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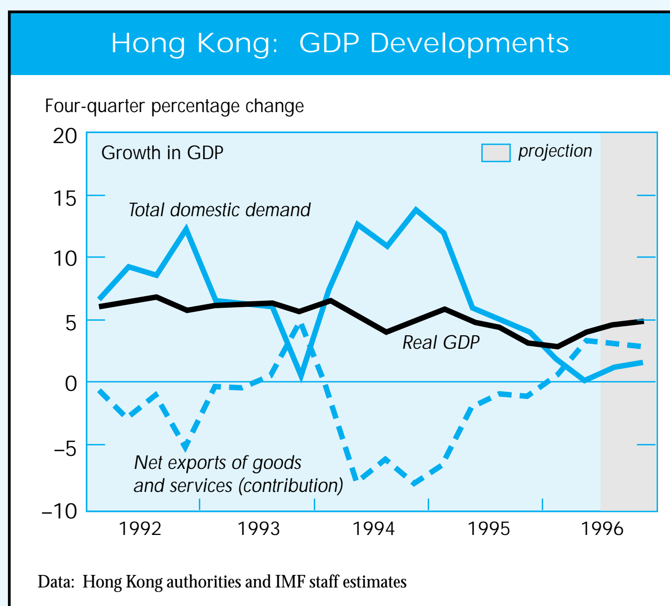
Hong Kong's Strong Fundamentals Bode Well For Smooth Transition

Hong Kong has turned in a strong economic performance over the past decade and a half. Since the initiation of economic reforms in China in 1978, real GDP growth has averaged nearly 7 percent a year, while exports have increased more than sixfold. Hong Kong has evolved into a service-based economy and an important international financial center. Its per capita GDP—$22,770 in 1995, versus $5,500 as recently as 1980—is comparable to all but the wealthiest industrial countries. Hong Kong's gains have been achieved in the context of a massive, market-driven economic restructuring that has also reflected an increasing degree of integration with China.

During the 1990s, Hong Kong's growth rates have *(Please turn to the following page)*

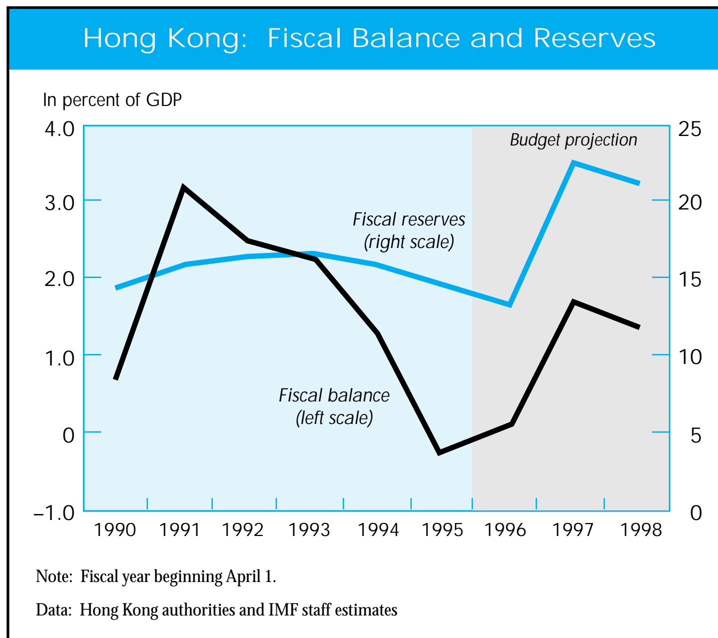


Eliminating Bias in the U.S. Consumer Price Index

The possibility that the U.S. consumer price index (CPI) may overstate the rate of inflation for the consumer sector of the U.S. economy has drawn considerable attention from the U.S. Congress, the administration, and users in the academic and business community. The recent report of the "Boskin Commission" (the Advisory Commission to Study the Consumer Price Index, commissioned by the U.S. Senate Finance Committee) has drawn attention to the potential magnitude of this problem for the United States and the fiscal consequences it poses, because the CPI is used to escalate payments in many federal programs and to adjust the marginal tax brackets used for the assessment of income taxes. In an IMF Working Paper entitled *Improving the Efficiency of the U.S. CPI*, Paul Armknecht discusses the concepts and methods underlying the U.S. CPI and proposes changes to resolve many of the sources of bias that contribute to overstating inflation.

