IMF SURVEY
www.imf.org/imfsurvey

International Monetary Fund
VOLUME 30
NUMBER 4

February 19, 2001

In this issue

53 Davos World Economic Forum

53 IMF Board–UN ambassador meeting

55 China quota increase

56 Financing for Development

57 IMF posts ethics, financial disclosure guidelines

58 Experience with sovereign bond restructurings

61 Policy response to U.S. downturn

62 Review of Turkey program

64 *Emerging Market Financing*

66 Evaluating reserve adequacy

and...

59 Recent publications

60 Use of IMF credit

63 IMF arrangements

65 Selected IMF rates

67 New on the web

Davos World Economic Forum

Participants meet amid concerns over global economic outlook

PHOTO NOT AVAILABLE

Davos, Switzerland, hosted the World Economic Forum.

In the last week of January, several heads of state, chief executives of some of the world's largest corporations, academics, and senior officials of international organizations met in Davos, a small Swiss Alpine town, to discuss the state of the world. The occasion was the annual meeting of the World Economic Forum, the Geneva-based foundation that famously serves as a vehicle to bring together governments, the corporate sector, multilateral institutions, and civil society. The IMF was represented by First Deputy Managing Director Stanley Fischer. Also present in Davos this year were hundreds of people protesting globalization. They believed the main players in the international community are not acting in the best interests of the world.

Security, both inside and outside the Congress Center, was exceptionally tight, but this only added to the uncertainty of the participants. If euphoria was the defining feature of the 2000 Davos meetings, which took place against a backdrop of an unprecedented surge in the share values of technology stocks, this year's meeting was characterized by a sense of gloom. The reasons for this were not hard to uncover. The meeting's four main themes were a slowing U.S. economy and an uncertain global economic outlook;

(Please turn to the following page)

Secretary-General's report

IMF Board, UN ambassadors find common ground in Financing for Development effort

In preparation for a UN-sponsored global meeting of policymakers to be held in early 2002, IMF Executive Board members met on February 6 with members of the UN Preparatory Committee for an informal and open exchange of views about the UN's Financing for Development effort (see box, page 56). The basis for the discussion, chaired by IMF Managing Director Horst Köhler, was UN Secretary-General Kofi Annan's policy report to the Preparatory Committee of proposals on all issues on the Financing for Development agenda. In its final form, this report, issued on January 30, will serve as a main contribution to the discussions during the 2002 meeting.

Role of international institutions

Köhler opened the discussions by noting that the IMF was part of the "workforce" committed to achieving the UN's goal of reducing poverty by half by 2015. The question, Köhler said, was not whether the IMF had a role in this effort, but how best to implement it. He suggested that the "comprehensive process" should be built on two main pillars: the responsibility of each country for its internal economic and political stability, particularly in such areas as governance, conflict, corruption, and mismanagement; and more and more efficient international support for poor countries, including better access to capital and goods markets, faster delivery of official development assistance, and better use of technical assistance.

Cochair of the Bureau for the Preparatory Committee Jørgen Bøjer, UN ambassador for Denmark, noted that the guiding principle behind the Financing for Development effort was to find a unified and comprehensive

(Continued on page 56)

(Continued from front page) the pros and cons of globalization (with UN Secretary-General Kofi Annan and Fischer emphasizing the benefits of open markets and free trade, while representatives of nongovernmental organizations (NGOs) claimed that globalization disproportionately benefited rich nations and rich people in poor nations); poverty reduction and debt relief; and efforts to start a new round of multilateral trade negotiations.

How goes the global economy?

At a session entitled "Steadying the Course of the Global Economy," Fischer noted that world economic growth is weakening, with key factors being a slowing U.S. expansion and a waning of recovery in Japan. However, Europe's growth prospects for 2001 were promising, he said, and this could help prevent a major global slowdown.

PHOTO NOT AVAILABLE

Fischer: "We are a long way from global recession."

Nevertheless, global growth projections for 2001 are being revised downward, Fischer said. In September 2000, the IMF forecast global growth of 4.2 percent for 2001, but it is now revising its projections, with a new forecast likely to be in the range of 3.5 percent. "We are a long way from global recession," Fischer stressed. The United States, he added, is likely to experience a pickup later this year. The Japanese economy, meanwhile, slowed sharply in the second and third quarters of 2000 but may have improved slightly in the fourth quarter.

PHOTO NOT AVAILABLE

Annan: "If we cannot make globalization work for all, in the end it will work for none."

Fischer observed that East Asian economies—particularly countries that are major electronics exporters—will be negatively affected by the slowdown in the U.S. economy, but that China and India will be more robust. In Latin America, he said, Brazil is recovering nicely, while Argentina may be starting a long-awaited turnaround.

Other speakers—including German Federal Minister of Finance Hans Eichel, French Finance Minister Laurent Fabius, Japanese Vice-Minister of Finance for International Affairs Haruhiko Kuroda, and former U.S. Treasury Secretary Lawrence Summers—endorsed Fischer's assessment of the global economy. Eichel was buoyant about Europe's prospects, stating that "the dynamism of the European economy remains unbroken, and one can say that Europe is back." Kuroda argued that digital technology is a driving force behind Japan's restructuring. Companies are under pressure to be more competitive, he said, adding that there are signs of recovery in the Japanese economy, with the weakest link proving to be the household sector.

Summers, long a pessimist about the Japanese government's economic restructuring efforts, suggested, however, that one has to be "profoundly troubled" by Japan's failure to restructure and break out of its near-zero growth rut. "Without a change in monetary and financial conditions that could produce the impetus and fuel for nominal GNP growth, it is not likely that the generation of positive supply shocks through microeconomic efficiencies will have a material impact on the underlying path of demand growth," Summers said. Discussion of a Japanese recovery without a macroeconomic vision, he said, "is rather like a discussion of Hamlet without the prince."

Globalization's pros and cons

After listening to many of the world's most influential policymakers, Davos participants appeared confident that a global recession was not around the corner. They seemed unconvinced about the arguments against globalization put forward by NGOs.

UN Secretary-General Kofi Annan set the tone of the debate at Davos by urging that policymakers strive to ensure that globalization works for all. He emphasized that "if we cannot make globalization work for all, in the end it will work for none. The unequal distribution of benefits and the imbalances in global rule making that characterize globalization today inevitably will produce backlash and protectionism. And these, in turn, threaten to undermine and ultimately unravel the open world economy that has been so painstakingly constructed over the course of the past half-century."

John J. Sweeney, President of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), said that the world was witnessing not a backlash, but the pangs of birth. "We are witnessing," he suggested, "a new internationalism, bottom-up driven, and located in the public square rather than the boardroom." He pointed to student movements against sweatshops and for workplace rights everywhere. "Seattle should be celebrated for calling the WTO [World Trade Organization] to account," he said. "We've been able to transform the agendas of various organizations including this one. Now is the time for actions such as debt forgiveness, increased aid, and greater World Bank and IMF support for education and health."

Thabo Mbeki, President of South Africa, agreed with Sweeney. The new internationalism is basically the challenge of coping with the pressures of globalization, he said, noting that he presented the view of someone coming from Africa, "a poor and marginalized continent" struggling under debt and asking for relief. "We're told, 'That's globalization,'" he said, but

these problems are not the problems of the poor alone. It would serve rich nations' interests too, Mbeki indicated, if debts were written off and industrial country markets opened to the commodities and products of the developing world. Perhaps then Africans could do what they want at home and not be forced to "cross borders in sealed trucks," seeking better lives as illegal immigrants.

Debt relief

The issue of debt relief did receive prominent attention at Davos. Fischer, speaking at a session on the Heavily Indebted Poor Countries (HIPC) Initiative, said that 22 countries were now benefiting from the initiative, exceeding the goal set by leaders at last year's Group of Seven summit (see *IMF Survey*, July 31, page 241). The IMF and the World Bank, he added, have coordinated approximately $20 billion in debt relief—measured by the net present value of future payments forgiven—from bilateral and multilateral lenders. "This is a considerable achievement," Fischer explained, "but of course it isn't the end of the process." The funds made available through debt relief must be used to meet social priorities such as health care, education, and economic development. The enhanced HIPC Initiative, he stressed, requires debtor governments to work with local and international aid groups and develop written strategies for reducing poverty. But there is no guarantee, Fischer said, that these programs will always work, particularly when difficult obstacles must be overcome. He urged that realistic targets for progress be set so that critics cannot use failure as an excuse to reject all development aid.

