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"New Architecture" Outlined

Camdessus Says IMF Support for Asian Programs Is Marked Departure from Traditional Role

Speaking before the Council on Foreign Relations on February 6, IMF Managing Director Michel Camdessus outlined the new directions that the IMF's activities in Asia have taken and spelled out the implications of the Asian crisis for the future architecture of the international financial system (see page 50 for excerpts of the speech).

The IMF-supported programs in Thailand, Indonesia, and Korea represent a "marked departure" from those the institution has traditionally supported, Camdessus said. Instead of austerity measures to restore macroeconomic balance, the centerpiece of each program is a set of forceful, far-reaching structural reforms aimed at restoring market confidence. The reforms included in these programs will require vast changes in domestic business practices, corporate culture, and government behavior.

Answering critics who have argued that the programs are too tough because they could slow economic activity, Camdessus said that without the programs and the international support behind them, the slowdown would be much more dramatic, the costs to the general population much higher, and the risks to the international economy much greater.

Camdessus also answered critics who claim that providing assistance to countries in crisis will only encourage more reckless behavior by borrowers and

(Please turn to the following page)

Moscow Communiqué

Russia and IMF Agree to Extend and Augment Financial Support Under EFF Program

The IMF and the Russia government have agreed to extend the current $10 billion Extended Fund Facility (EFF) credit for an additional year and to augment the IMF's financial support under the program. The agreement was announced on February 19 in Moscow by Russian Prime Minister Victor Chernomyrdin and IMF Managing Director Michel Camdessus following a review of the medium-term strategy supported by the EFF. In a joint communiqué released after their meeting they said that that they shared "a common assessment of the situation, of the strategy, and of the policies needed to bring the program to a full success given the prevailing challenges in the international financial environment." The EFF had been approved by the IMF Executive Board on March 26, 1996, IMF Survey, *April 1, 1996, page 119. Excerpts from the communiqué follow:*

The Prime Minister and the Managing Director expressed satisfaction that their respective negotiating teams have just finalized understandings on the policy parameters and measures to be incorporated in the 1998 program. These understandings are specified in a draft Statement of Economic Policies that will be published once it has been signed by the Prime Minister and the Chairman of the Central Bank of Russia and formally approved by IMF management. Following the usual technical procedures, it is expected that the statement will be signed within the next couple of weeks.

The visit has allowed the Russian authorities and the Managing Director to take stock of what has already been accomplished during the first two years under the EFF. They agreed that, notwithstanding substantial achievements in the areas of macroeconomic stabilization and the establishment of market mechanisms and institutions, a number of remaining challenges require decisive action without

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IMF Support for Asian Programs

(Continued from front page) lenders in the future. The global interest, he said, lies in containing and overcoming the Asian crisis as quickly as possible, even at the cost of some undesired side effects. Working through the IMF offers the most expeditious and cost-effective way to accomplish this.

In light of the Asian crisis, attention is now turning toward how to strengthen the international financial system so that such crises will be less likely to occur and those that do occur can be handled more effectively, Camdessus said. He outlined six pillars supporting a new architecture for managing the international monetary system:

- more effective surveillance over countries' economic policies;
- regional surveillance;
- financial sector reform;
- more effective structures for orderly debt workouts;
- orderly capital account liberalization; and
- stronger international financial institutions.

Other related developments include:

- Prabhakar R. Narvekar, a former Deputy Managing Director of the IMF, has been appointed Special Advisor to the President of Indonesia and Senior Consultant to the Managing Director of the IMF. Narvekar will assist the Indonesian authorities with the implementation of Indonesia's IMF-supported economic program.
- Speaking to the Bretton Woods Committee on February 13, Camdessus said Indonesia should pursue economic reforms before proceeding with a plan to establish a currency board to fix the value of the rupiah. Implementing a rigid currency regime now, he said, could damage the Indonesian economy by further undermining confidence. ■

IMF Extends Program with Russia

(Continued from front page) delay. In particular, structural reform notably promoting the principles of good corporate governance should be deepened and the fiscal imbalances addressed. The 1998 program is designed to take into account the recent international financial market turmoil that has led to a sharp deterioration in the economic environment in which the Russian economy has not been entirely spared.

Recognizing that fiscal imbalances have been a source of recent financial market uncertainties, the government has proposed some key amendments to bring the 1998 budget in line with realistic revenue projections. Forceful efforts will continue to be taken to improve revenue performance. At the same time, comprehensive efforts will be made to cut federal government spending; the completion of the new operational treasury system should establish the control necessary to ensure that the budget appropriations can be fully financed without arrears while reducing the deficit further. The EFF program for 1998 is fully consistent with the draft 1998 budget as amended by the government. Furthermore, in pursuit of the prime objective of laying the basis for growth, the program also envisages a strengthening of structural reforms in areas such as private sector development, fiscal institutions, banking, and natural monopolies.

The Managing Director also met with President Yeltsin, who confirmed his strong support for the 1998 program, as was clearly shown in his annual address to the Federal Assembly on February 17. In view of the tasks that remain to be accomplished, the Prime Minister and the Managing Director agreed to propose an extension of the EFF by an additional year through early 2000. In this context, an augmentation of the size of the IMF's financial support under the program and a revised quarterly disbursement schedule was agreed. In concluding the negotiations, the Managing Director was confident that fulfillment of the policies under the program would result in Russia's successful transition to a dynamic market economy. ■

IMF Response to Crisis Highlights New Directions In Managing International Monetary System

Following are edited excerpts of an address given by IMF Managing Director Michel Camdessus at a meeting of the Council on Foreign Relations, in New York, on February 6.

Without the programs, the slowdown would be much more dramatic

Many people assume that the IMF-supported programs in Thailand, Indonesia, and Korea must be the same kind of belt-tightening adjustment programs that the public has long associated with the IMF. Quite the contrary. These programs represent a marked departure from the kind of programs we have traditionally supported in the past.

The centerpiece of each program is not a set of austerity measures to restore macroeconomic balance, but forceful, far-reaching structural reforms to strengthen financial systems, increase transparency, open markets, and, in so doing, restore market confidence. To this end, nonviable financial institutions are being closed down, and other institutions are being required to come up with restructuring plans and to comply with internationally accepted best practices. Other institutional changes are under way to strengthen financial sector regulation and supervision,

increase transparency in the corporate and government sectors, create a more level playing field for private sector activity, and increase competition. Taken together, these reforms will require a vast change in domestic business practices, corporate culture, and government behavior, which will take time. But the process is already in motion, and already some dramatic steps have been taken.

Will It Work?

Some have argued that these programs are still too tough, either in calling for higher interest rates, tightening government budget positions, or closing down financial institutions. But by the time these countries approached the IMF, the value of their currencies was plummeting, and in the case of Thailand and Korea, reserves were perilously low. Thus, the first order of business was, and still is, to restore confidence in the currency.

Here, I would like to dispel the notion that the deep currency depreciations seen in Asia in recent months have occurred by IMF design. On the contrary, in our view, these currencies have depreciated far more than is warranted or desirable. Moreover, without IMF support as part of an international effort to stabilize these economies, it is likely that these currencies would have lost still more of their value.

To reverse this process, countries have to make it more attractive to hold domestic currency, and that means temporarily raising interest rates, even if this complicates the situation of weak banks and corporations. This is a key lesson of the "tequila crisis" in Latin America 1994–95, as well as from the more recent experience of Brazil, Hong Kong SAR, and the Czech Republic—all of which have fended off attacks on their currencies over the past few months with a timely and forceful tightening of interest rates, along with other supporting policy measures. Once confidence is restored, interest rates can return to more normal levels.