The traditional measures used worldwide to gauge inflation lack some desirable statistical properties and are based on unrealistic economic assumptions, according to Armknecht. The literature on index number theory suggests measures that are superior to the more traditional fixed-quantity weight price index formulas as currently used by the U.S. Bureau of Labor Statistics, producer of the U.S. CPI. Such fixed-weight indexes assume that consumers purchase constant proportions of various goods and services despite the fact that, as relative prices change, consumers substitute less expensive items for more expensive ones. Armknecht presents two improved measures that more closely approximate consumer behavior and suggests how one of these can be implemented without great difficulty using existing Bureau of Labor Statistics procedures.

Many countries use scientific sampling techniques to select the geographic areas and the retail shops in their CPI surveys. The United States, however, is the only country that uses probability proportionate to sales sampling techniques to select the individual varieties of goods and services within *(Continued on page 77)*



tended to moderate, with economic activity becoming more stable. The external-demand-led growth of the 1980s has given way to predominantly domestically led growth, with the main growth impetus provided by consumer spending. In 1994–95, growth slowed in response to high U.S. interest rates and a downturn in asset markets, with the slowdown continuing into the first half of 1996. During the second half of the year, however, growth revived moderately; real GDP grew by 5.1 percent in the third quarter, buoyed by private consumption and investment and a rebound in asset markets.

A sharp deceleration in imports helped to narrow the merchandise trade deficit by some 2½ percent of GDP in 1996 to about $17.8 billion (equivalent to 11¼ percent of GDP). Services exports have been strong and the balance on goods and nonfactor services is estimated to have reached a surplus of about 1 percent of GDP at the end of 1996. Moderate domestic demand, combined with falling import prices resulting from exchange market developments and some labor market slack, led to a decline in inflation—to about 6 percent in 1996—with unemployment remaining low, at about 2½ percent. And Hong Kong's official reserves stood at nearly $64 billion at the end of 1996—a 15 percent gain over a year earlier.

Continuation of the improving economic trends evident in the second half of 1996 would support real GDP growth for Hong Kong of about 5 percent in 1997, with inflation remaining in the 6–7 percent range. The pace of

Monetary Relations Between Hong Kong and China

Following are excerpts of a speech given by Chen Yuan, Deputy Governor of the People's Bank of China, at the Federal Reserve Bank of New York on February 14.

China will resume the exercise of sovereignty over Hong Kong on July 1, 1997. Hong Kong will then become a Special Administrative Region of the People's Republic of China [HKSAR]. According to the Basic Law of HKSAR promulgated by our National People's Congress on April 4, 1990, we are going to implement the policy of "one country, two systems" in Hong Kong. This policy will be realized in various areas, including politics, the economy, and social life. "One country, two systems" means that two entirely different systems will be practiced within one sovereign state. Specifically, this means that after 1997, China will continue to implement its existing socialist system, while Hong Kong's present capitalist system and way of life will remain unchanged for 50 years. Another important indication of the one country, two systems principle is that Hong Kong will enjoy a high degree of autonomy, with Hong Kong people ruling Hong Kong. In effect, this means that the HKSAR will enjoy autonomy in all areas except foreign affairs and defense matters.

Legal and Policy Framework

In monetary and financial areas, the Basic Law sets out clear provisions in the following five areas:

- The government of the HKSAR shall provide an appropriate economic and legal environment for the maintenance of its status as an international financial center.
- The government of the HKSAR shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law.
- The Hong Kong dollar, as the only legal tender in Hong Kong, shall continue to circulate, and the existing currency issuance mechanism shall continue.
- The Hong Kong dollar shall remain freely convertible, with the free flow of capital and no exchange control.
- The Exchange Fund shall be maintained and controlled by the government of the HKSAR, primarily for regulating the exchange value of the Hong Kong dollar.

These provisions form the foundation for defining the monetary relationship between the Mainland and Hong Kong under the principle of "one country, two systems." This relationship can best be summarized as

the recovery will depend critically on the expected resurgence in exports. The key challenge for policymakers is to maintain business confidence—most effectively by continuing the rules-based policy framework that has served Hong Kong so well over the years. That policy framework—which has fostered a high degree of flexibility in factor and product markets—consists of an exchange rate linked to the U.S. dollar, open capital markets, firm financial regulation, and prudent fiscal policy.