Justin Forsyth, Policy Director of Oxfam, an NGO, cited the enhanced HIPC Initiative as proof that cooperation between groups like Jubilee 2000 and international financial institutions is possible. But while $20 billion in debt relief is not insignificant, the debt relief program does not go far enough, he said.

Trade liberalization

Looking beyond debt relief, Fischer said that poor nations will benefit tremendously from trade liberalization by rich nations, particularly in sectors such as agriculture and textiles. Trade liberalization was a touchy issue at Davos, as representatives of government, WTO, and NGOs engaged in intense debate about the need to restart a new round of trade negotiations. Mike Moore, Director-General of the WTO, called on the corporate sector to step up and make the case that the multilateral trading system benefits everybody. "If the WTO fails," he warned, "the risk of hostile trading blocs shouldn't be taken lightly as a long term-threat. This is not a time to be shy." Peter Sutherland, the WTO's first Director-General, rejected the criticisms directed at the WTO by protesters. "The WTO is being blamed for the very problems of underdevelopment and exploitation that it seeks to address. It's like blaming the doctor for trying to cure the disease," he said.

Pascal Lamy, a member of the European Commission, suggested that the WTO faces three key challenges: integrating those nations still outside the multilateral system, grappling with the larger problems of globalization, and dealing with public concerns raised by the anti-WTO protesters. Any new trade round, he indicated, must put development issues at center stage and address environmental protection, health, and other social issues. His last comment set off another debate on the appropriateness of linking environmental and social issues with trade. All in all, this is a sign that while discussions on these weighty issues may have ended in Davos on January 31, the debate about globalization, free trade, and poverty reduction will remain high on the global agenda this year. ■

Vasuki Shastry
IMF External Relations Department

IMF Board of Governors approves quota increase for China

On February 8, the IMF announced in a news brief that the Board of Governors approved a proposal by the Executive Board for an increase in China's quota to SDR 6.4 billion (about $8.3 billion) from SDR 4.7 billion (about $6.1 billion) (see Press Release No. 01/01 and *IMF Survey*, January 8, page 6). The decision came in response to a request from China for a special increase in its quota to reflect its position in the world economy following the resumption of Chinese sovereignty over Hong Kong SAR.

China will have 30 days to consent to, and pay, the increased quota subscription. The decision provides that China should pay 25 percent of the quota increase, SDR 420.5 million (about $545 million) in SDRs or usable currencies specified by the IMF, with the remainder paid in China's own currency. The increase in China's quota brings total IMF quotas to SDR 212.4 billion (about $275 billion).

Ten members with largest IMF quotas

Country	Million SDRs	Percent of total
1. United States	37,149.3	17.49
2. Japan	13,312.8	6.27
3. Germany	13,008.2	6.12
4. France	10,738.5	5.06
4. United Kingdom	10,738.5	5.06
6. Italy	7,055.5	3.32
7. Saudi Arabia	6,985.5	3.29
8. Canada	6,369.2	3.00
8. China	6,369.2	3.00
10. Russia	5,945.4	2.80

Cooperative development effort

(Continued from front page) approach to meeting the world's development financing needs through cooperation and coordination among the various international institutions. The idea was to capitalize on each institution's area of expertise while respecting the mandate of each.

As important as consensus is on what the Financing for Development effort should do, IMF Executive Director A. Shakour Shaalan said, agreement on what the effort should *not* do was equally important. It should not, for example, erode the mandate of existing international financial institutions; nor should it lead to a proliferation of forums and institutions that would only diffuse the effort. Most important, Shaalan said, quoting directly from the Secretary-General's draft report, the effort "is not meant to revisit the goals and content of development—its primary purpose should be to address the need for finance to meet those development needs."

UN ambassadors and IMF Executive Board members exchanged views on the Financing for Development effort.

The IMF is indispensable to the Financing for Development effort, Shamshad Ahmad, UN Ambassador for Pakistan, noted. At the same time, the Committee had no intention of encroaching upon the mandate of its "institutional stakeholders." Rather, the intent was to raise the level of consensus building to ensure that all players—rich and poor countries—could take advantage of the benefits of globalization. This required concerted efforts, he said, directed at unsustainable debt burdens, inequitable terms of trade, increasing protectionism, restricted access to technology, and the negative impact of structural adjustment.

Attracting private investment

U.S. Executive Director Karin Lissakers said she was not worried about "international turf issues." The

United Nations spearheads Financing for Development effort

As part of its Financing for Development effort and in preparation for a meeting of global policymakers slated for early 2002, the United Nations issued, on January 30, a comprehensive assessment of how the world's developing financing needs can be met.

The Financing for Development effort is an outgrowth of the UN Millennium Summit (September 6–8, 2000), during which world leaders endorsed a set of key development goals, including sustaining economic growth, integrating countries left behind in the surge of globalization, and continuing the drive to eradicate poverty (see *IMF Survey*, October 23, 2000, page 351). To achieve this ambitious agenda, UN Secretary-General Kofi Annan asserted "the availability of finance for public and private purposes is crucial."

The Millennium Declaration, issued following the summit, called on the world's economic policymakers to convene in early 2002 to confer—and reach consensus—on relevant national, international, and systemic issues to ensure adequate financing for global development. Currently dubbed the High-Level International and Intergovernmental Event on Financing for Development, the assembly is more than a year away, but comprehensive planning is proceeding on several fronts.

Secretary-General Annan's draft report, written in consultation with other UN agencies and with the IMF, the World Bank, and the World Trade Organization (WTO), summarizes current thinking on the still-evolving agenda and was prepared for consideration and discussion by the event's Preparatory Committee. It identifies six topics: domestic financial resources; international private capital flows; international trade; international financial cooperation, official development assistance, and new and innovative sources of resource mobilization; debt relief; and systemic issues, including financial architecture reform, governance, and the role of the United Nations.

The United Nations and the Preparatory Committee are looking specifically at the ideas, views, and perspectives of the IMF, the World Bank, and the WTO—institutions that have had special relevance for the Financing for Development initiative. The Secretary-General relied on several interagency working groups drawn from these organizations in the preparation of his report. The Preparatory Committee's 15-country bureau (both bodies are cochaired by the Permanent Representatives to the United Nations of Denmark and Thailand) has had continuing interactions with the IMF, the World Bank, and the WTO, which, along with other international institutions, have also actively contributed to the work of the Committee's Coordinating Secretariat, located in the UN Department of Economic and Social Affairs.

The meeting of the bureau members with the Executive Boards of both the IMF and the World Bank allowed them to discuss the Secretary-General's report and to provide additional input to the planning for the 2002 event (see page 53).

The Preparatory Committee is meeting February 13– 23. It is scheduled to meet again in early May and in January 2002.

Information about the Financing for Development event, including Secretary-General Kofi Annan's Report to the Preparatory Committee, is available at the following address on the UN's website: www.un.org/esa/ffd/.

IMF had learned, she said, that economic issues cannot be addressed in isolation from political and social issues (in the same way, the United Nations cannot ignore economic issues). In that spirit, she noted that a primary purpose of the Financing for Development effort was to equip even the most marginalized countries with the means to participate in the globalized economy. One sure way for a country to establish credibility is to develop sufficient capacity to permit it to adhere to internationally agreed codes and standards. For this reason, Lissakers took issue with a suggestion in the draft report that in the setting and assessment of international standards by the IMF and other agencies, a "'one size fits all' approach should be avoided." The essence of standards, she said, is that they reflect a principle everyone can agree on—meaningful but without denying differences. Vice-Chairman Hazem Fahmy (First Secretary of the Egyptian mission to the United Nations) agreed, noting that a level playing field was essential for development and access to international markets. Bernd Esdar, IMF Executive Director for Germany, concurred, noting that time should certainly be allowed for acceptance of standards but that exceptions would defeat the purpose of establishing a level playing field.

Although acknowledging the importance of individual country efforts, Julian Hunte (UN Ambassador for Santa Lucia) said that equal responsibility must lie with the international organizations to ensure that the development effort was comprehensive, coherent, and holistic. He also stressed the importance of private initiative and private sector activity; the involvement of the IMF in this effort, he said, was crucial, particularly for small countries.