Companies with substantial foreign currency debts are likely to suffer far more from a long, steep slide in the value of their domestic currency than from a temporary rise in domestic interest rates. Moreover, when interest rate action is delayed, confidence continues to erode. Thus, the increase in interest rates needed to stabilize the situation is likely to be far larger than if decisive action had been taken at the outset. Indeed, the reluctance to tighten interest rates in a determined way at the beginning has been one of the factors perpetuating the crisis.

Other observers have advocated more expansionary fiscal programs to offset the inevitable slowdown in economic growth. Here, the programs must strike a delicate balance. At the outset of a crisis, countries need to firm their fiscal positions to deal both with the future costs of financial restructuring and—depending on the balance of payments situation—with the need to reduce the current account deficit. Beyond that, if the country's economic situation worsens, the IMF generally agrees to let automatic stabilizers work and allow the deficit to widen somewhat. However, we cannot disregard the level of the fiscal deficit, particularly since a country in crisis typically has only limited access to borrowing and the alternative of money printing would be potentially disastrous.

Likewise, we have been urged not to recommend rapid action on banks. It would be a mistake, however, to allow clearly bankrupt banks to remain open, as this would only perpetuate the region's financial crisis, not resolve it. The best course is to recapitalize or close insolvent banks, protect small depositors, and require shareholders to take their losses. At the same time, banking regulation and supervision must be improved.

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

> There is a trade-off in how the international community chooses to handle the Asian crisis.

Of course, not everyone agrees with this approach. Some say that it would be better simply to let the chips fall where they may, on the grounds that providing assistance to countries in crisis will only encourage more reckless behavior on the part of borrowers and lenders in the future. I do not share this view. The notion that the availability of IMF programs encourages countries to behave recklessly is not very plausible: no country would deliberately court such a crisis even if it thought international assistance would be forthcoming. The economic, financial, social, and political pain is simply too great. Nor do countries show any great desire to enter IMF programs unless they absolutely have to.

Despite the constant talk of bailouts, most investors are taking heavy losses in the crisis. With stock markets and exchange rates plunging, foreign equity investors have lost nearly three-quarters of the value of their equity holdings in some Asian markets. Many firms and financial institutions in these countries will go bankrupt, and their foreign and domestic lenders will share in the losses. International banks are also sharing in the cost of the crisis. It is true that some short-term creditors

are being protected, and this is an issue that needs to be addressed.

The bottom line is that there is a trade-off in how the international community chooses to handle the Asian crisis. It could step back, allow the crisis to deepen, bring additional suffering to the people of the region, and, in the process, possibly teach a handful of international lenders a better lesson. Or it can step in and try to do what it can to mitigate the effects of the crisis on the region, and the world economy, albeit with some undesired side effects. In my view, the global interest lies in containing and overcoming this crisis as quickly as possible. Working through the IMF offers the most expeditious and cost-effective way of doing this.

Toward a New Architecture

In the initial months of Asia's financial turmoil, much of the world's attention was focused on how to contain the crisis. But today, thoughts are turning to how best to strengthen the international financial system so that such crises will be less likely to occur in the future and those that do occur can be handled more effectively. I see six pillars supporting this new architecture:

• *More effective surveillance over countries' economic policies*, facilitated by fuller disclosure of all relevant economic and financial data.

• *Regional surveillance*, because experience shows that there is considerable scope for improving economic performance on a regional basis when neighboring countries get together to encourage one another—or put pressure on one another—to pursue sound policies. The IMF is assisting with such initiatives in Asia.

• *Financial sector reform*, including better prudential regulation and supervision.

• *More effective structures for orderly debt workouts*, including better bankruptcy laws at the national level and better ways at the international level of associating the private sector with official efforts to help resolve sovereign debt problems.

• *Orderly capital account liberalization*: this means neither a return to antiquated capital controls nor a mad rush to full, immediate liberalization, regardless of the risks, but properly sequenced and cautious liberalization, so that a larger number of countries can benefit from access to the international capital markets.

• *Strengthening the international financial institutions*, including their financial resources.

Suffice it to say, when all these elements are in place, the architecture of the international financial system will indeed be more modern and more substantial, and more equal to the challenges in the global economy today. ■

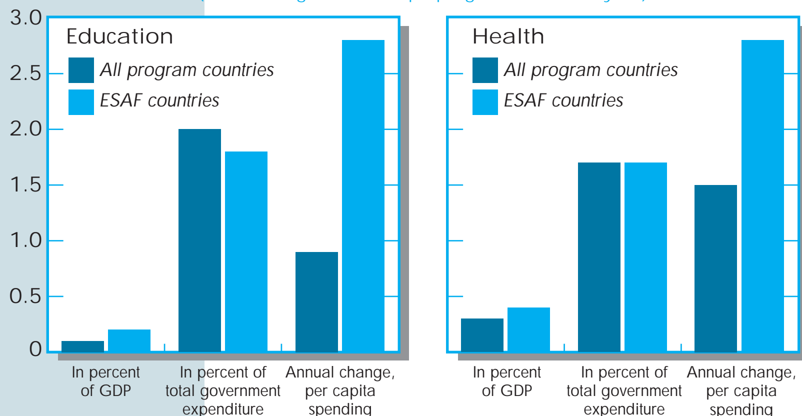
Sample of 66 Economies

Social Spending Rises and Indicators Improve With IMF-Supported Programs

Social spending has increased and social indicators have improved since the mid-1980s in countries with IMF-supported programs, according to a recent assessment made by the Fiscal Affairs Department in collaboration with other IMF departments. The data for the study were compiled as part of the IMF's ongoing effort to improve its collection and analysis of data on government education and health spending in developing and transition economies. This effort has received additional attention in the wake of IMF Managing Director Michel Camdessus's call for a strengthening of the staff's work in this area (*IMF Survey*, June 23, 1997). The results of the new analysis largely confirm an earlier analysis of developments in social spending in 23 countries supported by the Enhanced Structural Adjustment Facility (ESAF) (*IMF Survey*, July 21, 1997), although they indicate more modest increases in real spending.

Government Social Spending Under IMF-Supported Programs 1986–96

(mean changes between preprogram and latest year)[1]



[1]Latest year for which data are available.

Data: Country authorities and IMF staff estimates

These results should be interpreted with caution. Consistent social expenditure data are difficult to collect, owing to lags in the reporting of data, varying coverage of data from country to country, and the fact that local government expenditures may not be included. These considerations make cross-country comparisons problematic. It should be noted that the figures reported here do not include social spending by the private sector, which can be sizable. In 1990, for example, the private sector accounted, on average, for

45 percent of all health outlays in Africa and 60 percent of such outlays in Asia (see Psacharapouluos and Nguyen, *The Role of Government and the Private Sector in Fighting Poverty*, World Bank Technical Paper No. 346, 1997).

Education Spending

In a sample of 66 countries with IMF-supported programs for the period 1986–96, education spending rose by 0.1 percentage point as a share of GDP between the preprogram year and the most recent year for which data are available (a period averaging eight years) (see chart, page 52). Changes were larger for a sample of 32 countries supported by ESAF, with education spending rising by 0.2 percent of GDP. Although modest, these changes occurred in the context of countries' efforts to secure fiscal adjustment through reductions in total government outlays. As such, these small increments in spending as a share of GDP led to proportionally larger increases in education spending as a share of total spending. Such outlays rose as a share of total government spending by 2.0 percentage points for the sample of 66 countries, and by 1.8 percentage points in ESAF countries. Since the preprogram year, real per capita spending has increased on average by 0.9 percent a year for the full sample of countries and 2.8 percent a year in ESAF countries.

The increase in education spending varied substantially between regions (see chart, this page). For example, real per capita spending increased sharply (5.9 percent a year) in Asia, while real per capita outlays declined in sub-Saharan Africa. Increases in spending as a share of GDP were relatively large in the Western Hemisphere (0.5 percentage point).

