	6,901.00	5,031.99
ESAF arrangements			**3,922.92**	**1,709.28**
Armenia	February 14, 1996	February 13, 1999	101.25	67.50
Azerbaijan	December 20, 1996	December 19, 1999	93.60	93.60
Benin	August 28, 1996	August 27, 1999	27.18	22.65
Bolivia	December 19, 1994	December 18, 1997	100.96	33.65
Burkina Faso	June 14, 1996	June 13, 1999	39.78	33.15
Cambodia	May 6, 1994	May 5, 1997	84.00	42.00
Chad	September 1, 1995	August 31, 1998	49.56	24.78
Congo	June 28, 1996	June 27, 1999	69.48	55.58
Côte d'Ivoire	March 11, 1994	June 13, 1997	333.48	—
Ethiopia	October 11, 1996	October 10, 1999	88.47	73.73
Georgia	February 28, 1996	February 27, 1999	166.50	111.00
Ghana	June 30, 1995	June 29, 1998	164.40	109.60
Guinea-Bissau	January 18, 1995	January 17, 1998	9.45	5.78
Guyana	July 20, 1994	July 19, 1997	53.76	17.92
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Honduras	July 24, 1992	July 24, 1997	47.46	13.56
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	July 20, 1994	July 19, 1997	88.15	32.25
Lao P.D.R.	June 4, 1993	May 7, 1997	35.19	5.87
Madagascar	November 27, 1996	November 26, 1999	81.36	67.80
Malawi	October 18, 1995	October 17, 1998	45.81	22.91
Mali	April 10, 1996	April 9, 1999	62.01	41.34
Mauritania	January 25, 1995	January 24, 1998	42.75	14.25
Mozambique	June 21, 1996	June 20, 1999	75.60	63.00
Nicaragua	June 24, 1994	June 23, 1997	120.12	100.10
Niger	June 12, 1996	June 11, 1999	57.96	48.30
Senegal	August 29, 1994	August 28, 1997	130.79	35.67
Sierra Leone	March 28, 1994	March 27, 1997	101.90	10.11
Tanzania	November 8, 1996	November 7, 1999	161.59	135.88
Togo	September 16, 1994	September 15, 1997	65.16	32.58
Uganda	September 6, 1994	September 5, 1997	120.51	23.43
Vietnam	November 11, 1994	November 10, 1997	362.40	120.80
Zambia	December 6, 1995	December 5, 1998	701.68	50.00
Total			**30,467.84**	**14,923.48**

EFF = extended Fund facility.
ESAF = enhanced structural adjustment facility.
Figures may not add to totals owing to rounding.

Data: IMF Treasurer's Department

IMF and World Bank Move Forward On Debt Initiative

In September 1996, representatives of the member governments of the IMF and the World Bank announced a joint initiative to address the debt problems of the heavily indebted poor countries—most of which are in sub-Saharan Africa. This step represented a commitment by the international community to provide special assistance to those heavily indebted poor countries that followed sound policies but for which traditional debt relief mechanisms had failed to secure a sustainable external position. To convey a clearer understanding of the debt initiative, the IMF and the World Bank sponsored an Economic Forum on January 9 at IMF headquarters. Moderated by Shailendra Anjaria, Director of the IMF's External Relations Department, participants included Jack Boorman, Director of the IMF's Policy Development and Review Department; K.Y. Amoako, UN Under-Secretary General and Executive Secretary of the UN Economic Commission for Africa; Catherine Gwin of the Overseas Development Council; and Masood Ahmed, Director of the World Bank's International Economics Department.

Policy Directions

In outlining the joint IMF-World Bank debt initiative, Boorman listed six basic principles governing its operation:

- to target overall debt sustainability by focusing on the totality of a country's external debt;
- to link eligibility to a prior track record of reform and sound policies;
- to build on existing mechanisms, including the IMF's enhanced structural adjustment facility (ESAF), the World Bank's International Development Association (IDA) operations, and mechanisms of the Paris Club and other creditors.
- to ensure that additional efforts to address problem cases are coordinated among all the creditors to ensure a comprehensive resolution of the country's debt problem;
- to preserve the financial integrity of the institutions and their preferred creditor status; and
- to ensure that new external financing for the countries is on appropriately concessional terms.

There is no specific list of countries qualifying for the new debt initiative, said Boorman. The staffs of the IMF and the World Bank had performed forward-looking analyses of the balance of payments prospects for all heavily indebted low-income countries. From this analysis of 41 countries, 8 were judged to have a clearly unsustainable debt burden, and an additional 12 were seen as "stressed." To qualify for assistance, a country had to meet two criteria, said Boorman: eligibility for the concessional windows of the IMF and the World Bank, and the existence of an unsustainable debt burden even after the application of traditional debt-relief mechanisms.

From start to finish, a two-stage process was envisaged, during which a country would undertake strong adjustment and reform programs, said Boorman. The first three years, or stage one, would begin with the adoption of an ESAF-supported program by a country. During this period, the country would receive a flow rescheduling on Naples terms from the Paris Club and concessional assistance from relevant bilateral donors and creditors. Following this, if the country's debt burden remained unsustainable, a second phase would ensue, during and at the end of which the country would receive special assistance to assure the sustainability of its external debt position. Countries now undertaking programs with the support of the IMF and the World Bank would be considered already to be at some point within this process. Special assistance would be provided to the qualifying countries to help them service their obligations to the IMF in a manner that reduced the present value of its claims on them, Boorman stated. IMF assistance would be made available through long-term highly concessional loans or, in some cases, outright grants. All the major creditors had committed themselves to this operation, said Boorman.

Making It Work

From an African perspective, the new debt initiative was a welcome step forward, said Amoako. By pushing the issue of unsustainable debt to center stage, the international community had committed itself to helping those heavily indebted poor countries for which traditional debt-relief mechanisms had proven inadequate. Amoako also welcomed the initiative's integrated and coordinated focus on debt reduction covering all creditors and the support for continued financing of basic health and social services.

Implementing the initiative would pose important challenges to the donor community, said Amoako. Efforts should be made to ensure that qualifying countries are provided with adequate financing at the outset. The IMF and the World Bank should also be prepared to render appropriate technical support in the development of those necessary institutions for effective implementation of reform and adjustment programs. Financing pro-

K. Y. Amoako (left), Masood Ahmed, Shailendra Anjaria, Jack Boorman, and Catherine Gwin at the Economic Forum on the debt initiative.

visions of the initiative also concerned Amoako. Translating the agreed minutes of previous Paris Club meetings into actual bilateral debt restructuring agreements had frequently been protracted, he observed. Might similar problems hinder implementation of the current initiative?