The Chinese authorities' recent assurances that Hong Kong's economic, monetary, and legal systems will remain intact—in keeping with the "one country, two systems" framework developed for the future Hong Kong Special Administrative Region (see box below)—have helped increase confidence in Hong Kong's prospects as it readies for a return to Chinese sovereignty on July 1, 1997. Continuation of the existing policy framework, combined with flexible markets, offers the best prospects for future macroeconomic stability and growth.

Stance of Policy

Hong Kong's fiscal policy stance has, on balance, recently tended to have a mildly stimulative effect on economic activity. The budget for fiscal 1995/96 (April 1–March 31) registered a small deficit (0.3 percent of GDP), reflecting increases in both current and capital spending on infrastructure and a fall in the revenue ratio. Capital spending is estimated to fall in 1996/97 and the budget is expected to return to a small surplus (0.3 percent of GDP). Fiscal policy is expected to sustain its noninterventionist approach, which is aimed at keeping government small and avoiding deficits and countercyclical stabilization policies. In current circumstances, moderate budget surpluses and a high level of fiscal reserves are desirable from a macroeconomic standpoint.

Hong Kong's exchange rate link with the U.S. dollar serves as an anchor for other policies, and, except for a brief episode of speculative activity in early 1995, the exchange rate has been free of pressure. In support of this system, the authorities have accumulated substantial reserves and given priority to maintaining a high-quality system of banking supervision in line with international standards—the latter to maintain Hong Kong's reputation as a safe and stable financial center. At present, Hong Kong's banks enjoy high capitalization and low loan-default rates.

Medium-term prospects appear favorable for Hong Kong, given the outlook for solid and more stable growth in China and the encouraging prospects for regional and global economic expansion. With its record of sound macroeconomic management, flexible markets, and strategic location, Hong Kong is well positioned to maintain its status as a pre-eminent international financial center and to continue to benefit from China's rapid growth. ■

IMF Asia and Pacific Department

two currencies, two monetary systems, and two monetary authorities, under two different social and economic systems within a sovereign state.

International Monetary Relations and Prospects

Hong Kong will continue to maintain and develop its international monetary relations and participate in the activities of international and regional financial institutions. According to the provisions of the Joint Declaration and the Basic Law, Hong Kong may, on its own, maintain and develop economic, trading, and financial relations and conclude and implement agreements with other countries, regions, and relevant international organizations, using the name "Hong Kong, China."

Hong Kong's prosperity and stability, to a large extent, are attributable to China's economic growth. The Mainland of China and Hong Kong are each other's leading trade partner. During 1978–95, the volume of trade between the two rose from $1.4 billion to $126.6 billion a year, an increase of nearly eightyfold. Currently, Hong Kong is the largest external investor in the Mainland. From 1970 to 1996, total cumulative direct investment from Hong Kong reached $97.3 billion, accounting for 57 percent of total foreign direct investment [in the Mainland]. Also, of the 26 Chinese companies listed on overseas stock markets, 24 have their primary listing in Hong Kong.

China's sustained and rapid economic development will certainly create favorable conditions for Hong Kong's continued prosperity and stability. According to our Ninth Five-Year Plan, China's economy will continue to grow steadily after 1997. Hong Kong as an international financial center will become more and more important to China. It will become the most important funding center for China. Such a complementary and mutually reinforcing relationship between the Mainland of China and Hong Kong will certainly help to maintain and further strengthen Hong Kong's status as an international financial center.

Deputy Governor Chen Yuan

Globalization and Asia: Challenges for Regional Cooperation and Implications for Hong Kong

Following are excerpts of an address given by IMF Managing Director Michel Camdessus at a conference sponsored by the Hong Kong Monetary Authority and the IMF on financial integration in Asia and the role of Hong Kong, on March 7, in Hong Kong.

Hong Kong is an ideal location to discuss globalization, since many of the East Asian economies, and Hong Kong in particular, represent the essence of globalization—open, dynamic economies that continue to amaze the world with their rapid economic growth and development. Today's discussion takes place less than 120 days before the resumption of Chinese sovereignty—a historic event that highlights the benefits of combining further world economic integration and adaptation within a sound policy framework.