Health Spending

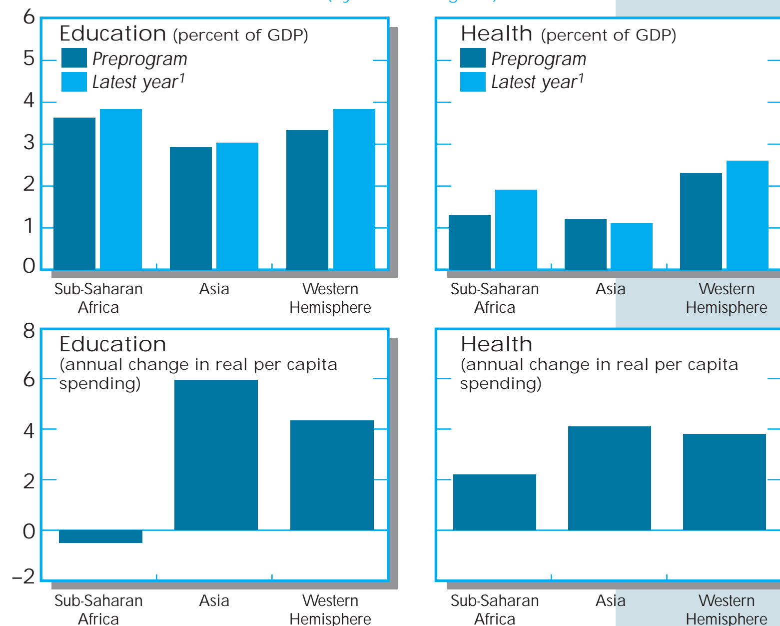
A similar analysis of health spending indicates that outlays rose as a share of GDP by 0.3 percentage point between the preprogram year and the latest year for which data are available, and by 1.7 percentage points as a share of total government spending. Comparable increases were experienced in the sample of ESAF countries. Real per capita government health outlays increased on average by 1.5 percent a year for the whole sample and 2.8 percent a year in ESAF countries. As with education spending, there was considerable variation between country groups. Real per capita health outlays rose strongly in Asia and the Western Hemisphere (4.1 percent and 3.8 percent a year, respectively), and increased slightly as a share of total spending. Owing to rapid economic growth, however, this spending actually fell as a share of GDP in Asia. This underscores the importance of looking beyond spending-to-GDP ratios in assessing changes in social expenditures.

Social Indicators

Social indicators are influenced by a host of factors besides government social expenditures. These include general economic conditions, improvements in health technology, and the activities of nongovernmental organizations and other private sector service providers.

Government Social Spending Under IMF-Supported Programs 1986–96

(by selected regions)



[1]Latest year for which data are available.

Data: Country authorities and IMF staff estimates

Nevertheless, it is recognized that well-targeted and efficient social spending can be instrumental in achieving improved performance in these areas.

Keeping these caveats in mind, it appears that rising social spending was accompanied, on average, by improvements in social indicators (as reported by the World Bank and UNESCO) for countries with IMF-supported programs. The illiteracy rate fell by an average of 2.4 percent a year, and gross enrollment rates in primary and secondary education rose by 0.9 and 0.4 percent a year, respectively. Health indicators also improved, as life expectancy increased by 0.3 percent a year and infant mortality rates fell by 1.8 percent a year. Progress was especially substantial with respect to increases in access to health care (4.6 percent a year) and immunization rates (approximately 6 percent a year).

Conclusions

Government spending on education and health has risen since the mid-1980s in countries with IMF-supported programs, especially in those supported by ESAF. These outlays have become a higher priority for these countries, and the share of social spending in total government outlays has increased. Nevertheless, spend-

ing increases have varied by region. Furthermore, there is scope for strengthening the linkage between social spending and social indicators by reallocating these outlays toward activities that benefit the most needy, such as primary education and preventive health. Increases in the efficiency of social spending could also be achieved with a better mix of inputs, in particular through the rationalization of employment levels in these sectors.

Sanjeev Gupta, Benedict Clements,
Marijn Verhoeven, and Erwin Tiongson
IMF Fiscal Affairs Department

Stand-By Arrangements typically cover a 12–18 month period, although they can extend up to three years.

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

Member	Date of Arrangement	Expiration Date	Amount Approved	Undrawn Balance
			(million SDRs)	
Stand-By Arrangements			**27,564.52**	**13,345.81**
Bulgaria	April 11, 1997	June 10, 1998	371.90	124.30
Djibouti	April 15, 1996	March 31, 1998	6.60	2.63
Egypt	October 11, 1996	September 30, 1998	271.40	271.40
El Salvador	February 28, 1997	April 27, 1998	37.68	37.68
Estonia	December 17, 1997	March 16, 1999	16.10	16.10
Hungary	March 15, 1996	February 14, 1998	264.18	264.18
Indonesia	November 5, 1997	November 4, 2000	7,338.24	5,136.77
Korea [1]	December 4, 1997	December 3, 2000	15,500.00	5,800.00
Latvia	October 10, 1997	April 9, 1999	33.00	33.00
Romania	April 22, 1997	May 21, 1998	301.50	180.90
Thailand	August 20, 1997	June 19, 2000	2,900.00	1,100.00
Ukraine	August 25, 1997	August 24, 1998	398.92	253.86
Uruguay	June 20, 1997	March 19, 1999	125.00	125.00
EFF Arrangements			**11,046.90**	**5,116.62**
Algeria	May 22, 1995	May 21, 1998	1,169.28	168.88
Azerbaijan	December 20, 1996	December 19, 1999	58.50	33.35
Croatia, Republic of	March 12, 1997	March 11, 2000	353.16	324.38
Gabon	November 8, 1995	November 7, 1998	110.30	49.63
Jordan	February 9, 1996	February 8, 1999	238.04	59.18
Kazakhstan	July 17, 1996	July 16, 1999	309.40	309.40
Moldova	May 20, 1996	May 19, 1999	135.00	97.50
Pakistan	October 20, 1997	October 19, 2000	454.92	417.01
Panama	December 10, 1997	December 9, 2000	120.00	110.00
Peru	July 1, 1996	March 31, 1999	300.20	139.70
Philippines	June 24, 1994	March 31, 1998	791.20	245.95
Russian Federation	March 26, 1996	March 25, 1999	6,901.00	3,064.74
Yemen	October 29, 1997	October 28, 2000	105.90	96.90
ESAF Arrangements			**4,058.44**	**2,060.85**
Armenia	February 14, 1996	February 13, 1999	101.25	50.63
Azerbaijan	December 20, 1996	December 19, 1999	93.60	38.02
Benin	August 28, 1996	August 27, 1999	27.18	18.12
Bolivia	December 19, 1994	September 9, 1998	100.96	16.82
Burkina Faso	June 14, 1996	June 13, 1999	39.78	19.89
Cameroon	August 20, 1997	August 19, 2000	162.12	135.10
Chad	September 1, 1995	August 31, 1998	49.56	16.52
Congo, Republic of	June 28, 1996	June 27, 1999	69.48	55.58
Ethiopia	October 11, 1996	October 10, 1999	88.47	73.73
Georgia	February 28, 1996	February 27, 1999	166.50	55.50
Ghana	June 30, 1995	June 29, 1998	164.40	109.60
Guinea	January 13, 1997	January 12, 2000	70.80	47.20
Guinea-Bissau	January 18, 1995	July 24, 1998	10.50	2.36
Guyana	July 20, 1994	April 17, 1998	53.76	0.00
Haiti	October 18, 1996	October 17, 1999	91.05	75.88
Kenya	April 26, 1996	April 25, 1999	149.55	124.63
Kyrgyz Republic	July 20, 1994	March 31, 1998	88.15	0.00
Macedonia, FYR	April 11, 1997	April 10, 2000	54.56	36.37
Madagascar	November 27, 1996	November 26, 1999	81.36	54.24
Malawi	October 18, 1995	October 17, 1998	45.81	15.27
Mali	April 10, 1996	April 9, 1999	62.01	20.67
Mauritania	January 25, 1995	July 13, 1998	42.75	0.00
Mongolia	July 30, 1997	July 29, 2000	33.39	27.83
Mozambique	June 21, 1996	June 20, 1999	75.60	37.80
Niger	June 12, 1996	June 11, 1999	57.96	28.98
Pakistan	October 20, 1997	October 19, 2000	682.38	568.65
Sierra Leone	March 28, 1994	May 4, 1998	101.90	5.06
Tanzania	November 8, 1996	November 7, 1999	161.59	74.47
Togo	September 16, 1994	June 29, 1998	65.16	10.86
Uganda	November 10, 1997	November 9, 2000	100.43	80.34
Yemen	October 29, 1997	October 28, 2000	264.75	220.75
Zambia	December 6, 1995	December 5, 1998	701.68	40.00
Total			**42,669.86**	**20,523.28**