While the current arrangement was not the comprehensive, multilateral debt facility that some had called for, it now enjoyed the full support of the international community and should be promptly implemented, said Gwin. To realize its agenda, however, the international community will need to clear up remaining ambiguities, especially regarding matters of the eligibility, timetable, and financing for the debt-relief action. If left unresolved, these ambiguities could create disincentives for both investment and policy reform. The immediate question confronting the Bretton Woods institutions was their readiness to accelerate the time frame during which conditional steps would need to be taken to allow the debt-reduction measures to kick in, noted Gwin. In this respect, provisions within the initiative to give credit for time already successfully spent in an adjustment program were encouraging, she said.

Gwin supported the commitment of the IMF and the World Bank to making good policy the ultimate focus of successful debt relief. Unfortunately, this message had not always gotten home to the right audience, she observed. In many instances, the donor community had ignored strong records of economic reform while failing to note the bad ones. To correct the imbalance, Gwin urged donors to insist on greater selectivity in aid provision, more recipient country ownership of adjustment and reform programs, and strengthened implementation capacity in program countries. Flexible implementation would be the key in determining whether the new initiative became the first step in a new era for indebted developing countries toward an orderly transition to reduced aid dependence and more sustainable growth, she said.

Flexibility and sustainability were the major ingredients of the joint IMF-World Bank debt initiative, said Ahmed. The Bretton Woods institutions did not intend to lock recipient countries into an arbitrary framework but to ensure that the program's principles were applied to each country on a flexible, case-by-case, basis. Further refinements of the initiative should wait until after the first group of countries had gone through the initial period and their experiences assessed.

Agreeing with Boorman, Ahmed said that the ultimate priority of the Bretton Woods institutions was to provide sufficient assistance to ensure the long-run debt viability of the poorer countries. Ahmed underlined the importance of having sound economic policies in place in the poorer countries before starting the initiative. While the requirements of each debtor would be handled in a flexible manner, recipients and creditors should feel "comfortable" with the adjustment program before debt relief was provided. Once this requirement was satisfied, however, the highly exposed poorer countries would require sufficient debt relief to shield them from external shocks. The immediate task, he said, was prompt implementation of the initiative.

In response to a question of whether the IMF and the World Bank had responded rapidly enough to the debt problems of poorer countries, Boorman said he was impressed with the speed with which the international community had agreed on the architecture of the new initiative. He noted the close working relations established over the previous months between staffs of the two institutions. Boorman also discussed the relationship between the new debt initiative and the role of the private sector in developing countries. An environment free of payments crises would help foster the kind of confidence private entrepreneurs needed to commit resources to invest in these countries, he said.

Responding to a question on actions that might be undertaken to foster greater policy credibility in African countries, Gwin said that a major step in the right direction would be to mobilize more intense peer pressure to encourage improved economic performance in countries that qualified for debt relief under the new initiative. Such a step would also help dispel the generally negative investor perception of Africa.

AEA Meeting Highlights Role of Consensus in Promoting Economic Reform

Among the major subjects discussed at the January 4–6 annual meeting of the American Economic Association in New Orleans were European monetary union, general reform issues, prospects for economic reform in the countries in transition, the fiscal role of government, and the role of the IMF. In addressing these issues, participants stressed the importance of sound macroeconomic fundamentals and the need to obtain domestic political support for economic reform programs.

European Union

Michael Mussa, Counsellor and Director of the IMF's Research Department, maintained that monetary integration would provide European governments with additional leverage to enact sound policies. Mussa expressed concern, however, that the EMU could be the object of a future political backlash if it were to be burdened with the responsibility for reforming Europe's fiscal and social policies.

Europe's support of monetary union was a "stroke of genius" given its mounting fiscal problems, noted Robert Mundell of Columbia University. To combat unemployment, Europe should adopt an ambitious package of structural measures embracing deregulation, lower taxes, denationalization, and privatization, he said. Rudiger Dornbusch of the Massachusetts Institute of Technology and Ronald McKinnon of Stanford University both maintained that earlier consensus by European central banks on the need for fiscal consolidation and low inflation had promoted the concept of EMU. Flexible entry criteria would make it possible for the monetary union to occur on schedule, predicted Peter Kenen of Princeton University.

General Reform Issues

Robert Bates of Harvard University called upon economists to devote more attention to assessing the structure of political power in industrial countries to help explain the growing readiness of politicians to surrender power to economic technocrats in the service of reform. The key dynamics underlying economic reform were the crucial interactions among demographic change, the stock of usable knowledge, incentive structures, and the institutional framework within which economic life unfolds, maintained Douglass North of Washington University at St. Louis. Dani Rodrik of Columbia University recommended more research on the "distributional consequences" that frequently overwhelm the efficiency gains of reform programs. Allan Meltzer of Carnegie Mellon University criticized the Bretton Woods institutions for their alleged unwillingness to apply conditionality strictly in a number of African countries. Unnecessary delay in carrying out reform, he advised, should be answered by an immediate interruption of disbursements.

Reform in Transition Economies

Padma Desai of Columbia University spoke on the optimal pace of reform in countries in transition. Bearing in mind the social costs—particularly unemployment—Desai favored faster reform in view of observed rates of higher growth and lower inflation. Privatization had been accompanied by widespread corruption throughout Russia, said Marshall Goldman of Harvard University. This outcome was largely preordained by the absence of binding rules governing commercial transactions. As a result, privatization had taken place in an environment of widespread rent-seeking activity and routine violations of commercial law, Goldman said. David Kotz of the University of Massachusetts suggested that a weak state was behind Russia's current economic difficulties. Higher growth and improved living standards depended directly on the state's ability to reassert control over the economy, he maintained. Similarly, Stanislav Menshikov of Erasmus University in Rotterdam called upon the Russian government to adopt more interventionist policies to ameliorate social inequality.

Government's Changing Fiscal Role

The government's fiscal function had become a complex issue in light of an aging and increasingly mobile global workforce throughout the industrial countries, observed Richard Musgrave of Harvard University. The public sector's fiscal function should be reformed by promoting greater efficiency in the provision of goods and services, said Musgrave, rather than done away with. Richard Wagner of George Mason University disagreed: the time was ripe for a thoroughgoing reevaluation of government's fiscal role, he maintained. Citizens, not government, should have the right to determine the content and reach of fiscal policy. Joseph Cordes of George Washington University

suggested that the normative theory of fiscal policy—the functions government should perform—could be usefully integrated with public choice discussions on how specific groups push forward competing fiscal agendas.