It is plain that globalization has changed Asia's role in the world. Less obvious, perhaps, are the changes that globalization is bringing about *within* Asia. Clearly, globalization has had a major impact on Asia's role in the world economy. As recently as a decade ago, the developing countries of Asia accounted for only one-sixth of world output. But with many countries in the region having followed sound domestic economic policies, mobilized large amounts of domestic savings, and attracted substantial private capital inflows, Asia—excluding Australia, Japan, and New Zealand—now accounts for about one-fourth of world GDP on purchasing-power-parity-adjusted terms. On this trend, the region could account for one-third of world output by the year 2005.

But what of the changes that globalization is bringing about within Asia? There is an ongoing transformation in the composition of production and trade as the comparative advantage of many Asian economies continues to change. In particular, economies with relatively high wage costs are shifting toward higher value-added products, including services.

Similar trends are also evident in the financial area. The continued growth in net private capital inflows to the region—to over $100 billion in 1995, or well over half of total private capital flows to developing countries—has been accompanied by a change in the composition of these flows. Between 1990 and 1995, foreign direct investment in the region increased more than fourfold. Portfolio investment flows have also risen dramatically and, in the process, have helped deepen domestic capital markets in Asia.

At the same time, financial flows within the region have become more significant. True, the developing countries of Asia still rely heavily on London and New York to intermediate foreign savings to the region. But Japan is, and is likely to remain, the world's largest exporter of capital, and the far-reaching reforms recently announced by the Japanese government are likely to enhance Tokyo's role as an international financial market. Moreover, Hong Kong and Singapore—with their well-capitalized banks, efficient clearing and settlement systems, and expanding range of financial products—have also emerged as major financial centers.

Challenges of Intra-Asian Integration

Increasing trade and financial sector integration—in the global economy and in the region—offers enormous potential benefits, but also poses new challenges for Asian countries. First, as these economies develop, their comparative advantages will continue to change, and these changes are likely to occur more rapidly in a globalized economy. Thus, efficiency and flexibility will become all the more important for continued economic success. Second, as trade and financial links within Asia intensify, developments in one economy will have a larger impact on the others. Accordingly, individual economies will have an increasing interest in the economic stability and prosperity of the others.

These considerations point to challenges in three related areas: trade, financial flows, and regional cooperation.

Trade. Although a number of countries in the region still have a way to go on trade liberalization, much of Asia's dynamism can be traced to the openness of its economies and to the competitiveness and transfer of technology that this openness has encouraged. Countries that have yet to open their economies significantly should do so, so that they too can reap these benefits. By the same token, countries that have already benefited from trade liberalization must ensure that the openness that has served them so well in the past is extended to the new trade frontiers, notably services. At the same time, it will be important to increase transparency and the free flow of information, on which the service and financial sectors—and, indeed, the modern economy—depend. And as production shifts to higher value-added products, countries will need to develop effective "exit" policies for noncompetitive industries.

These structural changes will inevitably require other adjustments, as well. To sustain growth, a number of countries will need to improve their infrastructure, especially in transportation, telecommunications, and power supply. The challenge will be to do all of this without unduly straining public finances or external positions.

Meanwhile, it will be important to ensure that regional trade initiatives are compatible with further global trade liberalization. In this regard, I am optimistic that Asia's emphasis on a cooperative approach to trade matters will complement and enhance the

global framework being developed through the World Trade Organization.

Financial Flows. At the domestic policy level, there is no substitute for stable macroeconomic policies—policies that give confidence to financial markets and attract private savings. Likewise, transparent and predictable regulatory policies and a reliable legal framework are essential ingredients in creating a favorable investment climate.

But the quickening pace of financial innovation and integration raises other challenges as well. The presence of large capital inflows reduces the room for policy maneuver and limits the scope for policy mistakes. Moreover, financial sector reforms and increased access to international markets expose domestic financial systems to new risks. In many countries, in Asia and elsewhere, prudential regulation and supervision have not kept pace with the new complexities of the banking business. If left unaddressed, this gap could pose dangers for domestic and external stability.

Asia also needs a stronger, more dynamic financial infrastructure that can handle the increasingly complex intermediation requirements of the region.