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

Data: IMF Treasurer's Department

How to Enhance the Transparency of Government Operations

Fiscal transparency—public openness in government structure and functions, fiscal policy intentions, public sector accounts, indicators, and forecasts—is widely regarded as fundamental to sound economic policy and has drawn increasing attention from policymakers in recent years. Notably, the IMF's Interim Committee's 1996 *Declaration on Partnership for Sustainable Global Growth* stated that "it is essential to enhance the transparency of fiscal policy by persevering with efforts to reduce off-budget transactions and quasi-fiscal deficits." Occasional Paper No. 158, *Transparency in Government Operations,* by George Kopits and Jon Craig, addresses many of the aspects of transparency in government operations. It discusses the major issues surrounding fiscal transparency and examines the IMF's role in promoting transparency in government operations. Kopits spoke with the *IMF Survey* about the study.

IMF SURVEY: *What aspects of transparency does your study deal with?*

KOPITS: The study deals with openness toward the electorate and financial markets over practically the entire spectrum of public sector activity, including behavioral, administrative, regulatory, accounting, and forecasting aspects. In each of these areas, our study identifies good practices and, wherever possible, provides country examples. A fundamental issue is the clear demarcation between the public and private domains, as reflected in, for example, conflict-of-interest rules for public officials and in freedom-of-information legislation. Likewise, it is important to hold an open legislative debate on the government's budget proposals, accompanied by estimates of tax expenditures and of the cost of quasi-fiscal operations conducted by nonfinancial enterprises or by financial institutions on behalf of the government.

Our study calls for a set of clear public accounts and forecasts that rely on accrual-based recording—supplemented by cash flow data—with consistency between the budget statement and the government balance sheet. The latter, of course, is critical for determining the magnitude and composition of public sector indebtedness, which should be published along with data on unfunded contingent liabilities and commitments. For any government, it is essential to issue periodic statements of its policy goals and quantitative targets, supported by realistic and well-documented short-term forecasts, plus medium- to long-term scenarios—to determine, respectively, the appropriateness of the fiscal stance as well as the sustainability of policies or the need for structural reforms.

IMF SURVEY: *What are the arguments for and against fiscal transparency?*

KOPITS: The arguments in favor of fiscal transparency heavily outweigh those against it. Over time, lack of transparency in government operations tends to be destabilizing, to create allocative distortions, and to exacerbate inequities. Although it is difficult to provide

Kopits: Over time, lack of transparency in government operations tends to be destabilizing, to create allocative distortions, and to exacerbate inequities.

conclusive proof, the study presents some evidence of a positive relationship between fiscal transparency and overall economic performance. In each major region, one can find that countries with a relatively high degree of fiscal transparency, usually associated with greater fiscal discipline, have been able to achieve higher growth and greater stability than comparable countries within that region. Such diverse countries as Botswana, Chile, Denmark, and New Zealand stand out as exhibiting both fiscal transparency and robust economic performance. On the other hand, the recent crisis in Southeast Asia illustrates that high growth is not sustainable without sufficient transparency—concerning, for example, the extent of government-directed or guaranteed lending. This is not to deny that in certain well-circumscribed cases—when premature disclosure of sensitive statistical information or policy measures would confer unintended windfall gains on some groups or weaken the effectiveness of those measures—there might be justification for a temporary departure from transparency.

IMF SURVEY: *Is fiscal transparency the primary means of establishing good governance?*

KOPITS: Fiscal transparency can be viewed as a necessary, but not sufficient, means to good governance. Indeed, in countries where the government is required to report its policy intentions and activities frequently to the public and where its dealings with private suppliers and financial institutions are subject to open procurement rules, periodic reporting, and audits, there is hardly any room for mismanagement or corruption. By contrast, opaque accounting practices, close—that is, less than arm's-length—relations between public officials and enterprises or banks, or proliferation of unreported quasi-fiscal activities—such as those arising from government-directed bank lending—are all signs of insufficient public accountability, which tends to breed private rent-seeking in the public domain.

Opaque accounting practices are signs of insufficient public accountability.

IMF SURVEY: *Have you found any trends or priorities in the move toward greater transparency?*

KOPITS: Among the many countries that have made progress toward transparency, none has been as impressive as the breakthrough in the economies in transition where, until recently, fiscal policy had been conducted in virtual secrecy. In the transition economies, as in a number of developing economies, it is essential to delineate clearly the boundaries between the public sphere and private interests through continued institution building. These countries also need to step up the timely dissemination of detailed and reliable government accounts and projections. As the advanced economies, for the most part, meet these basic transparency requirements, their priority lies in publishing transparent and comprehensive indicators of fiscal sustainability and promoting an open debate over reform options to restore or maintain sustainability.

IMF SURVEY: *What is the IMF's role in promoting transparency in government operations?*

KOPITS: The IMF has contributed to fiscal transparency in member countries in a number of ways: in the context of Article IV consultations, the *World Economic Outlook* exercise, program design and negotiations, technical assistance, development and application of statistical standards, and publication of consultation reports and research studies. The most recent initiative to enhance transparency, including in the fiscal area, is the creation of the Special Data Dissemination Standard (SDDS), which makes macroeconomic data on member countries available through the World Wide Web.

IMF SURVEY: *Some observers have suggested developing a rating system that would rank countries according to their degree of transparency. Would such a system be useful; if so, who would benefit most from it?*

KOPITS: Some broad assessment of the degree of transparency across countries would be potentially useful for encouraging the adoption of good practices by governments and for contributing to fiscal discipline and to the credibility of fiscal policies. Ultimately, the countries in question would stand to benefit the most from such a system: voters and financial markets would signal early on their approval or disapproval of a given policy stance, rather than through a rapid—often devastating—reversal in sentiment in response to a sudden revelation of a heretofore covert deterioration in public finances and thus in fundamental macroeconomic conditions.

IMF SURVEY: *Is a follow-up study planned?*

KOPITS: The Fiscal Affairs Department is currently engaged in an effort to develop guidelines on good practices in fiscal transparency that could be suggested for member countries. The design of such guidelines will need to take into account each country's technical and administrative capacity, for example, to collect fiscal data or to prepare reliable forecasts to implement them. ■

Copies of IMF Occasional Paper No. 158, *Transparency in Government Operations*, by George Kopits and Jon Craig, are available for $15.00 (academic rate: $12.00) from IMF Publication Services. See ordering information on page 58.

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Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
February 9	4.22	4.22	4.63
February 16	4.26	4.26	4.67

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (the U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 109.6 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171.