Vito Tanzi, Director of the IMF's Fiscal Affairs Department, observed that ideologically based pressures on governments to spend were beginning to abate. The public had learned that many demands for increased spending came from special interests. Changing attitudes toward spending, especially in Europe, had spawned new thinking about the role of the state, he said. Privatization had become the new buzzword. As a result, ideological and technical pressures to curtail public spending are at least as strong as the more traditional ones to increase spending, Tanzi said. This new intellectual climate was ultimately likely to lead to a reduction in the state's share of spending.

The IMF in Action

Discussing the IMF's current role, Michael Mussa focused on surveillance activities. He emphasized that IMF member countries are not compelled to accept IMF policy advice. But even sound IMF advice may—and often does—bow to political exigency. Both the quality of IMF advice and its political effectiveness were improving as the analytical and empirical basis for that advice was becoming more broadly accepted, he said.

Discussing IMF-supported programs, Stanley Fischer, First Deputy Managing Director of the IMF, noted that discussions between the IMF and the government of a member country frequently entailed long—at times contentious—negotiations. Although the design of IMF-supported programs remained an "imprecise art," assessing the effectiveness of such adjustment programs always required a judgment of what further economic deterioration might have occurred in their absence, said Fischer (see box).

Domingo Cavallo, former Argentine Minister of Finance, lauded the IMF for its catalytic role in helping restore stability during the early 1990s. The IMF's strong endorsement of Argentina's reform program in the early 1990s was "key" to his country's subsequent success. But the IMF and Argentina have also had their differences in the areas of tax cuts and the long-term viability of a currency board, noted Cavallo. While its focus on fiscal adjustment was appropriate, the IMF would be equally well advised to stress institutional reforms.

Fischer also delivered remarks prepared by Yegor Gaidar, former Acting Prime Minister of Russia. The IMF's role in Russia's reform process had been limited from the outset, according to Gaidar. A major part of the IMF's difficulties in Russia derived from the collapse of the Soviet Union and political conflict between the national government and parliament—developments over which the IMF had no control. Since 1995, however, the IMF's effectiveness in support of Russian reform had grown, especially in the monetary and fiscal areas.

John Starrels
Senior Editor, *IMF Survey*

Fischer Discusses IMF Program Design at AEA

Below are excerpts of remarks by Stanley Fischer, First Deputy Managing Director of the IMF, on IMF program design delivered at the session he chaired, "Applied Economics in Action: The International Monetary Fund," at the AEA conference.

Many questions remain open in the imprecise art of IMF program design, which involves multiple-level principal-agent problems. Most surprisingly, the IMF has not yet converged on the exchange rate system to recommend in different circumstances. Despite the frequent charge that the IMF adopts a one-size-fits-all approach, IMF programs in fact support a remarkable variety of exchange rate systems, from currency boards to free floating. Other recurring issues of program design include:

- the optimal pace of stabilization, particularly how rapidly to attempt to reduce inflation and the budget deficit;
- the optimal pace of structural adjustment, and more generally, how to design programs to increase growth over the medium term;
- how to ensure that stabilization does not adversely affect the poor;
- whether programs, particularly structural programs, should be kept simpler, and if so, what are the essentials;
- whether the IMF should be involved in structural programs at all, or should rather safeguard the organization's "monetary character";
- whether the IMF pushes too fast for too much sophistication, be it in the monetary system (indirect methods of monetary control) or the tax system (pushing the value-added tax relative to more easily collected taxes) or elsewhere (privatization);
- the optimal size of IMF loans;
- how to design, negotiate, and support programs that are more likely to be implemented and owned; and
- whether the commitment and signaling roles of IMF programs should become more central.

Elements of Successful Fiscal Adjustment

(Continued from front page) The widening of fiscal imbalances in industrial countries over the past 25 years, according to McDermott and Wescott, comes from rising government spending that has exceeded economic growth and left revenue growth lagging behind. From 1960 to 1994, the average ratio of tax revenue to GDP in these countries rose to 44 percent from 28 percent, compared with a rise in the ratio of expenditures to GDP to 50 percent from 28 percent. Further rises in taxation would lead not only to distortions but to considerable political resistance. As the authors note, however, whether deficit reduction will raise or lower demand and output and which instruments are best suited to achieving a consolidation that reduces the ratio of debt to GDP are open questions requiring empirical analysis.

For their examination of fiscal adjustment episodes, the authors analyze annual data from 1970 to 1995 for the primary structural (that is, cyclically adjusted) balances of 20 industrial countries. They concentrate on large fiscal actions (defined as an improvement of at least 1.5 percentage points in the primary structural government balance in terms of potential GDP over two years with no decrease in either of the two years). Successful fiscal adjustment is defined as a reduction of at least 3 percentage points in the ratio of gross public debt to GDP by the second year after the end of the two-year fiscal tightening. Of 62 adjustment episodes identified, 14—including the well-documented experiences of Denmark (1983–86), Ireland (1986–89), and New Zealand (early 1990s)—were successful; 48 were not.

The authors' examination of the consequences of fiscal consolidation reveals that successful consolidations tend to be associated with favorable economic performance. In the 14 successful episodes,

- economic growth and job creation increased both during the adjustment phase and in the year after;
- unemployment rate declined;
- both short- and long-term real interest rates declined; and
- currencies appreciated in real effective terms following a few strong depreciations before the consolidations.

Elements of Successful Consolidation. McDermott and Wescott find that size is an important feature of successful fiscal consolidation. The average magnitude of successful contractions was 4 percent of potential GDP, compared with 3.2 percent for the unsuccessful ones. A timid commitment to consolidation may be more likely to fail than a strong one, the authors suggest. Large adjustments revive confidence, giving growth a boost. Also, in many of the successful cases, fiscal consolidation was part of a broader adjustment and reform program that enhanced the overall credibility of the government's commitment to consolidation.

The composition of the consolidation also played an important role, according to the authors. Budgetary contractions that concentrated on expenditures, especially on transfers and government wages, were more likely to succeed in reducing the public debt ratio than tax increases.

