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In this issue

G-7 meeting

Ministers see light at end of global downturn, set priorities to combat terrorist financing

The Group of Seven Finance Ministers and Central Bank Governors met in Canada on February 8–9 to discuss the global economy, the importance of fostering development, and ongoing efforts to combat the financing of terrorism. The Managing Director of the IMF participated in the meeting.

Global economy. The Ministers noted that, despite remaining risks, prospects had strengthened for resumed expansion in the major industrial economies. They committed themselves to remaining vigilant, to continuing to take appropriate steps to promote a strong and sustained recovery, and to cooperating in exchange markets as appropriate. Emerging market economies, they said, face mixed economic and financial market conditions and should continue to implement policies conducive to investment and economic growth. The Ministers welcomed the *(Please turn to the following page)*

Group of Seven Finance Ministers and the President of the European Union met on February 9 at Meech Lake, Quebec.

Kenen, Calvo offer new proposals in debate over preventing and resolving financial crises

With the risk of financial crises seemingly a fact of life in our increasingly globalized world, recent years have seen numerous proposals on how best to prevent and resolve them. Some new proposals were added to the debate by Guillermo A. Calvo, chief economist at the Inter-American Development Bank, and Peter B. Kenen, professor of economics and international finance at Princeton University, when they spoke at seminars January 22–23 organized by the IMF Institute. Calvo called for an Emerging Market Fund, endowed with official debt instruments of major industrial countries, to be used to limit contagion during crises. For prevention, Kenen suggested a strategy based on formal contracts between a government undertaking reform and the IMF and the World Bank, as well as improved crisis warning systems. He also had suggestions on some outstanding issues relating to private sector involvement.

Calvo: The main problem was "market failure, not moral failure."

New role for the IMF?

Calvo, who is also affiliated with the University of Maryland and has served as a senior advisor in the IMF's Research Department, indicated that his call for a new role for the IMF stemmed from his analysis of the causes of recent crises. Proponents of the view that moral hazard has played a significant role argue that the prospect of international financial assistance encourages investors to take excessive risks. But Calvo rejected this. In particular, he took issue with the view that support provided to Mexico *(Please turn to page 51)*

Since September 11, almost 150 countries and jurisdictions have issued orders to freeze terrorist assets, and over $100 million has been frozen worldwide.

(Continued from front page) recent steps announced by the Argentine authorities and encouraged them to continue to work closely with the IMF and the international community on a program of financially and socially sustainable economic reforms that would improve their prospects for growth and investment.

Recent events, the Ministers said, have highlighted the importance of a predictable and fair framework, involving the private sector, to prevent and resolve international financial crises. They indicated their commitment to playing a lead role in improving this framework and, in this regard, welcomed the IMF management's proposal on sovereign debt restructuring as a useful contribution that addresses some of the legal and practical obstacles to timely and orderly debt restructuring.

Combating the financing of terrorism. The Group of Seven's October 2001 Action Plan to Combat the Financing of Terrorism had set out clear priorities for the fight against terrorist financing: vigorous application of international sanctions, including freezing of terrorist assets; rapid development and implementation of international standards; increased information sharing among countries; and enhanced efforts by financial supervisors to guard against the abuse of the financial sector by terrorists.

More than 200 other countries and jurisdictions have now expressed their support for this international effort. Since September 11, almost 150 countries and jurisdictions have issued orders to freeze terrorist assets, and over $100 million has been frozen worldwide. The Ministers noted that, although significant results have been achieved, more needs to be done (see box below).

Fostering development. Acknowledging the difficult challenges that the world's poorest countries face, the Ministers explored ways to extend the benefits of greater global economic integration to all countries. They will continue to work with other donors to ensure that additional resources for development are made available. Development assistance, they said, needs to be used more effectively and all countries must commit themselves to sound policies, good governance, and the rule of law. In advance of the UN conference on Financing for Development, the Ministers held productive discussions on development policy issues, including innovative ways to mobilize additional domestic and external resources, trade, and external debt.

Finally, the Ministers welcomed Russia's strong growth and significant structural reforms and agreed on the importance of the country's early accession to the World Trade Organization. They also encouraged the country to push forward with steps to strengthen the financial sector, improve corporate governance and the investment climate, and combat terrorist financing. ■

Members' use of IMF credit

(million SDRs)

	January 2002	January 2001
General Resources Account	400.82	2,246.48
Stand-By	125.58	2,246.48
SRF	0.00	1,481.97
EFF	275.24	0.00
CFF	0.00	0.00
PRGF	5.40	42.86
Total	406.22	2,289.34

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

International cooperation in combating financing of terrorism grows

As part of an effort to combat the financing of terrorism, the Group of Seven countries are implementing UN Security Council Resolution 1373 and are committed to the UN Convention for the Suppression of the Financing of Terrorism. The Financial Action Task Force (FATF) has agreed to a set of Special Recommendations on Terrorist Financing and is encouraging all countries to adopt them. In addition, the Group of Seven countries have established, or are establishing, Financial Intelligence Units to facilitate the sharing of information on money laundering and terrorist financing, and all have created mechanisms for sharing information on tracking terrorist assets.

Continued success requires even closer international cooperation and an intensified commitment, and the Group of Seven countries encouraged all countries to join them in implementing additional measures to advance this global effort. For example, enhancing international coordination in the freezing of terrorist assets requires a "mutual understanding of the information requirements and the procedures that different countries can use to undertake freezing actions." This understanding, the Ministers said, entails developing "key principles about the information to be shared, the procedures for sharing it, and the protection of sensitive information."

The Group of Seven countries are committed to fully implementing, by June 2002, the FATF standards against terrorist financing and urged all countries to commit to the rapid implementation of the standards. The Ministers called on the FATF, the IMF, and the World Bank to "quickly complete their collaborative work on a framework for assessing compliance with international standards, including all FATF recommendations, against money laundering and terrorist financing." They looked forward to the quick implementation of the IMF and World Bank plan to provide increased technical assistance for measures to combat money laundering and terrorist financing in coordination with the FATF, regional FATF-style bodies, the UN, and the Egmont Group. The Group of Seven countries are committed to providing technical assistance on a bilateral basis, as well as through these coordination mechanisms.

Calvo, Kenen address financial system reforms

(Continued from front page) and other countries in the context of the "tequila crisis" of 1994–95 gave rise to moral hazard and led to subsequent crises.

While this view was "easy on the mind," Calvo said, it had "feet of clay," because the evidence did not support it. Private capital flows to emerging markets, far from having been sustained by moral hazard in the wake of the tequila crisis, plummeted and never fully recovered. Moreover, the flows that have proved most resilient are not portfolio and banking flows, which are allegedly the most subject to moral hazard, but flows of foreign direct investment, which are not.

In Calvo's view, the main problem was "market failure, not moral failure" and what he referred to as "globalization hazard." By this, he meant the fragility of financial globalization arising from imperfections in information, markets, and institutions. Why had capital inflows to emerging markets surged between the late 1980s and the mid-1990s? Not, as was widely held, because of improvements in economic policies or other fundamentals that might have justified permanently higher flows. According to Calvo, the causes lay in institutional developments, like changes in regulations in industrial countries liberalizing capital outflows, and the creation of a market for Brady bonds in the early 1990s. These had increased investors' incentives to collect information about emerging markets, he said, and prompted the development of emerging bond markets.