Bernd Esdar agreed, noting that although it was important to regulate markets to avoid distortions and imbalances, private initiative can make a tremendous contribution to a country's efforts to attract investment. For this reason, an open environment is extremely important, for both developing and industrial countries.

Role of industrial countries

Among the partners in the Financing for Development effort, the industrial countries have an extremely important role to play, according to Wei Benhua, IMF Executive Director for China. The weight of their influence in the global economy obliges the major industrial countries, in particular, to pursue appropriate growth-sustaining macroeconomic policies that contribute to a stable international economic environment. Industrial countries also have an obligation to open their markets to developing countries to enable them to pursue their own growth-sustaining and development policies. Finally, the slowdown in official development assistance must be arrested; Wei noted that few countries have honored earlier official development assistance commitments.

Conclusion

Summing up the discussion, Horst Köhler said he saw a distinct move toward consensus, and he encouraged the members of the Preparatory Committee to "challenge us even further," as a means of building mutual trust. The social implications of structural change cannot be separated from the changes themselves, he said, and the concerted approach to financing for development and the ongoing collaboration between the UN and the IMF and other international institutions implicitly recognizes the need for "coherence of policies." The IMF intends to continue to play an active role in this collaborative effort, Köhler concluded. ■

IMF Managing Director Köhler (left) and Ambassador Bøjer, Cochair of the Preparatory Committee.

IMF posts guidelines on staff ethics, financial disclosure, and dispute resolution on website

In a news brief dated February 15, the IMF announced it had established a section on its public website (www.imf.org/hrd/index.htm) dedicated to highlighting guidelines and issues related to staff ethics, financial disclosure, and dispute resolution.

The section, which was created as part of the IMF's continuing commitment to enhanced transparency in its operations, contains electronic links to the codes of ethical conduct and financial disclosure rules that IMF staff and Executive Directors must observe. The terms of reference for the IMF's Ethics Officer and Ombudsperson are also available through this section of the public website.

In addition to publication of the ethical codes and standards of the IMF, judgments, orders, and other information related to the dispute resolution activities of the IMF Administrative Tribunal are also now published on the IMF's public website.

The Administrative Tribunal, which was established on January 13, 1994, provides a judicial forum for the resolution of employment disputes arising between staff members and the IMF.

The text of News Brief No. 01/20 appears on the IMF's website (www.imf.org).

Involving the private sector

IMF staff study, Board discussion examine experience with sovereign bond restructurings

Matthew Fisher

Sean Hagan

On February 5, the IMF posted on its website (www.imf.org) Involving the Private Sector in the Resolution of Financial Crises—Restructuring International Sovereign Bonds. *This report, coauthored by the IMF's Policy Development and Review (PDR) and Legal Departments and originally prepared for the IMF's Executive Board, also includes a summary of the Board's discussion of the topic. The* IMF Survey *asked Matthew Fisher, Chief of PDR's Capital Account Issues Division, and Sean Hagan, Assistant General Counsel of the Legal Department, to comment on the background to the paper and the report's findings.*

IMF SURVEY: What led the IMF to look at restructurings?

FISHER: After the Mexico crisis of 1994–95, there was an international effort to think through how future crises would be handled. A report by the Group of 10 deputies said, among other things, that under some circumstances sovereign bonds would need to be restructured. That was the real starting point.

At that point, of course, the work was still speculative, because there had been no restructurings. I see 1999 as the turning point. In late 1998, the Paris Club decided that Pakistan would need to seek comparable treatment of its international sovereign bonds in the context of a restructuring of the claims of Paris Club creditors. There was enormous opposition from the private sector, which argued either that it was impossible to do this or that the bond market would be ruined by it. The private sector indicated a restructuring would have a major disruptive impact on flows to emerging markets, and it wasn't worth having such an adverse systemic effect for such a relatively small sum of money.

Well, Pakistan went ahead and restructured its bonds, and there were no major systemic effects. Indeed, by the end of 1999, the very same people in the private sector who had been complaining about what had happened were bidding on contracts to restructure the Ukrainian bonds. There was thus a shift in the private sector away from "it can't happen" to "let's see how we do it." Predictably, when things needed to be done, incentives for earning fee income stimulated people's creative juices, and deals were struck.

The debate then moved on to "well, of course it's going to happen, but how it happens matters." The private sector obviously wanted to see restructurings only in extreme circumstances, but it was also interested in the process. Various groups in the private sector came together under the umbrella of the U.S. Council of Foreign Relations and suggested principles for how restructurings should work. These principles were based on the private sector's experience in dealing with nonsovereign restructurings and to some extent with its 1980s experience with commercial banks. But the parallels with nonsovereign restructurings and the commercial bank restructurings of the 1980s aren't very strong. There are certainly some important differences.

Nonsovereign debt workouts, for example, are arranged in the shadow of the applicable bankruptcy regimes. Such regimes do not apply to international sovereign bonds. Similarly, the bank restructurings of the 1980s benefited from a high degree of creditor homogeneity, some element of moral suasion, and an environment in which creditors were willing to allow difficult situations to persist for extended periods. Now, bondholders are relatively heterogeneous, generally not subject to moral suasion, and, as they mark the value of their claims to the secondary market value on a frequent basis, not inclined to allow difficult situations to persist.

IMF SURVEY: Why is the Legal Department involved in this review of restructurings?

HAGAN: We have found that when you move from economics into finance, legal issues become central, because it is the terms of financial instruments that determine the incentives of market participants.

When we first looked at restructuring issues, a good deal of attention was focused on the relative merits of amending the organization's Articles of Agreement to enable the IMF to impose a stay on litigation in the context of a sovereign default. As the IMF's work evolved, however, there has been an increasing focus on other legal issues, particularly on the terms of the instruments being restructured and the impact these terms have on the behavioral patterns of creditors who are considering how to react to a restructuring proposal.

A critical question is whether the particular terms of the instrument will facilitate or discourage litigation in the case of a default. In addition, and drawing on the work we have done in corporate restructuring and insolvency, there are a number of interesting issues relating to the appropriate negotiating framework that should be applied in the sovereign context.

IMF SURVEY: Your report examines the experiences of three countries. What did you hope to find?

FISHER: The experiences of Pakistan, Ukraine, and Ecuador suggest some similarities—in each case, it was possible to get a restructuring with very high participation rates on terms that were helpful in moving the country toward medium-term viability—but also enormous differences. When you look at the details,

you see differences in terms of the character of the instruments, the techniques and the mechanics of the actual restructuring, and the process used to move from recognizing the need to actually restructuring.

We felt that it was important, at an early stage, to discuss this experience. One of the crucial issues is whether or not the process of restructuring matters. Is it sufficient to reach a satisfactory conclusion in terms of the participation rates and the payment profile on the new instruments? Or is there something about the process used to restructure the bonds—about the perception of fairness in the way creditors are treated—that will eventually have important implications for other countries seeking access to private capital?

We don't know the answer to that. With so little experience, our analysis was inevitably speculative, but given the importance of the issue, we had to try to address this issue as best we could and have a discussion within the IMF's Executive Board. If you wait until you have the final answer, it may not be one you like and by then there may be little that you can do about it. We shouldn't forget what happened in the resolution of the 1980s debt crisis—commercial banks completely exited the market for extending financial credits to sovereign borrowers. We obviously do not want to see major damage to the international bond market.

IMF SURVEY: Could you summarize the findings?

FISHER: Unfortunately, the current state of knowledge does not enable us to come to conclusions on the key question, which is the systemic impact on markets. But the paper does attempt to offer an evenhanded discussion of the issues. It examines three very distinct cases. Pakistan is unusual in that the debt was not traded in the New York and London markets. The authorities and their professional advisors engaged in a dialogue with these investors, but we don't have very much feedback from this process, because these are not the traditional investors with whom we maintain links.