Global Climate and Fiscal Adjustment. McDermott and Wescott note a discernible relationship between the world economic growth climate and the success of fiscal consolidation efforts. But the size and composition of the adjustment, they say, still seem to be the dominant determinants of the outcome, even when the world economy is booming. For instance, none of the seven consolidation efforts undertaken during 1980–81—a time of global recession and spiking interest rates—was successful. Yet, of the 30 efforts undertaken during 1984–89—a period of solid industrial country growth and flat or declining world interest rates—only 12 were successful. More than half the successful efforts concentrated on spending cuts, while only one-third relied mainly on revenue-increasing measures. Policymakers need not necessarily wait for a favorable world growth phase before initiating fiscal consolidation, the authors conclude, but they may wish to delay such efforts during particularly bad periods.

The Importance of Composition

The composition of a fiscal consolidation may well be the most influential element of an adjustment effort, according to Alesina and Perotti, who base their conclusions on the experience of 20 industrial countries during 1960–94. Fiscal adjustments that rely primarily on spending cuts on transfers and the government wage bill have a better chance of being successful and may also generate growth. Fiscal ad-

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
January 13	3.92	3.92	4.29
January 20	3.89	3.89	4.26

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 109.4 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

justments relying primarily on tax increases and cuts in public investment, on the other hand, tend not to last and, moreover, to inhibit growth.

Tax increases and spending cuts can have different effects on the success of a consolidation effort, but, as Alesina and Perotti show, the composition of spending cuts themselves can have an important influence on the permanence of the fiscal adjustment and on its macroeconomic consequences.

• *Expectation Effect.* Different types of cuts may be more or less permanent. A reduction in public investment—for instance, in maintaining public infrastructures—will have a shorter-lived effect than cuts in welfare obtained by changes in eligibility criteria and government employment. The maintenance of public infrastructure cannot be postponed forever, but structural changes in the parameters that determine coverage of the welfare state can have long-lasting effects.

• *Political Credibility Effect.* Governments willing to tackle the politically more delicate components of the budget—public employment, social security, welfare programs—can signal that they are serious about fiscal adjustment.

• *Labor Market Effect.* Cuts in government employment shift the aggregate demand facing labor unions. This improves productivity through a fall in unit labor costs and a depreciation of the exchange rate in a flexible exchange system. But a cut in nonwage government spending does not have these effects, because the private and public sectors will continue to spend on the goods and services included under nonwage government consumption.

Success Linked to Composition. Concentrating on periods of tight fiscal policy, Alesina and Perotti examine data charting the fiscal adjustment efforts of 20 industrial countries during 1960–94. Tight fiscal policy is deemed successful if three years after the tight period, the ratio of the cyclically adjusted primary deficit to GDP is at least 2 percent—and the debt-to-GDP ratio is 5 percent—below the last year of the tight period.

Although the contractions in successful adjustments tended to be slightly larger than the unsuccessful ones, the more striking differences appeared in the composition. In successful cases, 73 percent of the adjustment was on the spending side, compared with 44 percent in the unsuccessful cases.

Even more striking were the differences in composition of different types of spending and sources of revenue. In unsuccessful cases, more than two-thirds of the cuts fell on capital spending, while everything else—particularly government wages—was virtually untouched. Policymakers tend to find capital spending cuts more politically palatable, Alesina and Perotti suggest, because the effects of cuts in public investment—such as postponing maintenance of infrastructure or delaying new capital projects—are less immediately visible to voters than cuts in their salaries or pension checks.

In striking contrast, only one-fifth of total spending cuts in successful adjustment efforts fell on public investment. But the critical difference is that the successful adjustments depend on broad-based spending cuts that do not spare the most politically sensitive parts of the budget—namely, transfers, social security, and government wages and employment; these, in fact, received the largest share of expenditure reductions.

Macroeconomic Consequences. The economies of those countries carrying out successful fiscal adjustment tended to perform far more favorably than those whose efforts were unsuccessful, according to Alesina and Perotti:

• GDP growth was more than 1 percent above the Group of 7 (G-7) industrial country average during successful adjustments; afterward, growth fell but was still higher than the G-7 average. During and after unsuccessful adjustments, on the other hand, growth remained below the G-7 average.

• Unemployment, relative to the G-7, stayed at about the same level before and after successful adjustments; but after unsuccessful cases, it doubled, from less than 1 percent above the G-7 average to almost 2 percent above it.

• A private investment boom occurred during and after successful adjustments, but the rate of growth of investment fell during and after unsuccessful adjustments.

A Leaner, Meaner Fiscal Future? Policymakers in many industrial countries, Alesina and Perotti assert, do not fully appreciate the importance of composition in formulating their adjustment efforts. This has particularly serious implications for the future of European economic and monetary union. The Maastricht criteria, they say, have shifted discussion of deficit reduction too much toward the simple arithmetic of primary surpluses, deficits, and debt-to-GDP ratios, and away from "how" one cuts deficits to meet these criteria.

For many industrial countries, fiscal adjustment is closely linked to reform of the welfare state, which has become more pressing over the last few decades. Any fiscal adjustment that avoids dealing with the problems of social security, welfare programs, and inflated government bureaucracies, Alesina and Perotti conclude, is doomed to fail.

Copies of IMF Working Paper 96/59, *An Empirical Analysis of Fiscal Adjustment*, by C. John McDermott and Robert F. Wescott; and 96/70, *Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects*, by Alberto Alesina and Roberto Perotti, are available for $7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org. *Fiscal Reforms That Work*, No. 4 in the IMF Economic Issues series, is based on material from Working Paper 96/59, and is available at no charge.

Issues Raised at Global Conferences Reflected in IMF's Work

Recent global conferences have dealt with a range of important issues, most of which are reflected in the work of the IMF. Indeed, the IMF has strengthened collaboration with other United Nations agencies and has reinforced its efforts with respect to key issues raised at these conferences. The Interim Committee's Partnership for Sustainable Global Growth, in particular, contains "11 commandments" for good governance of the world economy (see IMF Survey*, October 14, 1996, page 327), some of which emphasize the importance of the quality of government expenditure and the need to make more room for spending on key social sectors. In the article below, J.B. Zulu, Director of the IMF's Office at the UN, summarizes IMF work on such issues, with input from the Fiscal Affairs and Policy Development and Review Departments.*

New UN Secretary-General Kofi Annan met with Managing Director Michel Camdessus at the IMF on January 24.