Data: IMF Treasurer's Department

Fiscal Policy Can Have Direct Influence on Output Growth

Various macroeconomic models can be used to examine the impact of a range of variables on an economy's long-run output growth. Among these are recently developed "endogenous growth" models, which incorporate policies that affect the incentives to invest in physical or human capital and can have permanent impacts on the long-run rate of output growth. Inspired in part by the literature on endogenous growth models, a number of empirical studies have examined the impact of fiscal policy on output growth. However, most of these studies consider only aggregates, such as total expenditure or government revenues as a percent of GDP. In addition, they often fail to identify the channels through which fiscal policy can affect growth—for example, government spending on public education, which can affect human capital formation; the provision of public sector infrastructure, which can affect the productivity of private capital; or capital income taxation, which can help determine saving. In a recent IMF Working Paper, *The Impact of Fiscal Policy Variables on Output Growth*, Philip Gerson of the Fiscal Affairs Department surveys the theoretical and empirical literature on the relationship between fiscal policy variables and growth. He adopts a disaggregated approach, examining the effect of both expenditure and tax policies on labor productivity, capital productivity, and the cost and supply of labor and capital.

Fiscal Policy and Labor Productivity

Government expenditure on education and public health are two examples of fiscal policies that can raise long-run economic growth, since educated and healthy workers are not only more productive than uneducated and sickly ones, but also better able to be trained and to adjust rapidly to technological and other changes in the workplace. However, for these investments to raise the rate of growth, they must augment, rather than simply replace, private sector investment. This could occur if market failures exist. In the presence of imperfect capital markets, when, for example, a lack of collateral may mean that individuals are unable to borrow to finance their education—even if the prospect of higher future wages would justify the expense of schooling—government financing could ensure access to education. On a more basic level, if private returns to education are small relative to the cost of schooling, but social returns are large, students will tend to underinvest in education. Subsidized public education could ensure that the optimal number of people go to school for the optimal amount of time. Government spending on health and nutrition can also lead to increases in worker productivity. Not only can such spending reduce illness and absenteeism, it can also mean that workers are better able to absorb education and learn new skills. As with education, however, government funding should not simply replace private expenditure, but increase access to services.

Empirical studies suggest that educational attainment and public health have significant, positive effects on per capita output growth. However, the evidence on education and health spending is far less conclusive. This may be because government spending on education and health correlates poorly with actual achievement, either owing to gestational lags or because of inefficient allocation of resources. Government spending on education may not result in improvements in the overall educational level of its population if, for example, a large share of the education budget is directed to universities. Similarly, government spending on health care may not lead to improvements in the overall health status of its citizens if the health care budget is disproportionately allocated to services with lower rates of return. These results argue for better targeting of social spending—in most cases, toward primary services and away from tertiary ones—for fiscal policy to be growth-enhancing.

To enhance growth, government spending should augment private investment.

Fiscal Policy and Capital Productivity

Fiscal policy can influence output growth through its effect on capital productivity. An increase in capital productivity will increase output both directly, by increasing the amount of output that the existing capital stock can produce, and indirectly, by encouraging additional investment that increases the capital stock. Two classes of fiscal policy that can affect the produc-

Press Information Notices

Press Information Notices (PINs) are IMF Executive Board assessments of members' economic prospects and policies issued—with the consent of the member—following Article IV consultations, with background on the members' economies. Recently issued PINs include:

Hong Kong SAR, No. 98/5, February 16
Canada, No. 98/6, February 19

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

tivity of physical capital are international trade policy and government expenditure on productive inputs, such as physical infrastructure or defense and public order.

Trade and Productivity. Economists have devoted considerable attention to the impact of international trade on the growth of domestic output, especially in developing countries. The general consensus is that open economies grow faster than more closed ones. If, for example, innovations are embedded in new capital goods, then countries that restrict international trade—especially imports of capital goods—will restrict their access to technological improvements. Competition from imports can also lead to increases in the rate of domestic innovation, as local firms are forced to raise their own productivity to compete with foreign producers. In addition, in relatively small markets, indivisibilities or fixed costs may make it unprofitable to adopt more efficient production technologies. Export production may make it profitable to adopt some of these technologies, thus increasing growth rates. And import competition may force firms to operate more efficiently; economies adopting more open trade regimes would narrow the gap between actual and potential output, leading to temporary increases in the rate of output growth.

Most evidence indicates growth and openness are highly related.

Most of the evidence indicates that economic growth and openness are highly related. Accordingly, fiscal policies that encourage openness should also encourage growth. Nevertheless, studies that have attempted to determine causality between growth and openness have not yielded definitive results—openness does not necessarily lead to growth. Indeed, it is possible that as economies grow, they tend to become more open, so that growth causes openness. For example, as countries grow, they may be able to adopt lower cost, more efficient production technologies that allow them to compete in international markets.

Government Expenditure and Productivity. Unlike private investors, governments have the power to compel payment through taxes—even for the consumption of public goods, such as clean air, national defense, or flood control, whose benefits cannot be restricted to those people who are willing to pay for them. Accordingly, some investments that might be profitable for the government to undertake might not be profitable for an individual. If an investment is for a public good that would permanently raise the productivity of the private capital stock, then government investment in physical capital could have a positive impact on the long-run growth rate of output.

A number of studies have looked at the impact of government capital expenditure on output growth, generally finding it to be small or even zero. As with studies on the impact of health and education expenditures on growth, some variation stems from differences in data sets and specifications. However, these mixed results may also be explained by a lack of distinction among the various categories of government capital expenditure. A weak empirical link between infrastructure expenditure and output growth, however, may also reflect the fact that not all infrastructure investments are equally valuable: building one sewer system in a city may increase growth, while building three such systems may decrease it.

Another type of government spending that may have growth-enhancing effects is sometimes described as maintaining the social fabric. This consists of transfers to disadvantaged individuals, spending on defense and public order, and maintenance of a civil service. This may increase output growth if it contributes to political stability. In many countries, present levels of spending on defense and public order may exceed the minimum necessary to maintain the social fabric, but there is no conclusive evidence that this has hurt their growth performance.

Fiscal Policy and the Cost and Supply of Labor and Capital

The effects of taxes on economic growth are numerous and ambiguous. Taxes on labor income may increase or decrease work effort. Taxes on capital income may increase or decrease domestic saving in relatively closed economies, but in open economies, they may increase the rate of saving while decreasing the domestic capital stock. Even in a closed economy, taxes on the use of capital in particular industries can make labor—not capital—worse off.

Recent Use of IMF Credit
(million SDRs)

	January 1998	January 1997
General Resources Account	2,084.40	137.98
Stand-By Arrangements	1,500.00	53.58
Of which: Supplemental Reserve Facility	1,500.00	0.00
EFF Arrangements	584.40	84.40
CCFF	—	—
SAF and ESAF Arrangements	10.86	59.78
Total	**2,095.26**	**197.76**

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

Data: IMF Treasurer's Department

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In any case, virtually all taxes distort economic activity. Consequently, they are best viewed as necessary evils to finance government expenditure or as an indirect means of improving social welfare. Because the distortionary effects of a tax depend on the economic environment in which it is applied, there are strong interactions among taxes themselves. It is therefore important to look at a tax code as a whole and not to focus too much on any single tax. In open economies, even the tax codes of trading partners and competitors need to be considered.

Empirical studies show that secondary workers—those who will work only if the offered wage outweighs other highly valued options outside of working—are much more sensitive to changes in personal income tax rates than are primary workers. At the same time, cuts in income tax rates tend to increase the total volume of labor supplied, and progressive income taxes—which tax income at increasing marginal rates—discourage labor supply much more than do proportional taxes—which tax all taxable income at the same flat rate. Because secondary workers are much less numerous than primary workers, small changes in marginal tax rates are likely to have a minimal impact on labor supply and on growth.

Saving and investment appear to be relatively insensitive to changes in the rate of return, especially in developing countries. This implies that increases in the personal and corporate income tax rates have a limited effect on saving, investment, and growth. However, because individuals do not fully discount saving undertaken on their behalf by corporations, a revenue-neutral shift of the tax burden from corporations to individuals, or other policies that encourage firms to retain earnings rather than pay dividends, may increase saving, investment, and growth.