These factors, Calvo said, were more likely to cause a transitory reallocation of funds than to prompt permanently higher flows or a continuing up-trend. Subsequent crises, he argued, could be traced partly to the overoptimistic views of investors that had accentuated the surge of capital, and partly to the vulnerability of the emerging market economies to adverse developments. This was due, in turn, to such factors as financial sector weaknesses, inadequate information about emerging market investments, and constraints on exchange rate flexibility—a "fear of floating" linked partly to the foreign-currency denomination of external debt.

Globalization hazard called not only for reforms in emerging market economies but also for a more effective global safety net to make crises less likely, Calvo argued. And this is where his proposal for market intervention by the IMF and other international financial institutions came in.

To limit contagion in a crisis situation, Calvo proposed that an Emerging Market Fund (EMF) be established. Such a fund, he said, would be endowed with official debt instruments of major industrial countries and would be used to support emerging markets when they suffered steep declines. More specifically, an EMF endowed with 1 percent of the public debt of the United States, Japan, and Germany would represent about 30 percent of the value of the emerging market bonds listed in J.P. Morgan Chase's "EMBI +" index. If a crisis in a country led to steep and widespread declines in emerging bond markets—so that the "EMBI +" index fell by more than, say, 10 percent below trend—the EMF would be used to buy emerging market bonds, except those of the country at the center of the crisis. Calvo envisaged that the EMF would be managed by a board comprising representatives of the IMF, the World Bank, and the regional development banks.

Contracts, warnings, private sector

Kenen, who has been a visiting scholar and consultant at the IMF on several occasions, took a broader view of the international financial system and its needs. Beginning with crisis prevention, he asked what more could be done to encourage greater compliance with internationally recognized standards and codes and, thus, to strengthen the financial systems of emerging market countries. He saw shortcomings in the use of IMF conditionality and various other strategies and a lack of timeliness in IMF staff Reports on the Observance of Standards and Codes. Kenen also viewed market discipline as ill suited to the task.

A new approach was needed, Kenen said—one that recognized the time-consuming nature of financial sector reform and the need for national ownership of reform programs, but one that also understood the need for incentives and enforceable reform deadlines. These requirements could be met, he argued, by a strategy based on formal contracts between a government and the IMF and the World Bank. Each contract would set out in detail the financial sector reforms (customized for, and owned by, the country) that the government pledged to complete during the life of the contract (typically five to seven years, with a deadline for each step). The IMF and the World Bank would then monitor the country's progress over the life of the contract. The upside for countries meeting their obligations? Easier access to IMF loans and more favorable market ratings.

Such a contractual approach to financial sector reform would take time to reap benefits, and there would remain a need, Kenen recognized, for improved early warning systems that could help forestall crises by pointing to sources of vulnerability. Here, an important question was how warnings of vulnerability should be delivered. There might be a fine line, he admitted, between quiet advice that induced a country to take crisis-preventing action and loud advice that could induce a crisis.

Kenen: A new approach was needed—one that recognized the time-consuming nature of financial sector reform and the need for national ownership of reform programs, but one that also understood the need for incentives and enforceable reform deadlines.

Kenen saw a case for the establishment in the IMF of an independent council of economic advisors who would speak to countries confidentially on their own behalf.

According to Kenen, it was vital that IMF warnings be graduated, eventually leading, if necessary, to the threat of a public statement. He also saw a case for the establishment in the IMF of an independent council of economic advisors who would speak to countries confidentially on their own behalf, thus providing warnings not influenced or moderated by the views of the IMF's member governments.

Turning to crisis management and resolution, Kenen reviewed the evolving roles of official financing packages, adjustment and reform policies, and currency depreciations. The use of large financing packages (and only large-scale financing was likely to make a difference in capital account crises, he noted) had come up against the moral hazard objection. The need for policy changes had been questioned in cases where investor panic, rather than policy weakness, seemed to be at the root of the crisis. And the benefits of currency depreciation had appeared sometimes to be outweighed by the balance-sheet problems associated with the prevalence of foreign-currency-denominated debts. No wonder, then, that the possible role of temporary capital controls seemed to be attracting more attention and that mechanisms to secure private sector involvement more effectively were under active debate.

Referring to the approach to sovereign debt restructuring recently proposed by the IMF's First Deputy Managing Director, Anne Krueger (see *IMF Survey*, December 10, 2001), Kenen questioned its political feasibility. He also wondered whether the negotiations between creditors and debtors that it would entail would result in sustainable debt restructurings, given that they would tend, in his view, to favor creditors. Kenen preferred an alternative approach, based on a scheme proposed by Willem Buiter and Anne Sibert (of the European Bank for Reconstruction and Development and Birkbeck College University of London, respectively) in a 1999 article in *International Finance*.

Under the Buiter-Sibert approach, each government would require, through legislation, that all foreign debt contracts include collective action clauses and rollover options that would allow the debtor to extend the maturity of the bond or credit line for a specific period at a predetermined spread. The size of the penalty spread and other features of the rollover option applicable to a particular contract would be set by the parties concerned.

Kenen viewed the up-front assent of creditors in debt contracts to fixed-term debt suspensions under certain conditions as the most attractive feature of the approach, compared with other ways of imposing standstills. But he conceded that the time it would take to implement the scheme, through legislation and new debt contracts, was a significant disadvantage.

Both seminars illustrated how many issues relating to the reform of the international financial architecture remain under active debate. But the presentations also showed, explicitly or implicitly, that a good deal of progress has been made. ■

Graham Hacche
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Available on the web (www.imf.org)

Press Releases

02/8: IMF Executive Board Grants Waiver on Noncomplying Disbursement to Ghana, February 4

02/9: IMF's Independent Evaluation Office Announces Evaluation of Prolonged Use of IMF Financial Resources, February 11

02/10: IMF Executive Board Reviews Tajikistan Misreporting, Remedial Steps, February 13

News Briefs

02/9: IMF Completes Fourth Review of Cambodia's PRGF Program and Approves $10.4 Million Credit, February 7

02/10: IMF's Köhler Welcomes Remes Visit, Says IMF Working Closely with Argentina, February 8

02/11: IMF Completes Review Under Niger's PRGF Arrangement and Approves $11 Million Disbursement, February 8

02/12: IMF's Köhler: Good Start to New Relationship with Argentina, February 13

02/13: 2002 Spring Meetings of the IMFC and the Development Committee, February 15

Public Information Notices

02/6: IMF Concludes 2001 Article IV Consultation with the Republic of Kazakhstan, February 5

02/7: IMF Concludes 2001 Article IV Consultation with Brazil, February 7

02/8: IMF Concludes 2001 Article IV Consultation with Haiti, February 8

02/9: IMF Concludes 2001 Article IV Consultation with Korea, February 12

02/10: IMF Concludes 2001 Article IV Consultation with the Republic of Belarus, February 19

02/11: IMF Concludes 2001 Article IV Consultation with St. Vincent and the Grenadines, February 19

Transcripts

Conference Call with Journalists on IMF Board Decision to Lend to Turkey, by Michael Deppler, Director, IMF European I Department, February 4

Press Briefing by Thomas C. Dawson, Director, IMF External Relations Department, February 13

Other

Quarterly Update on the Special Data Dissemination Standard—Fourth Quarter 2001, February 11*

IMF Financial Activities (update), February 15*

*Date posted

Interview with Vassili Prokopenko and Paul Holden

Can financial market development reduce poverty?

In the past, few economists looked closely at the links between financial markets and poverty. But that relationship is now increasingly important in the policy prescriptions of the IMF and other financial institutions. The IMF Survey *met with Vassili Prokopenko, an Economist in the IMF's Monetary and Exchange Affairs Department, and Paul Holden, Director of the Enterprise Research Institute in Washington, to discuss their Working Paper,* Financial Development and Poverty Alleviation.