UN Conference on Environment and Development

The IMF's work is relevant for the UN Environment and Development Conference (Rio de Janeiro, June 1992), in that it pays due attention to the link between environmental and macro-economic issues, thereby enhancing prospects for sustainable develop- ment. Specifically, the IMF helps member countries achieve sustainable macroeconomic and financial stability—a prerequisite for sustainable development; helps low-income countries using its resources to prepare three-year policy frameworks for macroeconomic and structural policies (including environmental policies); and calls attention to the macroeconomic and financial implications of environmental policies in its policy dialogue with its members wherever necessary. The IMF staff helps members design and implement the structural policies—including subsidy and price reform, trade liberalization, and tax reform—that promote more efficient resource use and facilitate sustainable development, including from an environmental standpoint.

The IMF maintains contacts on environment issues with the World Bank and other specialized UN agencies, including the UN Development Program. It also participates in multilateral forums, including the UN Commission for Sustainable Development, the Inter-Agency Task Force on Environment Statistics, the UN Conference on Trade and Development, and in World Trade Organization discussions on trade and environment.

International Conference on Population and Development

The IMF contributes to promoting the action program of the Population and Development Conference (Cairo, September 1994) mainly through its public expenditure analysis and policy advice; in this connection, it encourages countries to reduce unproductive expenditures, thereby freeing domestic resources for basic social and infrastructure spending.

IMF-supported programs—especially as reflected in policy framework papers required for members seeking concessional financing from the enhanced structural adjustment facility (ESAF) for their adjustment programs—have increasingly emphasized the importance of spending on primary health and education services, particularly for girls. Since mid-1995, collaboration with the World Bank on public expenditure policy issues has been intensified through more regular exchange of information and identification of priority areas at the country, regional, and management levels.

World Summit for Social Development

In October 1995, the joint IMF-World Bank Development Commit-

tee urged the World Bank and the IMF to work closely with member governments to help improve their public finances, especially by increasing attention to funding social and economic development programs and cutting excessive military spending and unproductive expenditures. Also in October 1995, the Interim Committee, the IMF's principal policy advisory body, agreed that cooperation between the IMF and the International Labor Organization (ILO) should be strengthened, with a view to better integrating labor market and social protection issues in IMF policy advice and helping ILO staff further integrate in their policy advice to members the IMF's view on macroeconomic policies and targets for the country.

The IMF has reinforced its activities with respect to issues raised at the Social Summit (Copenhagen, March 1995), specifically in the areas of surveillance, adjustment program design, technical assistance, and analysis of social sector spending. In the design of adjustment programs, it is giving more attention to the composition of expenditure on the social sectors and on labor market policies and to implementing cost-effective social safety nets and reallocating public expenditure to better meet the needs of the poor and vulnerable. The IMF is also continuing to provide technical assistance aimed at helping countries achieve greater budgetary transparency, build institutional capacity to set and implement expenditure priorities, and raise revenues in an efficient manner. And it is increasing its reliance on the World Bank for information, analysis, and policy options regarding social sector spending. The IMF has also strengthened collaboration with other UN agencies at the country level.

The IMF is giving more attention to the composition of spending on social sectors.

Fourth World Conference On Women

The IMF's contribution to improving the status and quality of life of women over the medium and long term as discussed at the Conference on Women (Beijing, September 1995), is embedded in the IMF's policy advice to its members. This advice focuses on macroeconomic polices and structural reforms aimed at achieving high-quality growth to bring lasting gains in employment and poverty reduction for all, including women.

Through appropriate design and phasing of policies, IMF-supported programs have aimed at minimizing possible adverse effects on vulnerable groups, including women in rural areas. To mitigate short-term adverse effects of adjustment, members' IMF-supported adjustment programs have also increasingly sought to protect the poor and vulnerable by incorporating social safety nets. The IMF's emphasis on low inflation in its policy advice to members is also aimed at protecting lower-income groups, since the poor—many of whom are women—tend to have fixed nominal incomes and hold a large share of their wealth in cash.

The IMF's policy advice on public expenditure issues, in collaboration with the World Bank, is placing greater emphasis on spending on basic health and education for women. The IMF's support of liberalized pricing and marketing policies and labor market and financial sector reforms—including the establishment of small-scale rural financial institutions—helps foster private economic activity and thereby provide women with opportunities to participate in economic development.

Other Global Forums

The program of action of the Ninth UN Conference on Trade and Development (April–May 1996) is directly relevant for the IMF, as it focuses partly on interdependence and global economic issues from a trade and development perspective. These include issues stemming from the Uruguay Round of multilateral trade negotiations, such as helping developing countries improve their investment climates to attract foreign direct investment.

The action plan developed at the World Food Summit (Rome, November 1996) has an indirect bearing on the IMF's primary role as overseer of the international monetary system. The action plan stresses the importance of ensuring a secure and affordable food supply through the implementation of policies that alleviate poverty; the fostering of a market-oriented world trade regime; the pursuit of participatory and sustainable development; and the creation of a stable social and economic environment. These objectives are once again linked to one of the IMF's key purposes: to facilitate the expansion and balanced growth of international trade and contribute thereby to the promotion and maintenance of high levels of employment and real income. The IMF also provides financial assistance through its compensatory financing facility to help countries cope with fluctuations in the cost of cereal imports.

Photo Credits: Denio Zara and Padraic Hughes for the IMF, pages 17, 21 and 26; Sovfoto/Eastfoto, 1994, page 32.

IMF Lending Moderates from Record Level

IMF credit disbursements to member countries dropped substantially in 1996 from their unprecedented level in 1995, when large credits to Mexico and Russia predominated. Nonetheless, lending in 1996 amounted to SDR 6.0 billion ($8.4 billion), roughly the same as in 1994 and in previous years. (On January 22, 1997, SDR 1 = US$1.40269.)

Disbursements in 1996 increased significantly under the extended Fund facility (EFF)—mainly to Russia. In 1996, Russia drew SDR 2.6 billion ($3.6 billion) under both EFF and stand-by credits. Other member countries receiving large disbursements during the year under stand-by and/or EFF credits included Argentina (SDR 548.2 million, $768.8 million), Ukraine (SDR 536 million, $751.8 million), Algeria (SDR 337.6 million, $473.5 million), and Venezuela (SDR 350 million, $490.9 million). Algeria also received the only disbursement under the compensatory and contingency financing facility (CCFF), SDR 174.6 million ($244.9 million). Members receiving large IMF disbursements under the enhanced structural adjustment facility (ESAF)—the IMF's concessional financing facility aimed at supporting macroeconomic and structural adjustment in low income countries—included Vietnam (SDR 121.2 million, $170 million) and Côte d'Ivoire (SDR 95.2 million, $133.5 million).