Regional Policy Coordination. With countries becoming more closely integrated, each country has an increasing stake in the sound policies of the others. Accordingly, countries of the region can play a constructive role in encouraging each other to maintain sound policies.

But clearly, there is a broader need to reduce risks in the global economy and to strengthen financial safety nets. Of course, whenever a country faces a difficult situation, whether the problem is of a short-term nature or a more fundamental disequilibrium, the IMF is ready to help with policy advice—and with financial assistance, if warranted. Toward this end, our strengthened surveillance leads us to give greater attention to capital account developments, the soundness of domestic banking systems, the quality and timeliness of data that countries release to the public, and other issues of particular relevance to emerging market economies, including those in Asia.

We are also taking steps to ensure that the IMF has the necessary resources to fulfill its mandate. In this regard, I welcome the participation of several Asian economies in the New Arrangements to Borrow, which will double the amount of [borrowed] resources available to the IMF to deal with exceptional situations that may threaten the international monetary system.

Implications for Hong Kong

Hong Kong is a prime example of an economy that has successfully managed rapid structural transformation in an increasingly integrated world economy. Its history, geographic location, openness to trade, and importance as a financial center all point to its critical interest in continued global integration—an interest that is shared in China, in the region, and in the rest of the world.

Several ingredients of its success give me confidence—not only in Hong Kong's future—but also in its increasing contribution to global integration and prosperity. These include:

- *long record of sound policies.* Hong Kong's prudent monetary policy has created an environment of macroeconomic stability and investor confidence. The Joint Declaration and Basic Law provide confidence that this policy framework will continue. Also, the arrangements for the Hong Kong Monetary Authority and the People's Bank of China to operate as two mutually independent, but cooperating, monetary authorities have been clearly established.

Camdessus: Asia needs a strong, dynamic financial infrastructure to handle the region's complex intermediation requirements.

In the IMF's annual review of Hong Kong's situation and prospects—completed only two weeks ago—the IMF Executive Board strongly endorsed this policy framework; I am pleased to confirm that these consultations will continue on a regular basis after the transfer of sovereignty.

- *flexible product and labor markets.*
- *open economy.* Hong Kong is one of the most open economies in the world. China is also moving toward greater openness. Prudence is in order in view of the complexity of the issues still to be resolved, but the Chinese authorities know quite well that the sooner China moves to fuller trade liberalization and creates the conditions allowing for the progressive liberalization of all capital transactions, the more it, too, will benefit from further globalization.
- *continuing development as a world financial center.* Hong Kong's prudential supervision is already of the highest standard; banks are highly capitalized; and official foreign exchange reserves are large by any standard. Thus, Hong Kong is well placed to deal with any pressures that may arise.
- *sound legal and administrative framework, neutral civil service, impartial judicial system, and freedom of information.* These principles have been and will remain critical to Hong Kong's economic success, and I salute the wisdom of the Chinese, U.K., and Hong Kong authorities for incorporating them into the Joint Declaration and the Basic Law.
- *continued economic development of the mainland.* The vast mainland market provides excellent trade and investment opportunities for Hong Kong, just as Hong Kong's own dynamism will provide further impetus for China's growth and development. ■

Bank Restructuring Strategy Should Be Linked To Macroeconomic Policy

Systemic bank restructuring is a multiyear process that typically encompasses an array of microeconomic, institutional, and regulatory measures. According to an internal IMF study, such programs have significant macroeconomic implications, not least because their fiscal costs are usually substantial. They also have significant implications for macroeconomic stability, as well as for monetary policy; the balance of payments; economic growth; the equity, efficiency, and transparency of public policy; and for the future functioning of financial markets. Over the last 15 years, more than thirty IMF member countries have undertaken systemic bank restructuring programs in response to banking crises and financial sector distress. The IMF study analyzes the elements of a successful restructuring strategy, based on the experiences of 24 of these countries

In cases of banking crises or financial distress, the problems first need to be assessed, key decisions about who will bear the losses made, and institutional responsibility assigned. As soon as systemic banking problems are recognized, comprehensive policies should be implemented to prevent further deterioration, minimize the cost of restructuring, and reduce the likelihood of a liquidity crisis.

Building a Strategy

A successful restructuring—that is, one that does not need to be repeated—requires not only financial restructuring but also operational restructuring of individual banks.