IMF SURVEY: How has the thinking on the relationship between financial market development and poverty alleviation changed in the last decade or so?

PROKOPENKO: In the past, the traditional literature did not pay much attention to financial sector conditions. Now, most agree that financial intermediaries have a role to play. With regard to the linkage between growth and poverty reduction, most now agree that growth is beneficial for the poor. In the past, the thinking had been dominated by the work of Simon Kuznets and others, who argued that growth is more beneficial for the rich than for the poor, at least in the early stages of economic development.

HOLDEN: Development paradigms do evolve partly as a result of research on what is important and partly as a result of what is "in fashion." Twenty or so years ago, financial markets were commonly viewed as irrelevant to development and to the poor. There's been a great deal of evolution in that thinking. Financial markets are now seen as essential for promoting growth. Currently, there may be overemphasis on microcredit as an instrument of poverty reduction—in some circles microfinance is seen almost as a panacea for the poor, which is not correct in our view. The interesting debate presently centers on whether microfinance should be trying to help the poor as a direct instrument, or whether it should be promoting entrepreneurship among the poor, which will then lead to less poverty as a trickle-down effect. This critical debate has only just begun, and its outcome will be very important.

IMF SURVEY: Microfinance institutions have been the subject of some well-publicized success stories. Why do you urge caution?

PROKOPENKO: The quality of a microfinance institution's loan portfolio is often poor because of inadequate management and deficient control of its activities. As a result, many of these institutions never achieve the efficiency needed to cover costs and survive only by getting more subsidies from their donors. And because lending rates of microfinance institutions are usually very high, creditworthy poor are disadvantaged by participating in a pooling financing mechanism in which there are so many low-quality credits. Linkages between the microfinance institutions and commercial banks or other formal financial institutions are often weak. Moreover, there is virtually no path out of the informal sector into the formal sector in the countries where microfinance is widely available.

IMF SURVEY: Do you see microfinance as more successful in some regions than others?

HOLDEN: Microfinance in Latin America is more developed than elsewhere. In some countries, it is beginning to become viable and sustainable. We have evidence that some commercial institutions are beginning to enter the market successfully without subsidies and are doing very well. Interest rates are high, but it is important to remember that the competition for a microfinance institution is the local money lender, who often charges interest rates of 500–600 percent a year.

PROKOPENKO: In some Asian countries like Bangladesh and Indonesia, microfinance institutions are also relatively developed. But in Africa and the countries of the former Soviet Union, they are almost nonexistent.

IMF SURVEY: What is the potential for microfinance institutions to provide savings, insurance, and payment services?

HOLDEN: These institutions may be potentially important providers of these kinds of services—as well as distributors of remittances from industrial countries to developing countries. These services are extremely important and have a great deal of potential to alleviate poverty. Some fragmentary work done in El Salvador purports to show that having access to these services is at least as important as having access to credit.

IMF SURVEY: What are the main policy instruments needed to develop financial sectors in poor countries?

PROKOPENKO: Macroeconomic stability is quite important, as is an effective regulatory and supervisory framework. The state's role in the ownership of financial institutions is also important. We argue in the paper that private institutions normally perform better than state-owned institutions. These are probably the main instruments; our paper discusses many more.

HOLDEN: Macroeconomic stability is certainly a necessary condition, although it's far from sufficient.

Prokopenko: "With regard to the linkage between growth and poverty reduction, most now agree that growth is beneficial for the poor."

Holden: "Currently, there may be overemphasis on microcredit as an instrument of poverty reduction—in some circles microfinance is seen almost as a panacea for the poor, which is not correct in our view."

Interestingly, one sees wide variations in financial market development among countries that have similar degrees of macroeconomic instability. I would strongly emphasize the importance of the institutional foundations of financial markets, particularly secure property rights—for fixed and movable property. Strong and effective property rights provide the foundation of industrial countries' financial markets, yet in most developing countries these reforms have not occurred.

Prokopenko: "Leasing companies do not rely on the credit history of lessees or on accounting records. So these institutions may develop relatively quickly in poor countries that lack this financial information."

IMF Survey: Have there been any recent examples of countries that have made good progress in better defining their property rights?

Holden: On the fixed-property side, there was a very interesting World Bank–sponsored reform of titling and registration of poor people's property in Lima, Peru. There have also been very interesting movable-property reforms in Romania; these took place just over a year ago. I have only anecdotal evidence, but it appears to show that in the past year some 85,000 bank loans have been disbursed using movable property as collateral, whereas in the prior period there were essentially none. So the reforms appear to be helping. This is a very interesting case that warrants further analysis because, if it proves successful, it could be a model on which to base other countries' reforms.

Thailand has undertaken a comprehensive rural property reform in which large portions of the country have been titled over the past 20 years. The only econometric study that I have seen on this shows that the reforms have definitely had a strongly positive influence on the growth rate in the longer term.

IMF Survey: You highlight significant potential for specialized financial institutions to contribute to financial development and poverty reduction. What specific types of financial services do you see these institutions providing?

Prokopenko: Leasing companies do not rely on the credit history of lessees or on accounting records. So these institutions may develop relatively quickly in poor countries that lack this financial information. In some transition countries, such as the Czech Republic or Latvia, leasing companies became a rather important source of finance in the 1990s.

Holden: There are great advantages to specialization for two reasons. First, a financial institution that is highly specialized has a much better ability to assess the probability of being repaid because it understands the borrower's business. Therefore, when presented with a loan application, a specialized financial institution is generally better able than a commercial bank to determine the underlying viability of the business applying for financing. Second, in the event of payment default and seizure of assets, a specialized financial institution is much better able to sell the assets, often to its existing customers, and therefore recover a larger proportion of the defaulted amount.

Unfortunately, in most developing countries, the markets are not large enough to allow this type of specialization. Still, leasing is an interesting way around some of the deficiencies in the movable-property laws, because a leasing company often retains ownership of an asset until it's fully paid for and therefore has an easier method of repossessing the asset in the event of nonpayment. I should add parenthetically that there are some countries where trespass laws make it very difficult for leasing companies to operate; consequently, they specialize in leasing assets such as automobiles that remain primarily on public property. In many South American countries, for example, an automobile can be repossessed by the lessor, if necessary, despite trespass laws because the lessor can obtain access to it on the street.

IMF Survey: Since the late 1980s, many developing countries have been setting up stock exchanges. Is the development of banking systems and securities markets mutually enhancing? Or is it premature to promote stock markets in poor countries with undeveloped banking systems and perhaps even harmful to their socioeconomic development?

Prokopenko: Banking systems and stock exchanges can certainly be mutually enhancing, and the establishment of a stock exchange can benefit overall financial and economic development in a country. But to function effectively, a stock exchange requires a different level of transparency and accounting and a different infrastructure to overcome information problems. It requires some special institutions, such as rating agencies and venture capital firms, that are nonexistent in many developing and some transition countries. Many of the stock exchanges that have been established in developing countries since the 1980s are illiquid; these countries first need to build the necessary infrastructure. It is only then that a stock exchange can enhance overall financial development.

IMF Survey: Should priority in the early stages be almost entirely on developing the banking sector?

PROKOPENKO: In countries with poor disclosure and poor accounting, I personally think banks are better suited to financing growth than stock exchanges.