Use of IMF Credit and Loans in 1996

(million SDRs)

	1994	1995	1996
General Resources Account	4,979.8	16,967.9	5,271.0
Stand-by arrangements	1,829.3	14,382.1	2,471.0
EFF arrangements	900.3	1,965.2	2,625.3
CCFF	308.0	8.9	174.6
STF	1,941.8	611.7	0.0
SAF and ESAF arrangements	910.4	1,428.3	708.6
Total	**5,889.9**	**18,396.2**	**5,979.6**

Note: EFF = extended Fund facility.
CCFF = compensatory and contingency financing facility.
STF = systemic transformation 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

Lending activity under the EFF grew steadily over the past three years. Lending under the ESAF peaked in 1995, owing largely to a December disbursement to Zambia of SDR 651.7 million ($941.1 million). Lending under the systemic transformation facility—established in 1993 to help member countries experiencing severe balance of payments problems because of a shift from reliance on trading at nonmarket prices to multilateral, market-based trade—peaked in 1994, and access to this facility expired at the end of 1995. CCFF lending dropped off considerably in 1995, then jumped almost twentyfold in 1996, owing to the disbursement to Algeria.

At the end of 1996, 61 member countries were implementing macroeconomic and structural programs supported by IMF credits (see table, page 19). A total of SDR 30.5 billion ($42.8 billion) in IMF financing was committed at the end of 1996, of which SDR 14.9 billion ($20.9 billion) was undrawn.

From the Executive Board

Following are excerpts of recent IMF press releases. The full texts are available on the IMF's web site (http://www.imf.org) under the heading NEWS or on request (fax only, please) from the IMF's Public Affairs Division (fax: (202) 623-6278).

Malawi: ESAF

The IMF approved the second annual loan under the enhanced structural adjustment facility (ESAF), in an amount equivalent to SDR 15.3 million (about $22 million), to support Malawi's economic program in 1996/97. The loan is available in two equal installments, the first of which is available on December 13, 1996.

Medium-Term Strategy, 1996–97 Program

Malawi's medium-term strategy aims to consolidate the gains achieved thus far and to sustain economic growth within a framework of financial stability.

The program for 1996–97 aims to achieve real GDP growth of about 11 percent in 1996 and 5 percent in 1997, an annual inflation rate of 8 percent by end-1997, and an increase in gross official international reserves to the equivalent of 4.5 months by end-1997. To achieve these objec-

Malawi: Selected Economic Indicators

	1994	1995[1]	1996[2]	1997[2]	1998[2]
	(percent change)				
Real GDP	–11.6	9.0	10.8	5.0	5.0
Consumer prices (end of period)	66.0	74.9	4.0	8.0	6.0
	(percent of GDP)				
Overall fiscal balance[3] (excluding grants)	–27.8	–13.6	–9.0	–7.6	–6.9
External current account balance (excluding official transfers)	–17.8	–14.1	–7.6	–6.8	–6.4

[1]Preliminary.
[2]Program.
[3]Fiscal year is April/March.

Data: Malawian authorities and IMF staff estimates

tives, the program will rely on the continued pursuit of tight financial policies. The overall budget deficit (excluding grants) will be reduced from 13.6 percent of GDP in 1995 to 9.0 percent in 1996, and to 7.6 percent in 1997.

Structural Reforms

Malawi will continue to take measures to reestablish agriculture as an engine of growth, increase food security, and alleviate poverty. The liberalization of agricultural marketing and production arrangements has already resulted in substantial improvements in the growth of smallholder production and diversification into nontraditional or drought-tolerant crops. The privatization program, which started in early 1996, aims at bringing to the point of sale 26 public enterprises in 1996/97, and 20 more in 1997/98.

Social Issues

Higher economic growth and inflation reduction are contributing significantly to poverty reduction. The government's poverty alleviation program will also continue to focus on efforts to reform agriculture to benefit smallholders, reallocate budgetary resources to the social sectors, limit population growth, and improve the role of women in economic activities.

Challenges Ahead

Malawi's efforts at reestablishing financial stability have contributed greatly to recent economic expansion and to the recent decline in inflation, which also benefited from favorable weather conditions. Continuation of such efforts is essential to achieve low inflation on a lasting basis. To enhance its prospects for success, Malawi's efforts will require the continued assistance of the donor community.

Malawi joined the IMF on July 19, 1965, and its quota is SDR 50.9 million (about $73 million). Malawi's outstanding use of IMF financing currently totals SDR 75.4 million (about $108 million).

Press Release No. 96/59, December 5, 1996

PAKISTAN: Stand-By Extension

The IMF approved a request by the government of Pakistan to extend the current stand-by credit through end-September 1997 and to augment the amount available under it by SDR 160.7 million (about $231 million), in support of Pakistan's economic adjustment and reform program. The IMF's Executive Board took the decision in conjunction with the completion of the second review under the stand-by credit for SDR 401.9 million (about $579 million) approved on December 13, 1995 (see Press Release No. 95/66, *IMF Survey*, January 8, 1996).

The program supported by the stand-by credit was designed to reduce Pakistan's macroeconomic imbalances and to address a range of structural issues. However, achievement of these objectives has been undermined by slippages in policy implementation in 1995/96 and the first four months of 1996/97. In particular, Pakistan's fiscal policy entailed an excessive increase in bank borrowing by the government that put pressure on the balance of payments. These difficulties were compounded by a slowdown in structural reform efforts and had costly consequences in terms of external vulnerability and loss of market confidence. Against this background, the authorities have adopted a stabilization package consisting of a reduction of the budget deficit, an increase in interest rates, and a depreciation of the exchange rate to promote a rapid recovery in the country's international reserve position. These policies will be supported by far-reaching actions on the structural front, with emphasis on an improvement in the operations of Pakistan's major banks, broadening of the tax base, and rationalization of government expenditures.

Pakistan joined the IMF on July 11, 1950. Its quota is SDR 758.2 million (about $1.1 billion). Its outstanding use of IMF credit currently totals SDR 960 million (about $1.4 billion).

Press Release No. 96/63, December 18, 1996

Pakistan: Selected Economic Indicators

	1993/94	1994/95	1995/96	1996/97[1]
	(percent change)			
Real GDP	4.5	4.4	6.1	5.0
Consumer prices (average)	11.3	13.0	10.8	11.0
	(percent of GDP)			
General government budget balance (excluding grants)	–6.0	–5.9	–6.3	–4.0
External current account balance (excluding official transfers)	–3.6	–3.6	–6.9	–5.9
	(weeks of imports)			
Gross international reserves	12.6	12.9	8.2	6.4

[1]Program.