In the case of Ukraine, the authorities maintained a very close dialogue with the relevant investors. They did this in private through a process that seems to have been very effective. The concern in the market was generally expressed by people who did not have exposure and

Recent publications

Occasional Papers ($20.00)

204: *Monetary Union in West Africa (ECOWAS)*, Paul Masson and Catherine Pattillo

Working Papers ($10.00)

00/198: *A Panic-Prone Pack? The Behavior of Emerging Market Mutual Funds*, Eduardo R. Borensztein and R. O. Gaston Gelos

00/199: *Dual Currency Boards—A Proposal for Currency Stability*, S. Erik Oppers

00/200: *What Happened to Asian Exports During the Crisis?* Rupa Duttagupta and Antonio Spilimbergo

00/201: *Cooption and Repression in the Soviet Union*, Dmitry Gershenson and Herschel Grossman

00/202: *Measuring Off-Balance-Sheet Leverage*, Peter Breuer

00/203: *El Niño and World Primary Commodity Prices—Warm Water or Hot Air?* Allan Brunner

00/204: *Comprehensive Measures of GDP and the Unrecorded Economy*, Adriaan M. Bloem and Manik Shrestha

00/205: *Government Spending, Rights, and Civil Liberties*, Luiz de Mello and Randa Sab

00/206: *Day-to-Day Monetary Policy and the Volatility of the Federal Funds Interest Rate*, Leonardo Bartolini, Giuseppe Bertola, and Alessandro Prati

00/207: *Inflation in Albania*, Philipp Rother

00/208: *Will the Emergence of the Euro Affect World Commodity Prices?* John Cuddington and Hong Liang

00/209: *Financial Development and Economic Growth—An Overview*, Mohsin S. Khan and Abdelhak S. Senhadji

00/210: *The U.K. Business Cycle, Monetary Policy, and EMU Entry*, Zenon G. Kontolemis and Hossein Samiei

00/211: *An Incentive Approach to Identifying Financial System Vulnerabilities*, R. Barry Johnston and Jingqing Chai

00/212: *Measuring Integrated Market and Credit Risks in Bank Portfolios—An Application to a Set of Hypothetical Banks Operating in South Africa*, Theodore Barnhill, Panagiotis Papapanagiotou, and Liliana Schumacher

00/213: *Issues in the Unification of Financial Sector Supervision*, Richard K. Abrams and Michael Taylor

00/214: *Depositor Behavior and Market Discipline in Colombia*, Adolfo Barajas and Roberto Steiner

00/215: *The Role of Subordinated Debt in Market Discipline—The Case of Emerging Markets*, Cem Karacadag and Animesh Shrivastava

00/216: *The New Economy and Global Stock Returns*, Robin Brooks and Luis Catao

IMF Staff Country Reports ($15.00)

01/27: Burkina Faso: Second Review Under the Poverty Reduction and Growth Facility

01/28: Ukraine: Statistical Appendix

01/29: Albania: First Review Under the Third Annual Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria

01/33: Norway: 2000 Article IV Consultation

01/34: Norway: Selected Issues

01/35: Cambodia: Second Review Under the Poverty Reduction and Growth Facility

Publications are available from IMF Publication Services, Box X2001, IMF, Washington, DC 20431 U.S.A.
Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey*'s annual *Supplement on the IMF*, *Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.

were not involved. People who held the bonds seemed comfortable with the process.

Then you have the Ecuadoran process, where it is fair to say there was widespread concern on the part of the investors who held the exposure. There was a perception that the authorities generally tried to keep investors in the dark and then presented them with a take-it-or-leave-it deal. This generated a barrage of criticism.

Consistent with the general approach that the IMF has taken on the importance of debtors maintaining a constructive dialogue with their creditors, we certainly have come to the conclusion that more dialogue is better than less and that efforts to extract a better deal by keeping people in the dark—even if these efforts improve the immediate deal—probably do not serve the member well over the medium term with regard to getting back to capital markets and do create worries about spillovers.

Hagan: From a legal perspective, the findings are also very preliminary, but we tried to draw some lessons from the experience. For example, we tried to assess the extent to which collective-action clauses, which have been discussed extensively by the Board and have been endorsed by the official community, have been helpful. To be frank, the restructurings showed that this issue is a little more complicated than we had envisaged.

Although the staff's view is that the collective-action clauses were useful, they were somewhat overshadowed by the innovative use of "exit consents" in Ecuador. In essence, some bonds allow for restructuring through the consent of a majority of creditors; others require unanimity. Those that require unanimity—as with Ecuador's Brady bonds—have a provision that allows a majority to amend nonrestructuring terms. Effectively, what the lawyers representing the sovereign did was to use those provisions to amend the instrument in a manner that created incentives for creditors to accept a restructuring, even though the restructuring terms themselves were never amended. On the one hand, this was very useful, but on the other, it is not clear that the creditor community is very happy about it. And it will be interesting to see what effect the use of exit consents in Ecuador will have on the terms of future bond issues. We are somewhat cautious about this innovation.

Another interesting development was the prominent instance of litigation that Peru recently faced. The litigation was initiated by a creditor that had not participated in the 1996 Brady bond restructuring and that pressed Peru for full payment under the original debt through an aggressive litigation strategy. Such holdouts are sometimes referred to as "vultures." In this case, the strategy used by the creditor could be considered by some as very high-pressure tactics.

The creditor was able to find the accounts into which Peru was about to make debt repayments to Brady bond holdouts and succeeded in getting injunctions issued by courts in the United States and Europe that effectively precluded these payments from being made. The sovereign was left with the choice of either paying the holdout creditor or defaulting on its Brady debt, which would have been disastrous. The strategy worked, and the creditor in question was paid in full. What lessons does that give us for the future? While we are somewhat nervous about it, to date this has been an isolated instance. The three recent restructurings haven't involved any litigation.

IMF Survey: Is the experience with smaller countries relevant for larger countries?

Fisher: Many issues are the same in terms of the structure of the instruments, the mechanics of the exchanges, and the process needed to reach an agreement. A lot of the lessons can carry over for big cases. Of course, the concern about a big case is a systemic effect. It is an extraordinary feature of emerging market debt that about 60 percent of the J.P. Morgan Emerging Market Bond Index—the standard used to measure this type of debt—is accounted for by just three borrowers: Argentina, Brazil, and Mexico. It is not a very well-diversified market. And there are questions about what would happen if a very large borrower needed to restructure. But the official community has indicated it is determined that it is simply not going to bail out countries that don't have good prospects for getting back to capital markets. The concentration of the bond market is well known to the players in the market. The private sector has constructed these indices and is perfectly capable of assessing the risk that a borrower with

Member's use of IMF credit
(million SDRs)

	January 2001	January 2000
General Resources Account	**2,246.48**	**1.42**
Stand-By	2,246.48	1.42
SRF	1,481.97	0.00
EFF	0.00	0.00
CFF	0.00	0.00
PRGF	**42.86**	**20.71**
Total	**2,289.34**	**22.13**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.
Data: IMF Treasurer's Department

Photo credits: Alessandro Della Valle for AFP, pages 53–54; Leslie Kossoff for AFP, page 54; Denio Zara, Padraic Hughes, and Pedro Márquez for the IMF, pages 56–58, and 61–62; and Pornchai Kittiwongsakul for AFP, page 66–67.

an important weight in the index could get into difficulties.

IMF Survey: What is ahead in terms of issues?

Fisher: The issues discussed in this paper are, in a sense, the tail of the dog. The whole approach of involving the private sector is focused first and foremost on prevention. We would like to reduce the extent to which countries become vulnerable. The next step is to try to improve the operation of markets—both to help them reduce the buildup of vulnerabilities and to improve the environment for private sector decision taking.

Beyond that, there is the question of how to improve the way crises are handled. We hope restructuring won't be needed in the majority of crises. If countries have, in the IMF's judgment, good prospects for getting back to capital markets quickly, the hope would be to avoid concerted action, such as the restructuring of debt. That is what we are doing at the moment in Turkey and Argentina, where the IMF is relying on the catalytic approach to provide a reasonable assurance of continued private sector involvement. Restructuring is meant to be used only in exceptional cases, so in that sense it is the tail of a much bigger dog.