HOLDEN: I would agree. As Vassili said, stock markets require particular types of supporting institutions that are generally well beyond the status quo in most developing countries. Since development, like anything else, is about setting priorities, I would say first develop the banking system, then the supporting financial institutions, and, finally, the stock market. ■

Copies of IMF Working Paper 01/160, *Financial Development and Poverty Alleviation: Issues and Policy Implications for Development and Transition Countries* by Paul Holden and Vassili Prokopenko, are available for $10.00 each from IMF Publications Services. See page 58 for ordering information.

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

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina[1]	March 10, 2000	March 9, 2003	10,850.14	6,968.78
Brazil[1]	September 14, 2001	December 13, 2002	12,144.40	8,468.82
Croatia	March 19, 2001	May 18, 2002	200.00	200.00
Gabon	October 23, 2000	April 22, 2002	92.58	79.36
Latvia	April 20, 2001	December 19, 2002	33.00	33.00
Lithuania	August 30, 2001	March 29, 2003	86.52	86.52
Panama	June 30, 2000	March 29, 2002	64.00	64.00
Romania	October 31, 2001	April 29, 2003	300.00	248.00
Serbia/Montenegro	June 11, 2001	March 31, 2002	200.00	50.00
Sri Lanka	April 20, 2001	June 19, 2002	200.00	96.65
Turkey[1]	December 22, 1999	December 21, 2002	15,038.40	3,299.44
Uruguay	May 31, 2000	March 31, 2002	150.00	150.00
Total			39,359.04	19,744.57
EFF				
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2003	3,638.00	2,201.96
Jordan	April 15, 1999	April 14, 2002	127.88	60.89
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Ukraine	September 4, 1998	September 3, 2002	1,919.95	726.95
Total			7,971.93	5,275.90
PRGF				
Armenia	May 23, 2001	May 22, 2004	69.00	59.00
Azerbaijan	July 6, 2001	July 5, 2004	80.45	72.40
Benin	July 17, 2000	July 16, 2003	27.00	12.12
Bolivia	September 18, 1998	June 7, 2002	100.96	37.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	11.17
Cambodia	October 22, 1999	October 21, 2002	58.50	25.07
Cameroon	December 21, 2000	December 20, 2003	111.42	79.58
Chad	January 7, 2000	January 6, 2003	47.60	18.40
Djibouti	October 18, 1999	October 17, 2002	19.08	10.00
Ethiopia	March 22, 2001	March 21, 2004	86.90	52.14
Georgia	January 12, 2001	January 11, 2004	108.00	81.00
Ghana	May 3, 1999	May 2, 2002	228.80	105.17
Guinea	May 2, 2001	May 1, 2004	64.26	51.41
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Honduras	March 26, 1999	December 31, 2002	156.75	48.45
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	61.68
Lao People's Dem. Rep.	April 25, 2001	April 24, 2004	31.70	27.17
Lesotho	March 9, 2001	March 8, 2004	24.50	17.50
Madagascar	March 1, 2001	February 29, 2004	79.43	56.74
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2003	51.32	19.65
Mauritania	July 21, 1999	July 20, 2002	42.49	12.14
Moldova	December 21, 2000	December 20, 2003	110.88	92.40
Mongolia	September 28, 2001	September 27, 2004	28.49	24.42
Mozambique	June 28, 1999	June 27, 2002	87.20	25.20
Nicaragua	March 18, 1998	March 17, 2002	148.96	33.64
Niger	December 22, 2000	December 21, 2003	59.20	42.28
Pakistan	December 6, 2001	December 5, 2004	1,033.70	947.54
Rwanda	June 24, 1998	April 30, 2002	71.40	9.52
São Tomé & Príncipe	April 28, 2000	April 27, 2003	6.66	4.76
Senegal	April 20, 1998	April 19, 2002	107.01	19.54
Sierra Leone	September 26, 2001	September 25, 2004	130.84	84.00
Tanzania	April 4, 2000	April 3, 2003	135.00	55.00
Vietnam	April 13, 2001	April 12, 2004	290.00	207.20
Zambia	March 25, 1999	March 28, 2003	254.45	149.63
Total			4,213.78	2,757.21
Grand total			51,544.75	27,777.68

[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

Have Asian crisis countries reverted to precrisis exchange rate practices?

Following the 1997–98 financial turmoil, a number of crisis countries in Asia moved toward floating exchange rate systems, and one (Malaysia) moved to a fixed rate. These changes reinforced the bipolar view of exchange rate regimes and the "hollow middle" hypothesis—a vanishing middle ground between floating and a "hard" peg. But some academics have dissented, arguing that these postcrisis countries have pursued exchange rate policies similar to their precrisis ones and that the middle may not have vanished.

Tokyo foreign exchange brokerage.

In a recent IMF study, Postcrisis Exchange Rate Policy in Five Asian Countries: Filling in the "Hollow Middle"? *authors Leonardo Hernández and Peter Montiel identify and evaluate postcrisis exchange rate policies (up to the end of 2000) in the five countries most severely affected by the Asian financial crisis—Indonesia, Korea, Malaysia, the Philippines, and Thailand. What exchange rate policies did these countries pursue after the crisis? Did they revert to precrisis exchange rate practices? Why did they make the choices they did, and how should these policies be evaluated?*

Exchange rate policies and crises

The severe financial crises that many emerging market economies experienced in the last decade have been attributed to many causes. One common contributing factor was the attempt to maintain "soft" pegs—exchange rates pegged in value to some other currency or basket of currencies, with some commitment by the authorities to defend the peg, but with changes in the rate possible if the exchange rate came under significant pressure. In the context of increased integration with international capital markets, it was argued, only the polar extremes—floating or fixed exchange rates supported by very strong commitment mechanisms ("hard" pegs)—can be sustained for extended periods.

Among the crises of the 1990s, the Asian financial crisis of 1997–98 played a key role in forming the perception of a vanishing middle ground for exchange rate regimes in emerging market countries. Before the crisis struck, the five Asian economies had actively managed their exchange rates, partly to promote their competitiveness—something they saw as an important ingredient in their "miraculous" economic performance. The crisis forced all of these countries to abandon their de facto exchange rate pegs, and the subsequent floats of their currencies were associated with very sharp declines and fluctuations in their values. Thus, argued analysts, if economies with exceptional macroeconomic fundamentals could not successfully manage their exchange rates in a more financially integrated world, surely other developing countries faced even bleaker prospects.

Same old policies?

More recently, however, doubts have arisen about postcrisis exchange rate policies. Several observers have suggested that these countries may have reverted to exchange rate practices similar to those of the precrisis period, in an effort to stabilize the values of their currencies against the U.S. dollar, without adopting any of the strong commitment mechanisms called for by a "hard" peg. The worry among such observers is that, in view of the vanishing scope for "soft" peg arrangements with greater international financial integration, resuming such practices may make the former crisis countries vulnerable to a repetition of the events of 1997–98. According to this view, these countries should opt for one of the extreme or polar currency arrangements that their own experience (and that of others) suggests are the only viable options if they are to remain highly integrated with world capital markets.

More flexible now?

In terms of the official IMF classification, postcrisis Indonesia, Korea, and Thailand moved to more flexible exchange rate regimes, while Malaysia moved in the opposite direction. Only the Philippines retained its precrisis exchange rate regime, classified as "independently floating."

But a problem with classifying exchange rate arrangements is the difficulty of measuring a country's commitment to a "soft" peg. The study asserts that commitment can be gauged in terms of the observed volatility of financial variables, such as exchange and interest rates, and changes in stocks of foreign reserves. The empirical results suggest that de facto exchange rate regimes in all five countries changed after the crisis. While no country adopted a "soft" peg with unfettered capital movements, there was no movement either to the extreme (or corner) solutions of "hard" pegs and clean floats.