Data: Pakistan authorities and IMF staff estimates

AZERBAIJAN: ESAF and EFF

The IMF approved a combination of two credits for Azerbaijan totaling the equivalent of SDR 152.1 million (about $219 million) to support the government's economic program for 1996–99. Of this amount, SDR 93.6 million (about $135 million) is available under the enhanced structural adjustment facility (ESAF), and SDR 58.5 million (about $84 million) under the extended Fund facility (EFF).

Medium-Term Strategy, 1996/97 Program

Azerbaijan's medium-term program builds on the macroeconomic progress already made and is designed to prepare the country for the prospective oil boom as oil production is projected to double by the turn of the century and to quadruple shortly thereafter. The program includes a strengthening of structural reforms and improvements in the social safety net.

Within this medium-term framework, the 1996/97 program aims at an annual GDP growth of 5.1 percent, a further decline in the annual rate of inflation to 9.1 percent, and a narrowing in the external current account deficit to 15.9 percent of GDP.

Structural Reforms

The program envisages a further strengthening of structural reforms. The highest priority areas are banking reform, privatization, and termination of the government's heavy involvement in production and trade. In particular, enterprise restructuring associated with large-scale privatization is central to enhancing financial discipline and economic efficiency. In addition, Azerbaijan is expected to complete its trade liberalization process during the program period.

Social Needs

Azerbaijan will continue to reform the social safety net to provide adequate assistance to the most vulnerable groups of the population. Meanwhile, the government is considering a comprehensive reform plan to establish a financially secure and fair pension system.

Azerbaijan: Selected Economic Indicators

	1995	1996[1]	1997[2]	1998[2]	1999[2]
	(percent change)				
Real GDP	–11.0	1.2	5.1	7.6	8.4
Consumer prices (average)	411.7	19.9	9.1	6.5	6.2
	(percent of GDP)				
Overall fiscal balance	–4.3	–2.7	–2.0	–1.4	–0.5
External current account balance	–11.2	–19.1	–15.9	–18.8	–24.0
	(months of imports)				
Gross international reserves	1.2	2.0	2.9	3.4	3.5

[1]Estimate.
[2]Program.

Data: Azerbaijan authorities and IMF staff estimates

Challenges Ahead

Ensuring balanced and sustained growth will require a significant increase in investment. While foreign direct investments through international oil consortia will play a major role, the accumulation of business savings to support non-oil investments will be crucial to attain Azerbaijan's growth objectives.

Azerbaijan joined the IMF on September 18, 1992; its quota is SDR 117.0 million (about $168 million); its outstanding use of IMF credit currently totals SDR117.0 million (about $168 million).

Press Release No. 96/64, December 20, 1996

Camdessus Hails Early Repayment of Mexican Loans

On January 15, IMF Managing Director Michel Camdessus welcomed an announcement by the government of Mexico that it would make an advance repayment to the IMF for the equivalent of $1.5 billion and pay off the remaining balance of $3.5 billion owed to the U.S. government under the financial package that the IMF helped to arrange in early 1995.

Commenting further, Managing Director Camdessus said "this package, together with the decisive policy actions taken by the Mexican authorities since then, has contributed importantly to stabilizing the economy and creating the conditions for the resumption of growth and jobs.

"The Mexican economy is now expanding at a good pace; inflation and interest rates are declining; export volume is up strongly and imports have recovered; the external current account deficit is small; and there was a strong increase in net international reserves in 1996.

"I welcome these positive developments, which have been reflected in Mexico's improved standing in international capital markets and in the country's ability to restructure its external obligations on better terms that include longer maturities.

"The authorities' firm commitment to maintaining a strong fiscal position and a sound credit policy—while deepening economic reforms designed to raise domestic savings, improve efficiency, and generate jobs at a faster rate—provides a solid foundation for continuing support by the IMF to Mexico."

Baltics, Former Soviet Union Grapple with Energy Arrears

In recent years, the Baltic countries, Russia, and other countries of the former Soviet Union have encountered problems in meeting scheduled payments to domestic and foreign suppliers of energy. Arrears for electricity, oil, gas, coal, heating, and hot water supply continue to pose a widespread problem. Public sector entities, including the military and local governments, are generally among the largest debtors.

Notwithstanding definition and measurement difficulties, an approximate comparison of arrears can be made among countries. In Russia, overdue payments—over half of which are accounted for by the electric power sector—exceeded the equivalent of 4 percent of GDP in the autumn of 1996. Linked to this, and even larger, were the energy sector's overdue payments of taxes, wages, and suppliers' bills. In the Baltics, while Estonia recorded relatively small energy arrears, Latvia's amounted to as much as 6 percent of GDP in mid-1996 (although the arrears situation there is improving), and Lithuania's arrears, until recently, were serious as well.

Turkmenistan has partly avoided the arrears issue, but at considerable cost—choosing not to charge households and to heavily subsidize industries for gas and electricity use. Kazakstan and the Kyrgyz Republic have both experienced acute energy payments problems. Other countries—notably Belarus, Moldova, and Ukraine have also been caught in a web of energy-related nonpayments.

Causes of Energy Arrears

Although there are no clear-cut causes of energy arrears, some common patterns are discernible, including:

- *An inability or unwillingness to adjust to new economic circumstances.* The declining incomes or profitability and sharply higher prices experienced during the transition to a market economy have undermined consumers' ability and willingness to pay for energy supplies.
- *Payments discipline.* In many instances, suppliers have failed to cut off deliveries to nonpaying households and customers, particularly where the government views these customers as suppliers of strategic goods and services. Penalties for delinquent payments have rarely been enforced, and consumers have come to expect accumulated arrears to be netted out among state enterprises and/or bailed out by the government.
- *Weak collection efforts.* Slippages by energy companies have been compounded by difficulties in measuring energy consumption brought on by a shortage of meters.
- *Government intervention.* Regulation, particularly of payments and pricing arrangements, has adversely affected payments for energy supplies from both domestic and foreign sources.Governments have set a bad example by frequently failing to pay their own energy bills and designating privileged strategic users that benefit from subsidized rates and are exempt from penalties on delinquent payments.

Economic Consequences

Given the importance of the energy sector in these economies, accumulation of arrears tends to have a ripple effect—weakening the energy sector's payments ability and thus the ability and discipline to pay in the rest of the economy. Where the energy sector is an important taxpayer, accumulation of

arrears often severely disrupts tax payments, with serious budgetary consequences and implications for macroeconomic stability. Arrears also reduce transparency and make it difficult to judge the financial health of enterprises.