Assessment. To formulate a workable strategy and determine the instruments for achieving its goals, the authorities should assess both the financial and operational condition of individual banks and the problems of the overall banking system. The assessment should distinguish potentially viable banks that merit restructuring from nonviable banks that will have to be closed. An important lesson from the restructuring experience of several IMF member countries is that firm exit policies are an integral part of a successful strategy.

Allocating Losses. The losses of insolvent banks have already occurred by the time restructuring begins and should be distributed as transparently and as equitably as possible. Losses should first be charged against owners' capital to reinforce market incentives for remaining and future bank owners. Owners unwilling to put in additional capital to resuscitate an insolvent institution should be required to relinquish control to supervisors or liquidators.

Governments are generally excessively wary of imposing costs on depositors and other creditors for fear of political repercussions, disruption of the payments system, or general loss of confidence. For this reason, the public sector typically absorbs a large share of the accumulated banking losses, as well as most of the administrative costs of bank liquidation and bank restructuring. Equity considerations may also dictate that the government absorb losses that reflect or stem from government action, such as directed lending, grossly inadequate macroeconomic policies, or excessive support from the lender of last resort.

Strategy Design. Deficiencies in bank management and governance structures are important contributors to systemic banking problems. Operational restructuring of individual banks must therefore be an integral part of a systemic response. Extensive IMF experience with individual countries has shown that failure in this area is likely to lead to a recurrence of banking problems.

For the system as a whole, it is important that a legal and institutional framework promoting sound banking be in place, that supervision and prudential regulation are improved, and that the structure of the banking sector does not inhibit competition or profitability.

Achieving an early consensus on policy goals and broad principles about who will be responsible for planning and implementation will improve the efficiency of the strategy's execution and forestall coordination problems. The political commitment required to accomplish a restructuring implies that the overall strategy should be decided at a senior or ministerial level; but the details of implementation are best determined at the technical level.

Restructuring Instruments. Financial restructuring aims at restoring banks' solvency by improving their balance sheets and income statements, so as to provide an adequate level of capital, a capacity for sustainable earnings, and the flexibility to manage liquidity and control risk exposure. Country experiences indicate that instruments should be cost-effective and simple to implement and designed to distribute losses equitably and minimize the public sector burden. Finally, instruments chosen for bank restructuring should be consistent with sound macroeconomic management.

Macroeconomic Impact and Policy Responses

Systemic bank restructuring strategies will likely have substantial macroeconomic implications that will require a coordinated and significant policy response to ensure macroeconomic stability. But if tight macroeconomic policies are uncompromisingly pursued, they may aggravate solvency problems and ultimately raise the overall cost of bank restructuring. It may sometimes be necessary to consider stretching out the timetable for achieving macroeconomic objectives that may conflict with the restructuring strategy.

Fiscal Policy. Public sector financial assistance to the banking system tends to increase aggregate demand through its impact on interest spreads, private wealth, supply, and the extended money sector. Further, unless the fiscal stance is tightened in response to government assistance, the ratio of public debt to GDP will grow faster, or fall more slowly, over the medium term than envisaged before the financial assistance was extended, undermining the sustainability of public debt. Thus, any such assistance should be provided only in conjunction with a comprehensive restructuring plan that is consistent with macroeconomic stability, which will likely require substantial fiscal adjustment.

To determine the appropriate fiscal response, all types of assistance should be quantified and assessed in the context of a comprehensive medium-term macroeconomic framework. If the amount of fiscal consolidation required to attain a minimum level of macroeconomic stability is unacceptable or impractical, other options need to be examined, for example:

- adjusting the financing of government financial assistance operations to allow a more gradual fiscal adjustment;
- reducing the public sector's share of total restructuring costs by imposing greater costs on creditors; and
- narrowing the scope of the restructuring strategy by, for example, liquidating rather than recapitalizing some banks.

Monetary Policy. Increasingly, central banks have begun to state their primary monetary policy goals in terms of a single objective—such as attainment of price stability. When banking systems are unsound, the pursuit of primary objectives may require policies incompatible with those needed to support systemic restructuring. In particular, an unsound banking system acts as a constraint on monetary policy, limiting the scope to tighten liquidity and credit conditions and to raise interest rates. This constraint may persist into the systemic restructuring phase.