In other words, these countries continued to manage their exchange rates in an active manner and thus continued to occupy the supposedly vanishing hollow middle of exchange rate policy. The study shows that—with the exception of Malaysia, which fixed its exchange rate and adopted capital controls—these countries allowed greater flexibility in their exchange rates after the crisis. However, they did not float to the same extent as the industrial countries, such as Germany (against non-EMU currencies), Japan, and the United States. The evidence shows that Indonesia, Korea, Thailand, and the Philippines both intervened in foreign exchange markets and used monetary policy to influence their exchange rates (see chart, this page).

Possible objectives of the policies

What were the postcrisis objectives of these countries? Hernández and Montiel maintain that, while the monetary authorities may have intended to smooth high-frequency exchange rate fluctuations, this could not have been their only objective. In addition, the systematic accumulation of reserves after the crisis suggests that, consistent with their long-term (export-oriented) development strategies as well as with their short-term need to reactivate their economies, they may have been trying to moderate the appreciation of their real effective exchange rates after the overshooting associated with the crisis, and seeking to accumulate a "war chest" of reserves for possible future use in defending the exchange rate (see chart, page 58).

According to the authors, the postcrisis exchange rate policies of the five countries had three common features: limited flexibility, resistance of real exchange rate appreciation, and reserve accumulation.

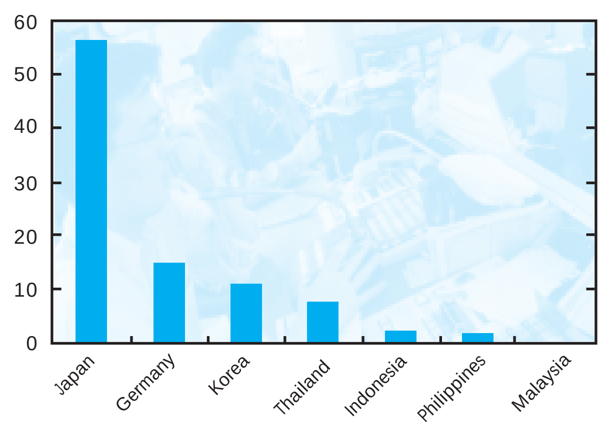
Evaluating the policies

The total policy packages in these countries, Hernández and Montiel observe, have been credible and perceived by the markets as sustainable. For the four countries that moved from "soft" pegs toward the flexible end of the exchange rate spectrum, allowing greater flexibility had a significant potential benefit in the postcrisis period: the absence of any explicit or implicit commitment to an exchange rate peg most likely discouraged "one-way bet" speculation by creating uncertainty about the future course of the exchange rate. At the same time, some degree of exchange rate smoothing may have helped anchor market expectations about the path of the exchange rate, which may have been particularly helpful in these countries that had recently emerged from a crisis. Thus, the authors explain, the limited exchange rate variability allowed by the four "floaters" may have represented an attempt to strike a compromise between desirable but potentially conflicting objectives in the postcrisis context.

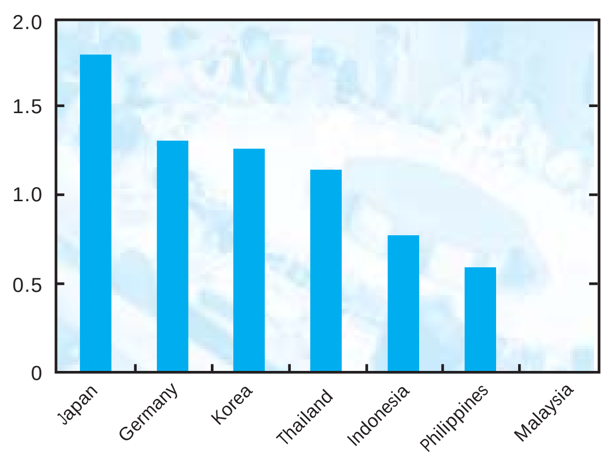
Unlike the other countries, Malaysia opted for exchange rate stability, forgoing the objective of flexibility. If an intermediate solution within the hollow middle was chosen by the other countries, why was the same choice not made by Malaysia? The authors believe Malaysia's choice was related to its decision not to request assistance from the IMF. Given the potential adverse effect on market sentiment of such a decision, the country may have faced a much less favorable flexibility-stability trade-off than other countries in the region.

Asian crisis countries more flexible but not like some industrial countries

(ratio of exchange rate volatility to interest rate volatility in postcrisis period)



(ratio of exchange rate volatility to reserves volatility in postcrisis period)

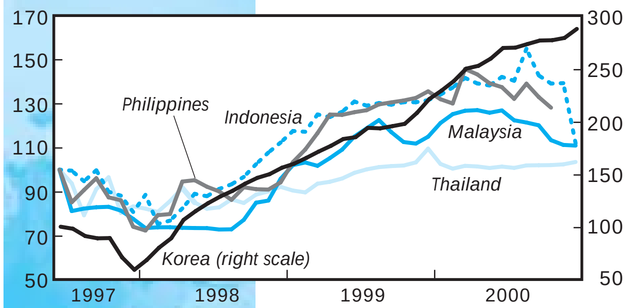


Data: Authors' calculations

Hernández and Montiel also suggest that reserve accumulation may be an important component of a natural transition to a new regime of floating exchange rates. One reason why some countries maintain large stocks of reserves is the “original sin”—the inability of agents in these economies to borrow externally in their own currencies. However, that accumulation may be a substitute for other measures (such as institutional reforms and corporate restructuring) that these countries need to take. To the extent that these measures have been absent and/or remain incomplete, reserve accumulation is best interpreted, the authors argue, as a second-best transition strategy.

Asian crisis countries built up reserve "war chest" in postcrisis period

(June 1997=100)



Data: IMF

Classifying the regimes

After looking at the five Asian crisis countries, the authors conclude that the simple classification of exchange rate regimes into “hard” pegs, “soft” pegs, and “floating” is a fiction. In practice, exchange rate regimes vary along a continuum. The crisis simply tended to propel the countries involved toward more flexibility in the postcrisis period. But this move was not uniform across the region:

• Malaysia moved in the direction of greater fixity and less integration with world capital markets.

• Korea and Thailand maintained or increased their integration with world capital markets and moved toward greater flexibility, but not to the pole of pure floating.

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• Because of domestic political uncertainties, it is not so clear that the Philippines and Indonesia truly moved into a postcrisis period during 1999–2000. But relative to the precrisis period, both countries have altered their exchange rate regimes in the direction of greater flexibility.

Lessons for other countries

Hernández and Montiel draw one tentative lesson: the middle ground between floating and a "hard" peg is probably smaller, but it still exists. It is smaller since it is far more difficult for financially integrated countries to sustain "soft" pegs, simply because capital markets will not allow domestic policy mistakes to go unpunished. But it still exists because a wide range of intermediate regimes may be both feasible and desirable, depending on country circumstances. Specifically, under postcrisis conditions, if the fragility of domestic balance sheets rules out "hard" pegs as an option (because of the strains caused by the high interest rates needed to defend the peg), the authors conclude that a dirty float designed to resist real appreciation and allow the accumulation of reserves may be more appropriate than the polar extreme of clean floating. ■

Copies of IMF Working Paper 01/170, *Postcrisis Exchange Rate Policy in Five Asian Countries: Filling in the "Hollow Middle"?* by Leonardo Hernández and Peter Montiel, are available for $10.00 each from IMF Publications Services. See page 58 for ordering information.