Energy payments arrears can promote the inefficient use of energy resources and disrupt energy supplies, with adverse consequences for output and productivity. Also, uncollected tax revenues may result in expenditure cuts, notably in infrastructure, that can further weaken production and growth. If countries are unable to generate financial surpluses for investment or attract foreign capital, there may also be long-term energy production and transmission difficulties.

Finally, failure to enforce payment of energy bills can skew income distribution, since nonenforcement disproportionately subsidizes higher-income groups. Persistent payments arrears can also considerably damage creditworthiness in domestic and foreign financial markets, and external payments arrears to energy suppliers can have serious adverse consequences for these countries, as in the case of Turkmenistan. Without corrective measures, the adverse consequences of energy arrears are likely to intensify.

Response to Arrears

A number of these countries have introduced rigorous measures under borrowing arrangements with the IMF; others are moving more slowly. The *Baltic countries* have taken important steps to improve revenue collection and tackle weak energy sector finances through more appropriate pricing policies and steps to improve efficiency and cut costs. All of the Baltic countries have cut off supplies to delinquent consumers, established repayment schedules, strengthened billing and collection procedures, and adopted plans to privatize and restructure energy sector enterprises. In addition, Lithuania has tightened enforcement of penalties for nonpayment, and Estonia has ended the government's role in importing energy. All three countries reduced energy arrears over the past year.

Progress has been more limited in *Russia*. Various nonmonetary instruments designed to clear mutual arrears have helped reduce budgetary arrears to energy companies, but interenterprise energy arrears outside the budget have persisted. Moreover, federal programs to supply fuel to agriculture by providing tax breaks to oil companies have largely been undertaken off-budget and without adequate consultation with the tax collection authorities.

In cases of persistent energy arrears, governments have abetted the problem by not paying their own bills.

Under an economic reform program—supported by an IMF extended Fund facility (EFF) arrangement—the Russian authorities are currently considering a number of measures to encourage commercial, profit-oriented energy markets. These include the removal of legal barriers—such as preferential arrangements—to normal commercial practices; strengthened treasury control over public expenditure on fuel and power to avoid the recurrence of public sector arrears; and privatization of regional power companies to improve corporate governance and reduce public sector interference in pricing and arrears policies.

In *Ukraine*, payments difficulties in the domestic energy sector have for the most part translated into large external arrears to the country's major gas suppliers, Russia and Turkmenistan, necessitating substantial rescheduling agreements. To improve payments discipline by consumers, the government, beginning in 1996, decided not to renew payments guarantees for gas imports. New import arrangements also permitted a number of wholesalers—representing regional monopolies supplying gas in different regions—to import gas directly for sale in the domestic market.

While payments discipline has improved somewhat, arrears have persisted. The government appears to have continued interfering in the domestic gas market, but since it no longer provides import guarantees, the settlement of external payments arrears has become the obligation of private regional importers. Given understandings reached within the framework of a prospective EFF arrangement, Ukraine is expected to take steps to improve payments compliance for gas use and develop (with the help of the World Bank and the European Bank for Reconstruction and Development) a plan for setting up a competitive gas market with appropriate regulatory bodies.

Armenia, Georgia, and *Moldova* are focusing on increasing energy tariffs and improving the payments discipline of energy consumers, partly by stopping deliveries to delinquent households and enterprises. These countries have also terminated government payment guarantees for energy imports, and Armenia and Georgia intend to begin privatizing certain energy sector activities in 1997.

Kazakstan plans to adopt measures in 1997 to cut off nonpaying customers and require deliveries of services by utilities to be made upon receipt of payment. At the same time, the government intends to examine closely the financial situation of the major energy and utility companies and authorize international audits. The *Kyrgyz Republic* is negotiating a rescheduling of its do-

Oil drills in Tyumen, Russia. Nonmonetary instruments designed to clear mutual arrears reduced budgetary arrears to energy companies, but interenterprise arrears outside the budget have persisted.

mestic energy arrears. It is also cutting off supplies to enterprises and government organizations that are in arrears, modernizing its billing and collection system, and initiating restructuring and privatization of the national energy company. Last year, the Kyrgyz Republic engaged in a three-way operation to settle energy company tax arrears, which involved offsetting Kyrgyz official debt to Kazakstan against Kazak arrears to the Kyrgyz energy company, and the clearing of the Kyrgyz energy company's arrears to the Kyrgyz government. Measures elsewhere generally reflect a similar thrust, although the extent and pace of implementation vary. Among this group, Belarus stands out as a country that has failed to make a serious attempt to address its energy arrears.

Broad Lessons

Where energy arrears have persisted, governments appear to have abetted the problem by not paying their own energy bills or instituting practices that impede collection efforts by energy companies. Energy payments arrears have encouraged, and been encouraged by, a broader culture of nonpayment. Notably, such arrears, particularly by governments or privileged users, have caused tax arrears by energy companies.

Although it is essential to phase out energy subsidies and more closely align domestic with international energy prices, periodic large increases in energy tariffs have tended to aggravate payments difficulties. In a number of cases, domestic nonpayment has triggered substantial payments arrears for energy imports and led to sizable external arrears. Ad hoc measures to clear arrears, such as netting-out arrangements, have not prevented their reemergence and, indeed, may have encouraged new arrears. The experience of these countries suggests that effectively reducing payments arrears will require a range of measures. These include:

- eliminating government intervention in the domestic energy market and terminating government guarantees on payments for energy imports;
- strengthening payments discipline through improved billing and collection procedures, including the removal of restrictions on energy companies to cut off supplies in the event of nonpayment, as well as the stricter enforcement of penalty fees on delinquent customers; and
- speeding up the restructuring and privatization of energy enterprises.

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CONTENTS

Volume 26, Number 2

Composition of Fiscal Adjustment Vital to Its Success
Page 17
Camdessus on Challenges Posed by Globalization for Germany, EU
Page 17
Table of IMF Arrangements
Page 19
Economic Forum on IMF-World Bank Debt Initiative
Page 20
AEA: Conference Highlights
Page 22
Fischer on IMF Program Design
Page 23
Selected IMF Rates
Page 24
Implications of IMF's Work for UN
Page 26
IMF Lending in 1996
Page 28
From the Executive Board
Page 28
Camdessus Hails Early Repayment of Mexican Loans
Page 30
Energy Payments Arrears in Baltics and Former Soviet Union
Page 30

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