In terms of our next work, we are trying to improve the analytical bases for assessing the circumstances in which countries emerging from crises have reasonable prospects for getting back to capital markets. We have laid out a pretty clear framework for involving the private sector in the resolution of financial crises, which the International Monetary and Financial Committee endorsed in Prague in September 2000. The framework does, however, leave open the question of how to make the analytical judgments. These are not easy issues, and I don't think we will ever have a very precise way of making these predictions. It depends on too many things that are unknown and unknowable. But we can do a better job in terms of developing the analysis to help guide those decisions. ■

Economic Strategy Institute

Panelists debate duration of U.S. downturn and appropriate mix of monetary and fiscal policies

Amid increasing concerns about the health of the U.S. economy—including talk of recession—the Economic Strategy Institute convened a panel of private sector experts in Washington, D.C., on January 30 to discuss the economic outlook and debate the appropriate course for monetary and fiscal policy. There was agreement on why U.S. growth had weakened but a broad range of views on the potential severity and duration of the downturn. And while the panelists broadly agreed that a tax cut, in addition to a continued easing of monetary policy, could provide further stimulus to the economy, the size, timing, and impact of that tax cut stirred considerable debate.

Soft landing?

William Dudley, Managing Director and Chief U.S. Economist for Goldman Sachs, predicted that though the risk of recession had increased, an aggressive easing of monetary policy would successfully, albeit narrowly, avert it. A number of factors were contributing to the downturn in U.S. economic activity, he said. The growth of consumption spending had slowed considerably from its rapid pace over the past few years—largely the result of higher energy prices and the recent decline in stock market wealth. Investment spending had also decelerated sharply, reflecting the higher cost of capital and tighter lending conditions.

In the near term, Dudley expected the U.S. Federal Reserve to continue to stimulate demand through further easing of monetary policy. He expected that by mid-2001, the Federal Reserve would have lowered the federal funds rate to about 4½ percent to prevent the economy from slipping into recession. Tax cuts could potentially provide some stimulus to the economy, but Dudley was not optimistic that the composition and size of the tax package could be agreed upon quickly. The legislative process could easily delay implementation of these cuts until late in 2001 at best, and tax cuts at that stage, he said, would not have much impact on economic growth for the year.

William Dudley

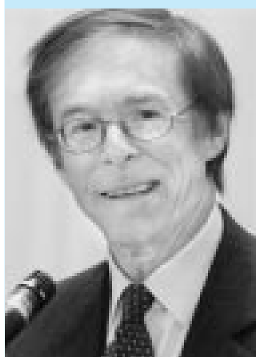
Right policy mix?

While also projecting a soft landing for the United States, Robert Litan, Director of Economic Studies at The Brookings Institution, underscored the trickiness of getting monetary and fiscal policy right under current economic conditions. He cited, in particular, questions about the timing and nature of the tax cut proposed by the new Bush administration. He believed the Bush administration had two choices: it could either hold out, perhaps until late in 2001, for the U.S. Congress to complete action on the proposed large-scale tax cut plan, or it could accept a smaller, compromise, tax cut that could be passed much sooner and thus provide a well-timed stimulus to the economy.

Robert Litan

The danger of holding out for the large-scale tax cut, Litan explained, is that the give-and-take of the legislative process might produce additional spending commitments as well as lower taxes. And the delay could negate its value as a stimulus in the near term. In addi-

Lawrence Kudlow



Allen Sinai

tion, a large-scale tax cut and possible spending increases would likely take effect at year-end—just when economic growth is expected to pick up as a result of the cumulative effect of recent and expected moves to ease monetary policy. If this happened, he said, the Federal Reserve could find itself in the awkward position of having to tighten monetary policy to offset the simulative impact of this easing in fiscal policy.

The best outcome, Litan suggested, would be for the Bush administration to implement a compromise tax plan—smaller in scale than the original, and front-loaded (with tax rate reductions occurring sooner rather than being deferred to future years)—to provide the economy with the boost it needs in the near term.

Downturn already over?

Taking a more optimistic view, Lawrence Kudlow—Chief U.S. Economist for ING Barings—stated that while U.S. economic growth had slowed sharply, this need not be viewed as a harbinger of a long and deep recession. Since World War II, severe recessions in the United States have come about when tight monetary policy was needed to reduce high inflation, and it resulted in a substantial loss in output. In current circumstances, inflation remains generally well contained, despite high energy prices, and this provides the Federal Reserve with considerable scope to ease monetary policy.

Kudlow noted that a number of developments—including improved equity prices and an easing of junk bond yields—suggest that the downturn may well be over. The economy, he said, has already begun to respond to the Fed's easing of monetary policy in early January. In addition, investment in new technology has dramatically improved inventory management, which should help firms resolve quickly the recent buildup in inventories. Kudlow expected U.S. economic growth to return to its earlier robust pace by the second half of 2001.

On fiscal policy, Kudlow argued that the budget surplus has been a drag on the economy. He supported tax cuts rather than spending increases as a means of eliminating the federal budget surplus. He also argued that tax cuts, once enacted, would be more effective than monetary policy in providing a quick stimulus to the economy—particularly if marginal personal income tax rates are cut for high-income households.

Prolonged downturn?

The most pessimistic view came from Allen Sinai, who is President and Chief Global Economist at Primark Decision Economics. He believed the process of a business cycle downturn is well under way. A slowdown in consumer durable and business capital spending—and, in particular, spending on information technology—is well documented in the business cycle literature as a trigger for further weakness in the economy.

IMF releases $1.4 billion credit in support of Turkey's economic program

On February 5, the IMF announced in a news brief that the Executive Board had approved the fifth review of Turkey's economic program. The full text of News Brief No. 01/13 is available on the IMF's website (www.imf.org).

The economic program is supported by a three-year IMF Stand-By credit, and the Executive Board decision will enable Turkey to draw up to SDR 1.1 billion (about $1.4 billion) immediately.

The Stand-By credit was approved in December 1999 for SDR 2.9 billion (about $3.8 billion) (see Press Release 99/66). On December 22, 2000, the Board decided to provide additional resources available under the Supplemental Reserve Facility for SDR 5.8 billion (about $7.6 billion) to alleviate balance of payments difficulties (see Press Release 00/80).

Of the total amount of SDR 8.7 billion (about $11.4 billion) under the Stand-By credit, Turkey has so far drawn SDR 2.84 billion (about $3.7 billion).

Commenting on the Executive Board discussion, IMF Managing Director Horst Köhler said that "policy implementation since the last Executive Board meeting has been most encouraging. In particular, the central bank has strictly implemented the monetary policy framework laid out in its December 2000 Letter of Intent, and important actions in the structural area have been implemented during January.

"On monetary policy, the Central Bank of Turkey has successfully mopped up most of the excess domestic credit created during the crisis, thus helping to restore market confidence, as evidenced by the reduction in interest rates and the increase in foreign reserves.

"On banking, the recent decision to adopt a time-bound plan to resolve the banks currently controlled by the Saving Deposit Insurance Fund that did not elicit market interest should help restore confidence in the banking system. The strengthening of regulations aimed at addressing sources of market risk is similarly welcome.

"Progress has been made also in other structural areas, including by implementing key steps envisaged under the program to facilitate the privatization of telecommunication, transportation, and energy sectors. In light of the progress made, and of the authorities' reassurance that the Electricity Markets Law would be enacted by mid-February, the Executive Board approved the request of the Turkish authorities for a waiver of compliance on the performance criterion relating to the enactment of this law.