IMF–World Bank outreach meeting

FSAPs help countries strengthen financial systems, reduce vulnerability to shocks

An essential defense against financial instability is a resilient, well-regulated financial system. With this and other lessons from the Asian and Russian crises in mind, the IMF and the World Bank created the Financial Sector Assessment Program (FSAP) in May 1999. The program strengthens monitoring of member countries' financial systems and helps countries safeguard against vulnerabilities and identify development priorities. Now that about 50 countries have undergone or are currently undergoing assessments, it is possible to get a good sense of how the program is working. Representatives from 13 of these countries (see box, page 61) and the Banking Commission for Central Africa gathered in Washington on January 31 and February 1 to share their experiences and suggest ways to improve the program—all of which will feed into a review of the FSAP by the Executive Boards of the two institutions later this year.

The FSAP outreach meeting examined experience with the program and sought ways to improve it.

What FSAPs do

The FSAP was created to help identify the strengths and vulnerabilities of a country's financial system, determine how key sources of risk are being managed, ascertain the sector's developmental and technical assistance needs, and help prioritize policy responses. The FSAP relies heavily on the expert support of about 50 cooperating official institutions—central banks, regulatory and supervisory agencies, standard-setting bodies, and multilateral development banks. This support has been particularly useful in the program's peer assessment of how well countries are adhering to financial sector standards and codes, although it has also been valuable in various areas of central bank operations. The IMF and the World Bank have been working closely with the standard-setting bodies and with the standards' assessors who have participated in the FSAP to improve the quality of assessments and develop and refine assessment methodologies. As background for the recent discussions, the participants were briefed on the latest developments in these areas.

Can they be improved?

The FSAP is basically well designed and is achieving its objectives, the participants agreed. Representatives from developing and emerging market countries noted that the FSAP helped them to identify and prioritize reforms and also to focus attention domestically on the need for ongoing reforms in their financial sectors. Industrial country representatives emphasized the benefits of undergoing a comprehensive review of stability

issues with an objective and expert counterpart team. Many industrial and developing countries have a particular interest in this aspect of the FSAP because it gives them a third-party assessment of where they stand relative to international best practices regarding financial system transparency, regulation, and supervision. There was also a consensus that the simultaneous review of financial subsectors and of financial sector regulatory and supervisory agencies helped national authorities focus on cross-sectoral links and similarities more than they otherwise might.

Although a comprehensive assessment under the FSAP is time consuming and resource intensive—FSAP teams tend to be large, and the assessments typically involve two country visits and extensive preparation by the assessment teams and country authorities—the process has been refined over time and has become both more consistent across countries and more efficient. While countries felt that the advantages of a more comprehensive assessment offset the burden involved, several participants felt that further improvements could be made. Most participants favored spreading the FSAP work over stages but agreed that, in all cases, discussions of the scope and coverage of the FSAP and the provision of questionnaires and so on should start well in advance.

There was an active discussion of ways to gain greater value from the analytical tools used in the FSAP, particularly stress testing, financial soundness indicators, and assessments of financial sector standards. The participants strongly supported further research and development in these areas, including in identifying the links between the macroeconomy and the financial sector. In particular, they debated stress testing—an evolving area of analysis that entails examining the resiliency of financial institutions to large but plausible shocks (for example, changes in exchange rates, interest rates, or asset prices). For each country, a wide range of possible approaches to stress testing needs to be considered, as data quality and availability vary significantly. In some cases, national authorities or financial institutions have only limited familiarity with stress testing and wish to take advantage of the FSAP to gain more experience. Participants agreed that, before tests are conducted, detailed discussions between a country's authorities and the FSAP teams would generally help ensure that the most appropriate approaches and test scenarios are used.

Participants also shared the view that assessing how well countries observe financial sector standards plays a critical role in the FSAP process, both in evaluating financial system stability and in identifying developmental priorities and gaps in implementation. That dual role highlights the close relationship between immediate stability considerations and more medium-term development issues and thus underscores the advantages of having the IMF and the World Bank undertake the FSAP jointly.

Cardinal Rodríguez visits the IMF

In a speech to staff from the IMF and the World Bank on February 20, Cardinal Oscar Andrés Rodríguez, Archbishop of Tegucigalpa, identified corruption as the number one global threat. Cardinal Rodríguez, who was welcomed to the IMF event by IMF Deputy Managing Director Eduardo Aninat, has launched a number of anti-corruption and social justice initiatives of the Catholic Church in Honduras. He has also been a strong promoter of civil society involvement in the poverty reduction strategy process. His presentation was part of the IMF's ongoing efforts to improve its dialogue with religious and civil society organizations.

Cardinal Rodríguez argued that the large resources generated from the drug trade are used to "buy" government officials and other members of society, posing a threat to a country's economic system. In his view, the best antidote against corruption is transparency. Individuals need to ask their governments more questions and hold them accountable for their actions.

On the debt situation, Cardinal Rodríguez said that debtor countries use a large portion of their resources to repay their debts, thus neglecting social programs. With such high debt payments, he asked, how can countries achieve sustainable growth? He agreed that the joint IMF–World Bank Heavily Indebted Poor Countries Initiative is a good first step, but it needs to be adjusted further. The main problem with the Initiative is that it is too general, underscoring a need for clearer and more precise rules to ensure that the benefits flow to all eligible countries. Another problem is that the period of time before debt relief is granted is too long.

On globalization, Cardinal Rodríguez said that the largest risk from greater integration is that some countries and groups will be excluded—in which case, globalization will not work. He felt that the international community has been indifferent to the "human dimension" of globalization, as evidenced by the higher incidence of poverty, and hoped that the Catholic Church and the IMF would work together to make a better world for all people.

Were there significant gaps in the coverage of the FSAP? Some participants thought the emphasis on current stability issues was appropriate and essential but that, in some countries, the FSAP should pay more attention to either gaps in the legal and institutional infrastructure that may be impeding financial system deepening or to factors that may be limiting access to credit. Most participants felt that stability and development were intertwined.

Publishing the results

After participating in the FSAP, countries have the choice of publishing any or all of a number of documents: the Financial System Stability Assessment, which the IMF staff prepares and presents to the IMF's Executive Board and which identifies surveillance issues; the Financial Sector Assessment, which the Bank staff prepares and which focuses on development issues; and the summary assessments of financial sector standards called Reports on Standards and Codes, prepared as part of the FSAP.

A number of countries have chosen to publish some or all of these documents, agreeing to have them posted on the IMF and the World Bank websites (see www.imf.org/external/np/fsap/fsap.asp). There was a clear concern that the contents of the documents should be current at the time of publication. Because changes in financial systems and regulation can be rapid, especially in emerging markets, it is critically important that the lags between undertaking the FSAP mission work and finalizing the findings be kept to a minimum.

What happens after an FSAP?

Another topic of particular interest was how the FSAP could best support the ongoing work of national authorities, as well as of the IMF—which conducts FSAPs during annual country checkups—and the World Bank. In the process of undergoing an FSAP, a country amasses extensive information about its financial system, its strengths and vulnerabilities, and its ties to the macroeconomy. Participants agreed that it would be desirable to keep this information updated to reflect changing circumstances and ongoing reforms.