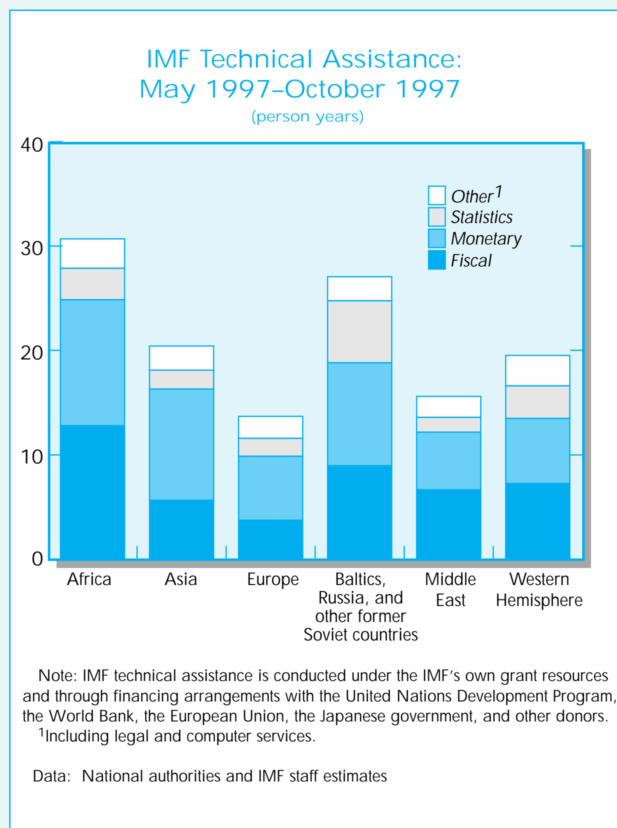
Growth Performance Rests on Range of Policies

Gerson's study suggests that government expenditure policies have a more important effect on growth rates than do revenue policies. That is, up to a point, balanced-budget increases in spending on health, infrastructure, and the social fabric—if well-targeted—can be growth-enhancing. Nevertheless, a country's growth performance is affected by the entire set of macroeconomic policies its government follows. Moreover, a variety of factors—many of them exogenous—affect growth and can diminish the impact of even the best-designed fiscal packages. In addition, while studies tend to focus on the impact of fiscal policy on growth, ultimately, it is welfare that governments should care about. While growth and welfare are linked, they are not identical. For example, a measure that increases saving by forcing individuals to forgo all of current consumption may increase capital and growth, but it would reduce welfare: the payoff from higher future consumption would never fully compensate for the loss of current consumption. As such, there may be some growth-enhancing policies that a benevolent government may not wish to adopt.

Copies of IMF Working Paper No. 98/1, *The Impact of Fiscal Policy Variables on Output Growth*, by Philip Gerson, are available for $7.00 each from IMF Publication Services. See page 58 for ordering information.

IMF Technical Assistance Remains at High Level

With economic and financial globalization, and the transition to market-oriented policies in the former centrally planned economies, the demand for IMF technical assistance has continued at a high level. The chart provides information on technical assistance to various regions in the six-month period May-October 1997. Africa was the leading recipient of technical assistance, with a total of 30.5 person years, followed by the Baltics, Russia, and the other countries of the former Soviet Union, with almost 27 years, and by Asia and the Western Hemisphere, with about 20 years each.



Note: IMF technical assistance is conducted under the IMF's own grant resources and through financing arrangements with the United Nations Development Program, the World Bank, the European Union, the Japanese government, and other donors.
[1]Including legal and computer services.

Data: National authorities and IMF staff estimates

Preparation for Stage 3

Issues in Design of Monetary Instruments for EMU Move Toward Resolution

In preparation for stage 3 of European economic and monetary union (EMU), when all members of EMU will be subject to a single monetary policy, the European Monetary Institute has been working with national central banks of the European Union to identify the set of instruments to be used in the operation of monetary policy. Several decisions regarding arrangements have already been made, but a number of issues remain to be addressed. In a new study, *Some Issues in the Design of Monetary Instruments for the Operation of European Economic and Monetary Union*, Charles Enoch, Paul Hilbers, and Arto Kovanen identify what important decisions still have to be made as well as where further refinements could improve the effectiveness and transparency of such instruments.

The Governing Council of the European Central Bank, which will be established when the decision is made to proceed to stage 3—scheduled for May 1998—will make the final decisions about the choice of monetary instruments. The European Monetary Institute has no decision-making powers and can only advise. It has therefore been able to make specific recommendations only in areas where all the members of the European Union have reached consensus. Where views have differed, the institute's role has been to identify and clarify the issues and prepare a menu of options for the operations of the European Central Bank. Despite this constraint, the institute has been able to achieve a remarkable amount of common ground, and the proposed framework has been fleshed out considerably. A number of issues remain to be addressed, however, and work is continuing to ensure that the transition to stage 3 will be as smooth as possible.

EUROPEAN MONETARY INSTITUTE

European Monetary Institute

The European Monetary Institute came into being on January 1, 1994, which marked the start of stage 2 of economic and monetary union. The two main tasks of the European Monetary Institute, located in Frankfurt am Main, are to:

- contribute to the fulfillment of the conditions necessary to reach the last stage of monetary union—in particular, the convergence of the main macroeconomic indicators; and
- make the preparations required for the establishment of the European System of Central Banks and the conduct of a single monetary policy and for the creation of a single currency.

Open Market Operations

In modern financial markets, where turnover is high and rates react quickly to news, uniform and clear signals from central banks have become increasingly important as an instrument of monetary policy. This will be particularly true, according to the authors, within the self-stabilizing framework of the EMU.

The main instrument of monetary operations is likely to be open market operations, which will play a pivotal role in steering interest rates, managing financial system liquidity, and signaling the stance of monetary policy. These operations, which will provide the bulk of refinancing to the financial sector, will be determined by the European Central Bank and operated through the national central banks according to a regular calendar, with weekly auctions of reverse operations with two-week maturities.

Longer-term refinancing operations will be executed every month, with a maturity of three months, to provide additional longer-term liquidity to the financial sector. But these will encompass only a limited portion of the liquidity provided by the European system of central banks and are not intended to signal the authorities' policy stance to the market. The desire not to send signals to the markets through these longer-term tenders is generated by the wish not to dilute the strength of the signals being generated in the regular weekly tenders. Although this intention seems valid, according to the authors, the mere fact that the system will be creating a monetary instrument with a three-month maturity and without any intention of creating a signal suggests that this market may provide an undiluted—and thus important—signal of market conditions.

The counterparties selected for open market operations should ensure that monetary operations have the desired results. In general, a wide range of counterparties—all financially sound and secure—will maximize the effectiveness of monetary measures in affecting market conditions. Moreover, it will be important to create a level playing field to prevent any institution or group of institutions from dominating the market. Modern telecommunication techniques increase the possibility for even relatively small players to react quickly to, and take part in, these operations.

The choice of instrument reflects the need to buttress the "self-stabilizing properties" of the system, so that the market itself will moderate volatility in liquidity and interest rates. There are thus likely to be two standing facilities at the disposal of the European system of central banks: a marginal lending (Lombard)

facility through which banks can obtain liquidity overnight; and a deposit facility through which banks can deposit their surplus funds overnight.

The Lombard and deposit facilities will set, respectively, a ceiling and a floor to overnight interest rates; together, they will define a corridor for market interest rates to limit the volatility of these rates. This function may be of particular importance at the start of stage 3, the authors observe, when the demand for euros may be unstable and interest arbitrage imperfect. The facilities will be administered on a decentralized basis with their features harmonized across the system.

Minimum Reserves and Payment Systems

A final decision on the desirability of reserve requirements will have to await the establishment of the European Central Bank. A minimum reserves system can enhance daily liquidity management by financial institutions and can contribute to more stable interest rates, according to the authors.