"Strict adherence to the monetary, fiscal, and structural reform program is needed. The determination shown so far augurs well for the return of full market confidence and for the success of the authorities' ambitious disinflation program," Köhler said. ■

Other factors yet to materialize are also likely to reinforce and exacerbate this downturn in activity, Sinai added. These factors included the correction of the inventory buildup; the second-round effects of weaker profits on business hiring, firing, and outlays; the impact of lower job growth on consumer spending; the effect of deteriorating consumer sentiment; and the negative feedback effects on U.S. exports of goods and services from slowing world economic activity. Sinai suggested that the Federal Reserve had not anticipated the magnitude of economic weakness and was now in the position of "playing catch-up" in easing monetary policy. Because there was no guarantee that monetary policy would be sufficient to stimulate the economy, a tax cut at this juncture, he said, was also appropriate. But even with an easing in monetary and fiscal policy, Sinai was not optimistic about the prospects for a V-shaped recovery for the U.S. economy. ■

Paula De Masi
IMF Western Hemisphere Department

Stand-By, EFF, and PRGF arrangements as of January 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By arrangements				
Argentina[1]	March 10, 2000	March 9, 2003	10,585.50	6,751.19
Bosnia and Herzegovina	May 29, 1998	May 29, 2001	94.42	13.99
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	113.38
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Nigeria	August 4, 2000	August 3, 2001	788.94	788.94
Pakistan	November 29, 2000	September 30, 2001	465.00	315.00
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	56.66
Romania	August 5, 1999	February 28, 2001	400.00	260.25
Turkey[1]	December 22, 1999	December 21, 2002	8,676.00	5,832.20
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			**32,172.69**	**17,099.80**
EFF arrangements				
Bulgaria	September 25, 1998	September 24, 2001	627.62	104.62
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
FYR Macedonia	November 29, 2000	November 28, 2003	24.12	22.97
Indonesia	February 4, 2000	December 31, 2002	3,638.00	2,786.85
Jordan	April 15, 1999	April 14, 2002	127.88	91.34
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	August 15, 2002	1,919.95	1,017.73
Yemen	October 29, 1997	March 1, 2001	105.90	65.90
Total			**9,112.57**	**6,758.51**
PRGF arrangements				
Albania	May 13, 1998	July 31, 2001	45.04	9.41
Benin	July 17, 2000	July 16, 2003	27.00	16.16
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	22.35
Cambodia	October 22, 1999	October 21, 2002	58.50	33.43
Cameroon	December 21, 2000	December 20, 2003	111.42	95.50
Central African Republic	July 20, 1998	July 19, 2001	49.44	24.96
Chad	January 7, 2000	January 7, 2003	36.40	26.00
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	13.63
FYR Macedonia	November 29, 2000	November 28, 2003	10.34	8.61
Gambia, The	June 29, 1998	June 28, 2001	20.61	6.87
Georgia	January 12, 2001	January 11, 2004	108.00	99.00
Ghana	May 3, 1999	May 2, 2002	191.90	120.85
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Guyana	July 15, 1998	July 14, 2001	53.76	28.88
Honduras	March 26, 1999	March 25, 2002	156.75	64.60
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	28.69
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2002	46.65	33.15
Mauritania	July 21, 1999	July 20, 2002	42.49	30.35
Moldova	December 15, 2000	December 14, 2003	110.88	101.64
Mozambique	June 28, 1999	June 27, 2002	87.20	33.60
Nicaragua	March 18, 1998	March 17, 2001	148.96	33.64
Niger	December 14, 2000	December 21, 2003	59.20	50.74
Rwanda	June 24, 1998	June 23, 2001	71.40	19.04
São Tomé and Príncipe	April 28, 2000	April 28, 2003	6.66	4.76
Senegal	April 20, 1998	April 19, 2001	107.01	42.80
Tajikistan	June 24, 1998	December 24, 2001	100.30	34.02
Tanzania	March 31, 2000	March 30, 2003	135.00	95.00
Uganda	November 10, 1997	March 31, 2001	100.43	8.93
Zambia	March 25, 1999	March 28, 2003	254.45	224.45
Total			**2,907.48**	**1,733.33**
Grand total			**44,192.74**	**25,591.64**

[1] Includes amounts under Supplemental Reserve Facility
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Treasurer's Department

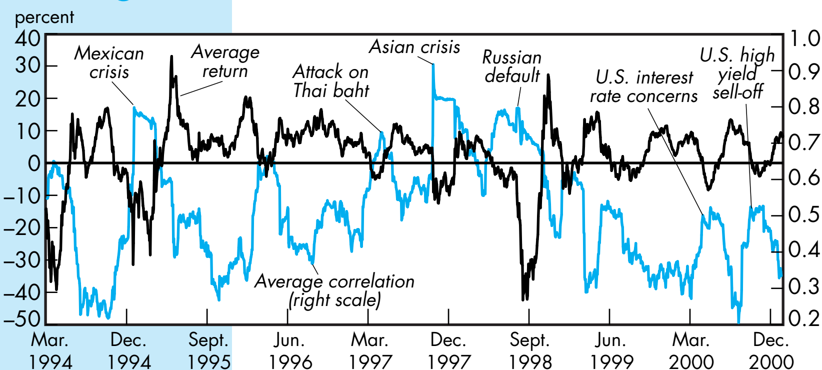
Members drawing on the IMF "purchase" other members' currencies or SDRs with an equivalent amount of their own currency.

Emerging Market Financing

Report weighs bond, equity market prospects, examines contagion and periods of "drought"

Heightened expectations of a slowdown in the U.S. economy; a downgrading of the long-run earnings potential of the technology, media, and telecom sector; and a deterioration in U.S. credit markets all took their toll on emerging bond and equity markets in the last quarter of 2000. In addition to analyzing the consequences of these developments, the latest issue of *Emerging Market Financing*, which is published quarterly and forms part of the IMF's surveillance over international capital markets, also discusses the outlook for emerging market financing this year and the potential risks, notably those that would be engendered if the U.S. economy were to slow sharply. The report also examines episodes of contagion and periods of drought in emerging bond markets—two salient features of emerging markets financing.

Emerging debt markets: average return and correlation



Data: IMF, *Emerging Market Financing*, fourth quarter 2000

Performance and outlook

As spreads widened sharply in emerging markets and in U.S. high-yield markets last quarter, tighter external liquidity conditions focused investor attention intensely on the prospects for the two largest emerging market borrowers on international bond markets—Argentina and Turkey. Emerging equity markets, again led by Asia, performed less well than their broader counterparts in the mature markets. Despite bond issuance virtually drying up for much of the quarter, however, total emerging markets fund-raising on international capital markets held up relatively well, supported by a surge in equity placements from China and a robust syndicated loan market.

As it has in the last three quarters of 2000, the outlook for emerging market assets and financing remains closely tied to developments in the external environment. According to the report, changing perceptions of the relative probabilities of a "soft" versus "hard" landing for the U.S. economy are likely to keep markets volatile. *Emerging Market Financing* sketches scenarios for both outcomes, noting that expectations of a relatively soft landing will lead to a continued easing of external financing conditions for emerging markets and—history indicates—increased discrimination among the better performers. Expectations of a hard landing, however, will prompt a move up the credit spectrum in debt markets and could spark another downgrading of the technology, media, and telecom sector, thereby tightening external financing conditions for emerging markets. The baseline outlook for 2001 sees a moderation in bond financing, selective equity placements, and a supportive syndicated loan market.

Contagion and discrimination

The report takes a close look at periodic bouts of contagion—that is, high correlations in the individual country returns on emerging debt markets. It finds individual country bond returns tend to move in sync during bad times, but considerably less so during market rallies. This suggests less investor discrimination during sell-offs (see chart, this page). This is consistent with both the "crossover" nature of the investor base (which tends to head for home markets in the face of bad news rather than seek refuge in better credits within the asset class) and leveraged position taking (losses prompt margin calls and broad-based liquidation across the asset class, but gains do not). But the report also finds evidence of a systematic decline in cross-correlations after the emerging market crises of 1997–98. This is encouraging, since it suggests a greater potential for diversification between emerging markets and could encourage increased allocations to the asset class.

Why have cross-correlations declined since 1997–98? The report identifies several factors: investors are less leveraged since the Asian and Russian crises, so that bad news necessitates less need for across-the-board liquidations; the upgrading of some countries—such as Mexico—to investment grade has increased the diversity of the overall investor base for emerging market debt, and a more diverse investor base should result in more diversified investor behavior; and we have not had a "full-blown" crisis in a major emerging market for some time now. According to the report, it remains an open question how high the correlations would go if there were another full-blown crisis in a major emerging market.

During 2000, there were two spikes in the average cross correlation, though these spikes were noticeably lower than in previous years. The first episode coin-

cided closely with revised expectations about U.S. monetary policy, suggesting expectations played the key role. In the second episode, a variety of factors coincided relatively closely with the sell-off in Argentina. Was there contagion from Argentina to other emerging markets? *Emerging Market Financing* finds that the deterioration in the external environment preceded the buildup of investor concerns about the sovereign to a critical level. By the time Argentine spreads rose above the broader market, the average cross-correlation had already risen.