While some participants favored reassessments more frequently than every 5 or 6 years—as is implied by the current rate of 24 a year—resource constraints limit the extent to which this can be done. Mechanisms to complement full FSAPs must therefore be found. Participants generally supported the idea of updating their information in the context of the IMF's bilateral surveillance, which is an ongoing process. A range of detailed follow-up and updating could be performed in the context of technical assistance missions by both the IMF and the World Bank. In countries where significant changes had occurred, making an in-depth review necessary, small focused FSAP-update missions might be required. ■

Sami Geadah and Mark O'Brien
IMF Monetary and Exchange Affairs Department

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 11	2.25	2.25	2.65
February 18	2.26	2.26	2.66

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?2002).

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

Data: IMF Treasurer's Department

FSAP participants

Representatives from Croatia, the Czech Republic, the Dominican Republic, Finland, Gabon, Georgia, Iceland, Latvia, Mexico, Senegal, Slovenia, Tunisia, and Uganda participated in the recently concluded outreach meeting, which was part of an ongoing effort to learn from country experiences. In October 2000, a similar meeting was held, which fed into the previous review of FSAP experience by the Boards of the IMF and the World Bank.

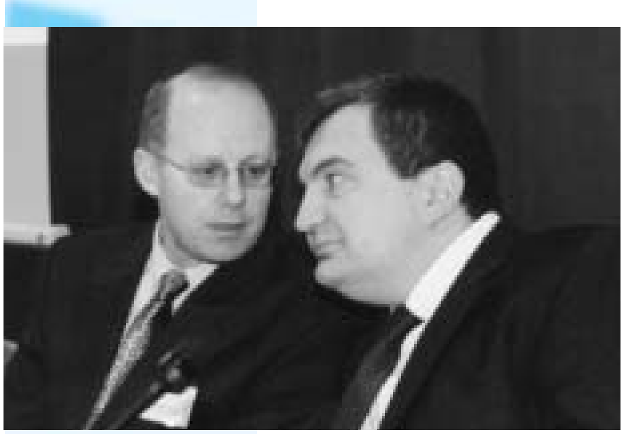
The other countries whose financial systems have been, or are currently being, assessed under the FSAP are Armenia, Bulgaria, Cameroon, Canada, Colombia, Costa Rica, Croatia, El Salvador, Estonia, Ghana, Guatemala, Hungary, India, the Islamic Republic of Iran, Ireland, Israel, Kazakhstan, Korea, Lebanon, Lithuania, Luxembourg, Morocco, Nigeria, Peru, the Philippines, Poland, South Africa, Sri Lanka, Sweden, Switzerland, the United Arab Emirates, the United Kingdom, Uruguay, and Yemen.

Assessments are under way or are being planned for the near future for industrial economies (Switzerland and the United Kingdom), transition economies (the Kyrgyz Republic and Ukraine), emerging market economies (Brazil), developing countries (Bangladesh and Zambia), and international financial centers (Hong Kong SAR and Singapore). The FSAP will continue to be refined as diverse economies undergo assessments.

A decade into transition…

Conference salutes Albania's economic progress, spotlights challenges for European integration

Ten years after Albania embarked on a transformation of its economy and joined the Bretton Woods institutions, its government and central bank sponsored a conference to mark the country's progress and outline the challenges ahead. Government officials; representatives from the IMF, the World Bank, the International Finance Corporation, and the European Bank for Reconstruction and Development; and academics gathered in December to evaluate what had succeeded and what steps are now needed to sustain macroeconomic stability and growth, and to position Albania for eventual integration with Europe's economy. Teuta Baleta, Director of the Research and Monetary Policy Department of the Bank of Albania, and Volker Treichel, the IMF's Resident Representative in Albania, report on the proceedings.



Shkelqim Cani (left), Governor of the Bank of Albania, confers with Ilir Meta, Albania's Prime Minister.

Transition to a market economy

Before it undertook broad-based reforms, Albania's centrally planned economy existed in virtually complete isolation from other communist economies following the disruption of its relations with China in 1978. Subsequent efforts to create economic autarchy failed, and the 1980s witnessed a period of perpetual economic decline.

When Albania embarked on its transition to a market economy in 1991, the economy was characterized by widespread shortages and a substantially amortized capital stock. Its decision to join the IMF and the World Bank in October 1991 marked a historic step, former Prime Minister Ylli Bufi said, signaling Albania's rejoining of the world economic community. It also gave the country the opportunity to elaborate and implement strategies for economic development and for its transition to a market economy.

As a first step, a one-year Stand-By Arrangement with the IMF, in 1992, helped Albania mitigate the difficulties associated with the sudden transition in the economy. A three-year Enhanced Structural Adjustment Facility (ESAF) Arrangement with the IMF in 1993 provided financing support for a number of key steps—chiefly the creation of a basic regulatory framework for a market economy and efforts to privatize small and medium-sized enterprises and fully liberalize prices.

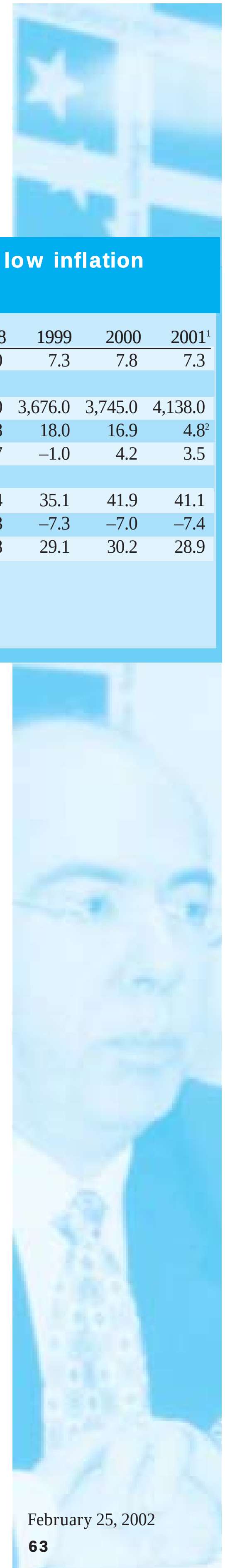
After the collapse of a pyramid scheme in 1997 imperiled the financial well-being of the country, Albania's recovery was aided by emergency postconflict assistance from the IMF. A second ESAF Arrangement in 1998—successfully concluded in mid-2001—focused on achieving macroeconomic stability, strengthening fiscal sustainability, and proceeding with privatizing strategic and small and medium-sized enterprises. The IMF's financial support for Albania's reform efforts also served to catalyze financing support from the World Bank and other donors.

Shkelqim Cani, Governor of the Bank of Albania, expressed appreciation for the crucial role that the IMF and the World Bank have played in the country's transition history, noting that the move to a market economy and toward European integration is now "irreversible." Anastas Angjeli, Albania's Finance Minister, agreed, stressing that his country's membership in the two institutions has been a powerful engine for its integration with Europe.

Progress on the macroeconomic front

Volker Treichel offered an overview of the progress the country has made over the past decade. He cited its positive macroeconomic performance since 1997, pointing, in particular, to the country's high growth and low inflation (see table, page 63), which have been supported by appropriately tight fiscal and monetary policies. There is evidence, too, of fiscal consolidation in the gradual reduction of Albania's domestically financed deficit. This reduction in the deficit, he said, has been driven by large revenue increases that are the result of improved tax and customs administration.

In its pursuit of a tight monetary policy, the Bank of Albania has maintained real interest rates at high levels and prevented state-owned banks with large portfolios of nonperforming loans from extending new loans. In the aftermath of the 1997 pyramid scheme crisis, this prudent monetary policy has bolstered confidence in the economy and attracted a high volume of remittances from Albanians living abroad. The resurgence in remittances has, in turn, fueled growth in the country's



service and construction sectors. And donors have restarted infrastructure projects, notably for road construction and water sanitation, and provided budget support. A stabilized exchange rate has also contributed to reduced inflation.