On the assumption that there will be reserve requirements, the reserve base will be defined in relation to the end-of-the-month balance sheet information, which will be the basis for calculating the required reserve holdings for the one-month maintenance period. The European central bank will decide what rate of remuneration, if any, should be paid on the required reserves.

The higher the level of required reserves and the lower the rate of remuneration, the greater the incentive for banks to artificially depress the level of their reported liabilities over the end-month reporting point. There is a risk that banks will indulge in such "window dressing" under EMU, so that the aggregate level of reserves held will be reduced and the burden redistributed. Such an effect, the authors caution, would also contaminate the monetary statistics, rendering them unreliable, especially in the early stages of EMU when the extent of the distortions would be difficult to judge.

The cross-border payment system will be a key element in the future European monetary and financial system. Not only will it need to be safe and efficient, it will also need to ensure that local money market conditions are instantly and continuously linked to conditions elsewhere in the European Union in order to guarantee a unified interest rate.

The TARGET system (trans-European automated real-time gross settlement express transfer system), an interbank transfer system, is scheduled to be fully operational by the end of 1998. TARGET, use of which will be mandatory for all monetary operations in the EMU, offers European Union commercial banks a system that can permit individual transfers to be concluded within the day of trading.

The national central banks will provide such liquidity through two facilities: fully collateralized overdrafts and repurchase agreements. An unresolved issue is the availability of intraday credit to national central banks from non-euro countries. These credits may spill over into overnight credit, which would have monetary implications. Options are being considered to avoid such spillovers. The authors suggest, however, that the proposed limitations do not seem to be fully in line with the adoption of a market-based framework for EMU and are unlikely to have a substantive effect, given free movement of capital and the presence of virtually all major financial institutions in more than one European Union country.

Three Stages to Economic and Monetary Union

In June 1988, the European Council of the European Union mandated a committee, chaired by Jacques Delors, President of the European Commission, to study and propose concrete stages leading to economic union. The resultant "Delors Report," issued in April 1989, proposed that this union should be achieved in three discrete but evolutionary steps.

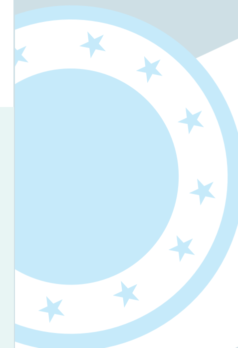
- *Stage 1* would represent the initiation of the process of creating an economic and monetary union. It would aim at greater convergence of economic performance through the strengthening of economic and monetary policy coordination within the existing institutional framework. This stage was reached on July 1, 1990.
- *Stage 2* would be a period of transition to the third and final stage, during which the basic organs and structure of the economic and monetary union would be set up. This stage was achieved on January 1, 1994.
- *Stage 3* would commence with the move to irrevocably locked exchange rates and the introduction of a single currency to replace national currencies. The European System of Central Banks would be responsible for the formulation and implementation of monetary policy, exchange rate and reserve management policies, and the maintenance of a properly functioning payment system. Stage 3 is to be attained on January 1, 1999.

Data: European Monetary Institute

Next Steps

The next phase in the preparation of the operational framework for EMU will be to reach decisions on the remaining issues and to test the options selected. It will be important, the authors conclude, to maintain the transparency of the decision and preparation process, so as to guide not only the European Central Bank and the national central banks but also their future counterparties in EMU. ■

Copies of IMF Working Paper 97/178, *Some Issues in the Design of Monetary Instruments for the Operation of European Economic and Monetary Union*, by Charles Enoch, Paul Hilbers, and Arto Kovanen are available for $7.00 from IMF Publication Services. See page 58 for ordering information.



Lessons from Recent Crises

What Are the Causes and Consequences of Sharp Falls in Current Account Deficits?

The collapse of the Mexican peso at the end of 1994 and, more recently, the balance of payments crises in Thailand, Korea, and Indonesia have shown the dangers of sudden changes in the direction of international capital flows after a period of large current account deficits. Such changes can force governments to adopt costly contractionary adjustment measures to reduce external imbalances and meet external obligations. Indeed, external crises often feature large depreciations followed by a reduction in current account deficits—that is, reversals in current account imbalances. What triggers such reversals, and what factors explain their cost? Are persistent current account deficits likely to end up in a crisis, or can they be reversed without large output costs? In a new study, *Sharp Reductions in Current Account Deficits: An Empirical Analysis*, Gian Maria Milesi-Ferretti of the IMF's Research Department and Assaf Razin of Tel Aviv University examine these issues, basing their analysis on the experience of 86 low- and middle-income countries during 1971–92.

Persistent current account deficits need to be reversed to stabilize the ratio of external liabilities to GDP.

External Sustainability and Reversals

Persistent current account deficits need eventually to be reversed in order to stabilize or reduce the ratio of external liabilities to GDP. This, in turn, requires a trade surplus, assuming that the country's real interest rate exceeds its economic growth rate. As such, the larger the external liabilities, the greater the necessary reversal will be. From the standpoint of interest rates, a reversal can, on the one hand, be thought of as lowering the risk premium on external debt, thereby reducing the actual size of the necessary turnaround in the trade balance. On the other hand, the need for a turnaround may also arise because of an increase in world interest rates, in which case the interest differential would raise the size of the necessary reversal.

A sharp reduction in a country's external deficits may result from a change in macroeconomic policy—for example, the introduction of a stabilization plan—or it can be forced upon a country by external developments, such as a sudden capital outflow. A country's ability to sustain prolonged imbalances without experiencing crisis-driven reversals depends on various elements, including macroeconomic policy variables, the structural features of the economy, financial determinants—such as the size and composition of external liabilities, and "external" variables—such as real interest rates and the terms of trade.

Defining and Explaining Reversals

The study focuses on countries experiencing sharp and persistent reductions in current account deficits, defined as an average reduction in the current account deficit of at least 3 percentage points of GDP over three years. The criteria also require that the current account deficit be reduced to below 10 percent. The maximum current account deficit after the reversal must be no larger than the minimum deficit in the three years preceding the reversal. This ensures that only reductions of sustained current account deficit are considered, rather than reversals of a temporary nature.

The study examines whether a set of macroeconomic, financial, and structural variables can determine if a country is likely to experience a reversal in current account imbalances. The empirical analysis finds that both domestic variables—such as the current account balance, openness to trade, and the level of reserves—and external variables—such as terms of trade shocks, U.S. real interest rates, and growth in industrial countries—play important roles in explaining reversals. There do not, however, appear to be any significant links between reversals and the rate of GDP growth however, or the real exchange rate (or its rate of change). Reductions in current account deficits are more likely in countries with:

- *Large current account deficits.*
- *Relatively closed economies.* Such economies have more difficulties servicing external liabilities and more incentives to renege on external debt, thereby making a turnaround in capital flows more likely.
- *Low reserves.* Low reserves can make it difficult to sustain large external deficits and may reduce the willingness of foreign investors to lend.
- *High share of savings and investment for a given size of the current account deficit.* While high levels of investment should increase the ability to sustain external deficits, high investment/savings can increase future exports and output growth, thereby contributing to narrowing current account imbalances.
- *Relatively high GDP per capita.* Extremely poor countries experience difficulties in reducing their external deficits.
- *Lower share of concessional debt in total debt.* Concessional debt flows are less likely to be reversed, and external imbalances are likely to be higher in those countries that have more difficulties reducing their

external imbalances and servicing their external obligations.

• *A smaller public sector deficit for a given current account deficit.*

Reversals are also more likely to occur:

• *In years in which the terms of trade improve.* Reversals are also more likely after a period of worsened terms of trade; one reason is that countries whose terms of trade have deteriorated are more likely to experience a reversal of capital flows and may therefore be forced to adjust.