The second episode had two phases. The first may be linked with concerns about Peru, the pricing-in of a global slowdown, and the Chase–J.P. Morgan merger. The second phase coincided with the sell-off in U.S. high-yield bonds. As concerns about Argentina grew—peaking on October 25 and again on November 9—the average correlation remained relatively flat. This evidence suggests that "contagion" within the emerging debt markets preceded the buildup of concerns about Argentina to a critical level and was a response to the deterioration of the external environment.

Droughts in emerging bond markets

Since 1993, emerging market borrowers have, according to the report, faced nine periods of market closure, or "droughts" in which they were unable to issue new debt securities (see chart, this page). The duration of these droughts has varied substantially, from one week (at the time of the Mexican crisis) to the most severe and prolonged drought of 13 weeks (at the time of the Russian crisis). The first five instances of market closure were associated with emerging market crises or uncertainties in the periods leading up to them, but droughts occurred even in the absence of emerging markets crises. In the four droughts since the Russian crisis, three have been associated with developments in the external environment, and the widening of spreads has been notably less pronounced in these episodes. The report found, rather surprisingly, that there was no clear relationship between the average level of emerging market spreads and droughts in emerging markets issuance.

A discrete event—such as a crisis in a major emerging market or a change in the external environment—typically prompts a sharp change in spreads and causes issuers and investors to wait, according to *Emerging Market Financing*. Issuers are loathe to lock in higher rates, and investors are concerned about taking mark-to-market losses (that is, losses accrued when their assets are marked to the prevailing market price) on new issues, because spreads might widen further. A resolution of the uncertainty about that outlook appears key for a reopening of the market. With time, issuers tend to accept higher borrowing rates, and once investors become convinced things will not worsen, they become willing to buy. Volatility of the secondary markets is, therefore, key to market closures, and its dissipation is key to reopenings.

As one would expect, droughts in issuance have also been a feature of other lower-tier credit markets, such as the U.S. high-yield market, but much less so of the high-grade market. Conditions in the U.S. high-grade and high-yield markets—the "external issuance environment"—have played a clear role in determining the receptiveness for emerging market issues. At the time of the Brazilian crisis, for example, while emerging market issuance fell markedly, U.S. high-yield issuance remained stable, setting the stage for early reaccess, and the slowdown in issuance at that time does not qualify as a drought under the report's definition.

Finally, droughts in emerging market issuance have been closely associated with spikes in the average cross-correlation of individual country returns—that is, periods of broad-based selling of emerging market debt in secondary markets (see chart). ■

Subir Lall
IMF Research Department

Emerging debt markets: average correlation and market closures (shaded)

Data: IMF, *Emerging Market Financing*, fourth quarter 2000

Emerging Market Financing: Quarterly Report on Developments and Prospects for the fourth quarter of 2000 is available on the IMF's website (www.imf.org).

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 5	4.37	4.37	5.06
February 12	4.36	4.36	5.05

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 rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

New framework

Reserves should be adequate to reflect increase in capital account flows, need for crisis prevention

A quiet revolution has taken place in reserve adequacy over the last few years. This article takes stock of the rapid changes in the framework for evaluating reserve adequacy.

Background

For much of the second half of the twentieth century, the rule of thumb was that reserves should provide at least three months of import coverage as a minimum desirable target for reserves. Reserve floors in many IMF-supported economic programs have been based on achieving such a minimum level. Market participants have also widely used this rule to gauge reserve adequacy. Indeed, the median observed reserve levels during the past fifty years mostly fell in the range of three to four months of imports. Following the spate of financial crises in emerging market economies in the 1990s (see chart, page 68), reserves in these countries increased substantially, reflecting, among other things, a new appreciation of the importance of adequate reserves.

The postwar focus on trade reflected limited opportunities to offset shocks to the current account through private capital flows. Such private flows had declined and were moreover regarded as relatively destabilizing in the period of and following the Great Depression. In itself, this focus on external factors represented a major departure from the earlier approach. In the world of credible gold standards, private capital flows were regarded as predominantly stabilizing, and reserve policies thus focused on underpinning the credibility of the gold (exchange) standard. Indeed, before World War II, reserve targets were largely guided by the need to back the gold or gold exchange standards and were primarily based on some concept of the domestic money stock (for example, base money).

Capital account focus

With the rise in private capital flows, the focus of reserve adequacy on trade—and the rule about three months' import coverage in particular—has increasingly come to be regarded as out of date for many countries. At the same time, the crises that affected emerging market countries in the 1990s have driven home the point that capital flows are important in financing the balance of payments and that access to these private capital flows is often uncertain and subject to rapid reversal. Such reversals can contribute to a liquidity squeeze and can result in or aggravate external crises. With recent estimates putting the average cost of such crises at a very sizable 20 percent of GDP, it is no surprise that the spotlight has turned to the role of reserves in crisis prevention.

Thus, a search has begun for new policy rules to assess reserve adequacy that reflect capital account and crisis prevention considerations. With crisis prevention as the primary objective, policymakers such as Alan Greenspan and Pablo Guidotti took the lead in proposing a new rule of thumb that targets coverage of short-term debt by remaining maturity as the main criterion for setting reserve levels. Following this line, adequate reserve levels have been drawn from models used to predict the incidence or severity of external crises. The focus on short-term debt and this new framework are reflected in an IMF Board discussion of a March 2000 policy paper, *Debt- and Reserve-Related Indicators of External Vulnerability* (on the IMF website: www.imf.org/external/np/pdr/debtres/index.htm).

New framework for assessing adequacy

It is useful to distinguish two aspects of the new approach to assessing reserve adequacy. The first is that empirically based indicators, derived from empirical, cross-country models of external vulnerability, can be useful to provide "ball park" estimates of reserve adequacy and serve as a starting point for further analysis. The results of the estimations are also useful in evaluating the macroeconomic or microeconomic factors that should be taken into account in assessing vulnerability. Research at the IMF has found empirical support for the notion that reserves in excess of short-term debt reduced the depth of crises in emerging market economies during periods of international contagion. Further work is being done in this area, especially to take account of country-specific factors and to quantify benefits in terms of preventing output losses.

The second element involves stress testing and is especially suitable for evaluating country-specific and idiosyncratic factors that affect reserve adequacy. Stress tests can be used to evaluate the ranges observed in the past for the various line items in the balance of payments and to examine potential variations in bad or worst-case scenarios. This approach is also particularly suited to evaluating policy responses and is practiced by a number of central banks. The use of stress testing and policy scenarios is also potentially useful in containing the spread of such crises by improving the authorities' understanding of the parameters and responsiveness of economic variables to policy reactions.

Reserves = short-term debt

The use of indicators and stress testing fits comfortably into the framework for assessing reserve adequacy outlined above. In most of the empirical work on external vulnera-

bility, the ratio of short-term debt to reserves has been identified as the most significant empirical reserve-related indicator. The rule of thumb that emerges is that reserves should be broadly equal to short-term debt by remaining maturity: R (reserves) = STD (short-term debt).This ratio has an intuitively appealing interpretation in terms of stress testing. For example, consider a simplified situation in which the current account has a zero deficit (as a percent of GDP), and there is no capital flight by residents. In such a situation, a level of reserves that is equal to short-term debt by remaining maturity allows a country to honor all its debt obligations if no new capital inflows take place and old debt is not rolled over or renewed.

In practice, such a simplified situation does not prevail, but it provides a natural departing point for considering more complex situations arising in individual country cases or enhanced stress tests. To illustrate, using an enhanced stress test, one could consider that the country is likely to benefit from continued foreign direct investment (FDI) inflows during a mild crisis. The FDI inflows then are a source of financing and reduce the reserve need as compared to the R = STD benchmark implied by the simplified test.

A central bank applying such a stress test approach may also consider exposure to the risk of capital flight by residents and exposure to the need to finance a current account deficit. Users of this framework may also judge that lack of access for a full year is too long or too short a time period in view of the capability to take adjusting measures—for example, as a result of the political cycle or the effectiveness of fiscal and monetary policies. It is also very useful to consider as parameters in such stress tests the type and size of flows that occurred during previous crises.

Considerations beyond R = STD

As noted, the rule of a level of reserves equal to short-term debt should be viewed as a starting point for analyzing reserve adequacy for a country with significant but uncertain access to capital markets. Several other considerations for assessing reserve adequacy also have been found to be key.