Franco Passacantando, the World Bank's Executive Director for Albania, noted that over the past 10 years the Bank had disbursed $392 million for 42 loans and 22 completed projects in the country. Albania's experience, he said, demonstrated the useful and essential role official development assistance can play in economic development. Successful development efforts, he said, need to complement appropriate macroeconomic measures with proper attention to institution building and strengthened public administration, as well as to social and gender issues. Albania's experience also provides convincing evidence that country ownership of the reforms is essential and is not inconsistent with the conditions ("conditionality") attached to IMF and World Bank lending.

Others, too, paid tribute to Albania's accomplishments on the macroeconomic front. Dhori Kule from the economic faculty of the University of Tirana attributed Albania's macroeconomic stabilization to its fast and complete liberalization of prices and its forceful implementation of structural reforms—in particular, the privatization of agricultural land and of small and medium-sized enterprises. Angjeli also pointed out that since 1998 Albania's fiscal policy has sought to boost industrial and agricultural production by promoting greater savings and stimulating investment. The government had also taken steps, he said, to establish a sound medium-term basis for the design of macroeconomic and fiscal policy. He noted, in particular, the country's work on its Medium-Term Expenditure Framework and Growth and Poverty Reduction Strategy. He also singled out for praise major efforts by the government to harmonize the country's fiscal legislation (for example, its customs code) with that of the European Union.

Road ahead

What is next on the reform agenda as Albania sets its sights on greater integration with Europe? Participants covered several crucial areas where major steps will be needed to sustain progress.

Macroeconomic environment. Riccardo Faini, former IMF Executive Director for Albania, emphasized the benefits that macroeconomic stability has delivered: namely, high growth and a greater convergence of Albania's economy with that of Europe's. But he cautioned that sustaining these results will require structural reform, particularly in the financial sector and in trade liberalization. In addition, he urged Albania to undertake fundamental tax reform and rigorously scrutinize existing expenditure programs to prevent the emergence of a difficult trade-off between macroeconomic stability and the need to press ahead with reforms.

In late 1990s, Albania achieved high growth and low inflation

(annual percent change, unless otherwise indicated)

	1993	1994	1995	1996	1997	1998	1999	2000	2001[1]
Real GDP growth	9.6	8.3	13.3	9.1	–7.0	8.0	7.3	7.8	7.3
GDP (current prices, million dollars)	1,228.0	1,884.0	2,422.0	2,689.0	2,284.0	3,046.0	3,676.0	3,745.0	4,138.0
Unemployment rate	22.3	18.4	13.1	12.4	14.9	17.8	18.0	16.9	4.8[2]
Annual inflation rate	30.9	15.8	6.0	17.4	42.1	8.7	–1.0	4.2	3.5
				(percent of GDP)					
Domestic debt	…	20.5	23.5	29.5	35.5	32.4	35.1	41.9	41.1
Current account	–29.4	–14.2	–7.3	–9.2	–12.3	–6.3	–7.3	–7.0	–7.4
Foreign debt	83.0	54.2	31.2	30.2	36.8	31.8	29.1	30.2	28.9

[1]Estimates.
[2]September 2001.
Data: Albanian authorities and IMF staff estimates

Monetary policy. The principal objective of Albania's monetary policy, explained Bank of Albania Governor Cani, is achieving and maintaining price stability. In pursuing its tight monetary policy, the central bank initially relied on direct monetary policy instruments, such as minimum deposit rates. In 2000, however, it completed a move to indirect instruments—in particular, the use of repurchase agreements, which allows a more market-driven determination of interest rates and financial intermediation. But Albania's monetary policy remains constrained, he said, by the absence of developed financial and capital markets, and he welcomed recent efforts to establish a stock market.

Over the medium term, Cani envisioned the Bank of Albania adopting an inflation-targeting regime. Conditions for such a shift seem to be increasingly favorable, he said, in light of the country's progress on macroeconomic stabilization and fiscal consolidation.

Financial sector. Fatos Ibrahimi, First Deputy Governor of the Bank of Albania, noted the considerable progress that Albania had made in shoring up its financial system. He highlighted improvements in banking, notably enhanced legal and regulatory frameworks, an enlarged network of branch banks, and a higher quality of service. But an essential feature of the Albanian financial system remains to be addressed—the dominant role of the Savings Bank, the last state-owned bank.

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Hormoz Aghdaey of the World Bank strongly agreed. The health of Albania's financial sector had benefited from the country's decisive move, after the 1997 crisis, to privatize all but the largest of the state-owned banks and close banks that could not be privatized. Now atop the reform agenda, he said, is the privatization of the Savings Bank and the state insurance company. Also a priority, he said, is further strengthening supervisory agencies in the financial sector.

Fatos Ibrahimi (left), First Deputy Governor of the Bank of Albania, addresses the conference.

Enterprise privatization. Several speakers stressed the crucial role that privatization had played in the Albanian reform process. Fatmir Mema of the University of Tirana discussed the problems that had been encountered in the privatization process and questioned whether its objectives had indeed been met. According to Mema, privatization vouchers, for example, had not had the desired effect—only some 20 percent of the distributed vouchers had been used. And many privatized enterprises were now struggling with severe management problems and were constrained by a lack of access to capital.

Institutional reform. All speakers agreed on the need to undertake further institutional reform if recent good macroeconomic performance was to be sustained. Gjergj Konda of the International Finance Corporation explained that key aspects of this continued institutional reform would be a fight against corruption, an improved business environment, a more efficient judiciary, and conditions that permitted fair competition.

Corruption and weak governance were recognized as major impediments to development. The private sector demanded a more reliable, independent, and efficient judiciary. And the delivery of public services remained inefficient. Filloreta Kodra from Albania's Department of Public Administration emphasized the critical role that public administration reform could play in building effective institutions and accelerating Albania's integration with the European Union. Crucial steps in this direction include the recently adopted civil service law that seeks to provide more transparent recruitment procedures and a more secure status for civil servants and the introduction, early this year, of a much more competitive pay scale for top civil servants.

European integration. Following several years of good macroeconomic policies, Albania is no longer viewing European integration as an impossible goal, said Ermelinda Meksi, the country's Minister of Economic Cooperation and Trade. She was appreciative of the value and importance of the European Union's Stability Pact for Southeastern Europe and noted, in particular, the importance attached to regional integration. While it is now clear that Albania has reached a point of no return in terms of democracy and market-based reforms, it remains unclear, she said, how long the integration process might take.

To further that process of integration, Domenico Nuti of the London Business School proposed the introduction of the euro or of a euro-backed local currency. Such a step, he said, would lead to greater exchange rate certainty and credibility, lower transaction costs and interest rates, improved prospects for economic integration with Europe, and expanded foreign direct investment. Of course, on the downside, he said, Albania would lose revenue from seigniorage, and use of the euro or a euro-pegged currency arrangement would constrain the Bank of Albania's ability to adjust the exchange rate in line with competitive pressures.

The conference concluded that Albania had indeed made major progress toward establishing a market economy, but much more remains to be done to sustain its recent good macroeconomic performance and reduce, in particular, high unemployment and poverty. In this regard, the conference underscored the vital importance of complementing policies to maintain macroeconomic stability with an appropriate focus on structural reforms, particularly in the energy sector, the judiciary, and public administration. Given Albania's good track record in recent years, conference participants expressed confidence that it could make further significant progress toward integration with Europe if the reforms continued at the appropriate pace. ■

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