• *In developing countries in years when the growth rate in industrial countries is high.* High growth increases the demand for exports from developing countries, helping to narrow current account deficits.

• *After a period of high real interest rates in industrial countries.* High real interest rates increase the cost of borrowing for developing countries and reduce the incentive for capital to flow to these countries.

• *When official transfers are low.* Higher official transfers would reduce the need to adjust the current account.

Determinants of Output and Export Performance

What is the behavior of output and export growth in countries that have experienced sharp reductions in current account deficits? Are reversals in current account deficits costly in terms of output performance? The study notes that costs can arise because reversals are associated with macroeconomic crises, or, more generally, because they require macroeconomic adjustment and a reallocation of resources across sectors. In addition, faster export growth may be needed in countries that have relatively large current account deficits but overall growth may be lower if adjustment measures need to be more drastic.

Countries with lower current account deficits tend to grow faster.

The study does not find a significant relationship between economic growth before and after the onset of a reversal. Preliminary results do indicate, however, that countries that had a relatively less appreciated exchange rate, higher investment, and more trade openness before a reversal, were likely to grow faster after the reversal. Countries that had relatively lower current account deficits also tended to grow faster. Turning to exports, the study finds that the value of export growth tends to accelerate after a reversal. In addition, export growth after the event tends to be higher in countries with relatively high investment rates and larger current account deficits. The effect on investment is consistent with the notion that building productive capacity allows a country to increase future exports. ■

Copies of IMF Working Paper 97/168, *Sharp Reductions in Current Account Deficits: An Empirical Analysis*, by Gian Maria Milesi-Ferretti and Assaf Razin, are available for $7.00 each from IMF Publication Services. See ordering information on page 58.

ESAF Review Assesses Macroeconomic Adjustment in Transition Economies

The IMF's concessional financing facility, the Enhanced Structural Adjustment Facility (ESAF), and its precursor, the Structural Adjustment Facility (SAF), have supported adjustment and reform programs in many low-income developing member countries for more than ten years. These facilities promote fundamental reform in the structure and institutions of the economies concerned, as well as strong macroeconomic policies, in order to further higher economic growth and external viability. The findings of an IMF staff study, concluded in June 1997, were described in the IMF Survey*, August 5, 1997, page 233. The study, which has now been published as IMF Occasional Paper No. 156, reviews the experience of 36 countries that had used SAF and ESAF financing in support of 68 multiyear reform programs. The study also includes an assessment of ESAF-supported adjustment programs in six transition economies—Albania, Cambodia, the Kyrgyz Republic, Lao People's Democratic Republic, Mongolia, and Vietnam. Excerpts from this assessment follow.*

The demise of central planning and the transition to a market-based economy began at different times for the six transition countries under review: in 1986 for the Lao People's Democratic Republic, 1989 for Vietnam, 1990 for Mongolia, and 1992 for Albania and the Kyrgyz Republic; Cambodia—still struggling with armed internal conflict—did not undertake comprehensive adjustment until 1993. ESAF-supported programs began in 1993 and 1994 in all but one of the six countries. The Lao People's Democratic Republic, the exception, began adjustment under an SAF arrangement in 1989, followed by an ESAF arrangement in 1993. In many respects, ESAF-supported programs in these countries continued and deepened adjustment efforts that had been initiated at the beginning of transition.

SAF/ESAF-supported adjustment programs vary widely in their emphasis and detail. Nevertheless, countries' common problems and the underlying aim of achieving higher sustainable economic growth have resulted in reform strategies that share core objectives, including:

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Editor-in-Chief
Sara Kane • Sheila Meehan
Senior Editors
Christine Hellemaa
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Sharon Metzger
Senior Editorial Assistant
Jessie Hamilton
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- raising saving rates;
- securing macroeconomic stability;
- liberalizing and opening economies to foreign trade;
- reducing government intervention and promoting well-functioning markets;
- reorienting government spending and restructuring revenues; and
- mobilizing external resources.

Although their strategies included the same core elements as in other ESAF countries, adjustment programs in the six transition economies tended to place greater emphasis on rapid stabilization, strong fiscal adjustment, and the dismantling of state dominance, consistent with their different circumstances.

ESAF Arrangements with Transition Economies

	Amount (million SDRs)	Date Approved	Date of Expiration[1]
Albania	42.4	7/17/93	7/13/96
Cambodia	84.0	5/6/94	8/31/97
Kyrgyz Republic	71.0[2]	7/20/94	3/31/98
Lao P.D.R.	35.2	6/4/93	4/30/97
Mongolia	40.8	6/25/93	6/24/96
Vietnam	362.4	11/11/94	11/10/97

Note: Data refer to countries covered in the ESAF review.
[1]After extensions.
[2]Subsequently augmented to SDR 88.2 million.

Data: IMF Policy Development and Review Department

Stabilization

Rapid stabilization—a central objective—was to be achieved mainly through strong fiscal adjustment and tight control of credit, particularly to public enterprises. Stabilization efforts were most successful in Albania and the three Indochinese economies, all of which reduced inflation to low levels, initially through a credit-based approach backed by wage controls. During 1992–95, following initial stabilization, Cambodia, the Lao People's Democratic Republic, and Vietnam maintained stable nominal exchange rates through tight fiscal and monetary policy. Although the Kyrgyz Republic and Mongolia also made notable progress in reducing inflation in 1994–95, their inflation rates remained relatively high (32 percent and 53 percent, respectively, at the end of 1995), mainly because of difficulties in curbing fiscal deficits and controlling credit growth to public enterprises.

Fiscal Sector

Strong fiscal adjustment, particularly through tax and public enterprise reform, was crucial. Budget deficits were reduced sharply in Albania, the Lao People's Democratic Republic, and Vietnam. In Albania, measures to improve tax and customs administration were delayed, and fiscal adjustment relied mainly on reductions in current spending, facilitated by the decline in unemployment (a consequence of greater private sector activity) and budget reforms. Government employment fell by close to a third from mid-1992 to February 1995, spending was shifted toward investment, direct subsidies were virtually eliminated by 1995, and other current expenditures were scaled back considerably. Tax reforms were introduced early in the Lao People's Democratic Republic and Vietnam, and subsequently in Cambodia.

By 1994–95, revenues had strengthened considerably in all three countries, aided in Vietnam by the improved financial performance of state enterprises. Fiscal deficits were kept to moderate levels, initially by lowering the real wage bill (partly through retrenchment, with labor being absorbed by the growing private sector), lowering subsidies and transfers to public enterprises, and reducing capital outlays and social services. The compression of capital and social spending was subsequently reversed as revenues were raised. Reform efforts failed to increase revenues in the Kyrgyz Republic and Mongolia, partly as a result of tax arrears and poor tax administration, and overall fiscal deficits were markedly higher.

Structural Reform

Wide-ranging structural reforms, particularly public enterprise reform and privatization, received strong emphasis. In Vietnam, state enterprises were given substantial management autonomy in 1988–89. Policies were adopted to increase competition (by liberalizing imports and encouraging foreign direct investment), harden budget constraints (by eliminating most direct subsidies and directed credit), and subject enterprises to uniform rules of taxation. As a result, the net budgetary contribution of enterprises rose to over 10 percent of GDP by 1994–95, partly through increased profits from the oil sector. Similar efforts were undertaken in Cambodia and the Lao People's Democratic Republic. Although a majority of small and medium-sized enterprises were privatized in Albania, the Kyrgyz Republic, and Mongolia by the end of 1995, ESAF-supported programs called for further restructuring and privatizing strategic enterprises. In all six countries, weak banking systems remain a concern. In addition, a need for further reforms in the legal and institutional framework was identified in programs, especially land programs in Albania and the Kyrgyz Republic. By the end of 1995, all six countries had extensively liberalized prices, trade, and foreign investment and had relatively few exchange restrictions on current transactions. ■

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