• General empirical analysis strongly suggests that other fundamentals, notably the current account deficit and real effective exchange rate misalignments, affect the need for reserves.

• While private debt (including corporate and banking sector debt) should be included in reserve cover, in line with empirical results, the need for reserves to be held against these exposures declines for cases where private sector risks are soundly managed, as in many industrial countries.

• A flexible exchange rate regime may promote sound micromanagement of risks and thwart some of the risks of speculative capital flight. However, a flexible exchange rate regime does not negate the risk of crisis, given the

Available on the web (www.imf.org)

News Briefs

01/12: Second Review of Cambodia's PRGF Loan, January 30

01/13: $1.4 Billion Credit Tranche for Turkey, February 5 (see page 62)

01/14: IMF Board Meets with UN Preparatory Committee on Financing for Development Event, February 6 (see page 53)

01/15: Madagascar, Chairman's Statement on HIPC Discussion, February 7

01/16: IMF and World Bank Heads to Meet African Leaders, February 7

01/17: IMF Board of Governors Approves Quota Increase for China, February 8 (see page 55)

01/18: Second Review of Mauritania's PRGF Loan, February 9

01/19: IMF Publishes Quarterly *Emerging Market Financing* Report, February 14 (see page 64)

Public Information Notices (PINs)

01/09: Benin, February 12

01/10: Norway, February 5

01/11: IMF Reviews Experience with Financial Sector Assessment Program, February 5

01/12: Sierra Leone, February 12

Speeches

IMF Deputy Managing Director Eduardo Aninat, "Developing Capital Markets in Latin America," IDB Conference on Capital Market Development, February 5

Transcripts

Press Briefing, Thomas Dawson, IMF External Relations Department Director, February 2

Letters of Intent and Memorandums of Economic and Financial Policies*

Turkey, February 6

Poverty Reduction Strategy Papers*

Mauritania, February 6

Concluding Remarks for Article IV Consultations*

Switzerland, January 29

Economic Policies of the Euro Area, February 2

Canada, February 4

Decision Point Document for Enhanced HIPC Initiative*

São Tomé and Príncipe, January 30

Guinea-Bissau, February 2

The Gambia, February 5

Report on the Observance of Standards and Codes*

Korea, February 7

Other

Quarterly Update on the Special Data Dissemination Standard, Fourth Quarter 2000, January 29

Involving the Private Sector in the Resolution of Financial Crises, February 5 (see page 58)

IMF Financial Resources and Liquidity Position, 1999–January 2001, February 8

IMF Financial Activities, February 12

* Date posted.

Ian S. McDonald
Editor-in-Chief
Sara Kane
Deputy Editor
Sheila Meehan
Senior Editor
Elisa Diehl
Assistant Editor
Sharon Metzger
Senior Editorial Assistant
Lijun Li
Editorial Assistant
Joann Wheeler
Staff Assistant
Philip Torsani
Art Editor/Graphic Artist
Jack Federici
Graphic Artist

The *IMF Survey* (ISSN 0047-083X) is published in English, French, and Spanish by the IMF 23 times a year, plus an annual *Supplement on the IMF* and an annual index. Opinions and materials in the *IMF Survey* do not necessarily reflect official views of the IMF. Any maps used are for the convenience of readers, based on National Geographic's *Atlas of the World*, Sixth Edition; the denominations used and the boundaries shown do not imply any judgment by the IMF on the legal status of any territory or any endorsement or acceptance of such boundaries. Material from the *IMF Survey* may be reprinted, with due credit given. Address editorial correspondence to Current Publications Division, Room IS7-1100, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-8585; or e-mail any comments to imfsurvey@imf.org. The *IMF Survey* is mailed first class in Canada, Mexico, and the United States, and by airspeed elsewhere. Private firms and individuals are charged $79.00 annually. Apply for subscriptions to Publication Services, Box X2001, IMF, Washington, DC 20431 U.S.A. Tel.: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

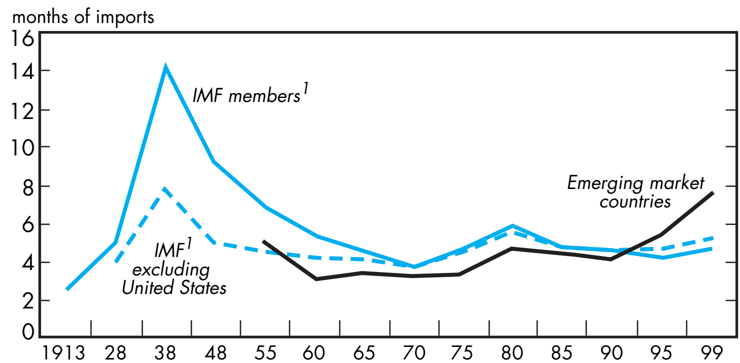
possibility that the currency may go into free fall without adequate liquidity support and that a country needs to continue to service private and public external debt.

• The availability of instruments for selling the currency short (that is, borrowing against the expectation of buying it back at a cheaper price) may affect the speed at which liquid resources are depleted and raise the size of the necessary liquidity buffer. Thus, the ability of nonresidents to take derivative positions vis-à-vis the central bank (directly or indirectly) may substantially increase liquidity needs or require a strong counterweight, such as sound risk management.

• The size of the short-term domestic debt position of the monetary authorities and the rest of the central government and the presence of a weak banking system can be a source of capital flight and inflow reversals. These factors weigh in more heavily, especially where there are no effective capital controls or other means to create a captive market, the exchange rate is fixed, and the debt is denominated in foreign currency.

The general framework, advanced above, can be adapted to capture these considerations in specific country cases through the use of stress tests and empirical indicators that reflect such factors. This work should be supported through a review of indicators of market access, notably indicators of solvency, because declining solvency will in due course lead to liquidity problems.

Reserves: long-run trends



[1]Current IMF members to the extent that data are available.
Data: IMF

Limited access to capital markets

The new framework applies to countries with significant and uncertain access to capital markets. What about countries with limited access? For these countries, the traditional arguments apply: without access to private capital, reserves are needed to absorb and smooth shocks, such as declining export volumes or increasing import prices. Reserve coverage can be examined based on either the past volatility of reserves (as a summary measure of overall volatility) or the past volatility of the current account.

Statistical measures can be used to construct approximate confidence intervals, or the maximum variations in observed past balance of payment flows can be used to construct worst-case scenarios. These factors—in combination with a judgment over the length of the period to which such a scenario applies and the scope for adjustment measures and the speed with which they can be implemented—can be used to assess desired reserve levels.

Implications for managing reserves

The new approach for evaluating the adequacy of reserves will have a profound impact on how reserves should be managed, notably the ideal composition of reserves in terms of currency, duration, and instruments. The logic of the framework suggests that the currency composition of reserves should focus closely on the currency composition of potential capital outflows rather than on the currency composition of the trade flows, though formal work is required on this topic. Thus, if outflows are likely to be in dollars (for example, because short-term debt is in dollars), the currency composition should be weighted toward dollars, not because other reserve currencies cannot be rapidly swapped into dollars but to minimize the risk that the value of the reserves as measured in dollars is low at the time they are needed.

More generally, the logic of the framework suggests that reserve composition should be set to maximize the available gross reserves when they are indeed needed. This implies, for example, that low-quality instruments, which tend to suffer from market risk during periods of international contagion or turmoil, are best avoided.

The general issues have been raised in a series of seminars and training courses with reserve managers around the globe. Recently, the World Bank and the IMF hosted a roundtable on reserves that examined reserve adequacy and the implications for reserve management issues.

Whither the import coverage rule?

Does this all mean that the traditional rule of thumb of three months of imports of goods and services is no longer useful? It is likely that reserves will continue to be expressed in terms of imports, especially for countries with limited access to capital markets, because this continues to be universally available and easily interpretable. However, the motivation for the level of reserves held should be justified in broader terms, as elaborated above. Such an approach, in practice, could be expected to lead to a much wider range of observed levels of reserves, when expressed in terms of imports, and a much greater focus on reporting and comparing reserves in terms of other measures, such as short-term debt. ■

Christian Mulder and Ydahlia Metzgen
IMF Policy Development and Review Department