In some cases, a looser monetary policy compensated by a tighter fiscal policy would be conducive to bank restructuring. Thus, close coordination of monetary and fiscal policy becomes even more essential when banks are weak.

External Policy. Pressure on foreign reserves and the exchange rate is likely to increase strongly during periods of systemic bank distress or crises. A run against the financial intermediaries could generate a sudden demand for foreign exchange reserves, forcing a depreciation of the domestic currency; or an expected depreciation could trigger runs on banks, helping to fulfill expectations. Although no single policy prescription applies to all countries, a clear, credible policy response to restructure the banking system will reduce external pressures on the banking system and pave the way for normalization of capital flows in the balance of payments.

Role of the Central Bank. The central bank is well placed to play a key role in developing and monitoring the overall bank restructuring strategy. As the lender of last resort, it is often called upon to provide liquidity before and during restructuring. A major risk is that the temporary support often expands rapidly, and the central bank can be drawn into supporting banks that turn out to be insolvent. Responsibility for such support should be shifted to the government budget once the recipient bank's insolvency becomes apparent.

In most developing countries, however, the central bank or other public entities typically provide a large share of financing for restructuring programs. Such solvency support is analogous to providing direct monetary financing of the fiscal position. Central bank sup-

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port also makes it a stakeholder in the banks being rehabilitated, possibly creating conflicts with its responsibilities for supervision, monetary management, and its function as lender of last resort.

Transparency in Fiscal Recording

Government involvement in the financial restructuring of banks is likely to have substantial fiscal implications. The recording of government bank assistance operations should therefore be comprehensive, transparent, and consistent. Current recording practices, however, vary considerably across countries and exclude many important operations, such as quasi-fiscal operations (for instance, central bank extending credit to troubled banks) and noncash operations (for example, recapitalization via unrequited issuance of public debt to troubled banks).

To strengthen current practices in accounting for the fiscal impact of bank assistance operations, the introduction of an "augmented balance" to complement the overall fiscal balance would be valuable. The augmented balance would explicitly incorporate the major quantifiable fiscal costs of bank assistance operations not already included in current definitions of the overall balance and would be used alongside the overall balance—and other measures of the fiscal stance—in countries where bank assistance operations are important.

Managing Bad Assets

Abandonment of nonperforming assets (or performing assets of failed banks) increases the total cost of restructuring, creates an inequitable distribution of losses by rewarding defaulters, and impairs incentives for debt repayment in the future. Such assets need to be actively managed to maximize returns and maintain asset values in the economy; sometimes, liquidation is required, but loan or debtor restructuring may also be indicated. In some cases, banks may create their own loan workout units to manage problem loans, but many countries have opted for centralized asset management companies that are independently capitalized. The success of such efforts is critical for the ultimate success of any bank restructuring program.

Role of the IMF

The links between banking system restructuring programs and macroeconomic policy, as well as the potential for spillover effects in an environment of globalized financial markets, have made such programs an important issue for the IMF. Although the primary responsibility for monitoring and implementing banking standards and bank restructuring rests with the national authorities, the IMF can play an important role in alerting members to weaknesses in their banking systems and their legal and regulatory regimes and focusing on the macroeconomic implications of systemic bank restructuring strategies. ■

Transition Economies Need Health and Educational Reforms

Despite economic difficulties and strained financial resources, expenditures on health and education continue to rise in most transition countries at the expense of public investment and other expenditure categories, according to a new IMF Working Paper, *Health and Education Expenditures in Russia, the Baltic States and the Other Countries of the Former Soviet Union*, by Mark A. Horton. As a result, the health and education sectors in these countries have failed to absorb the brunt of fiscal adjustment up to now. At the same time, growing financial and administrative problems in these countries' health and educational sectors will require major improvements in the use of financial, administrative, and intellectual resources. The most basic changes need to include efforts to streamline sectoral planning, more clearly delineate operational responsibilities among governmental agencies, and replace physical production targets—so many beds, physicians, or teachers per person—with more market-oriented approaches to reaching health and education goals, according to Horton.

The Legacy

The collapse of the Soviet Union in 1990–91 left Russia, the Baltic states, and the other countries of the former U.S.S.R. with a health and education system in urgent need of reform. The core problems were attributable to an overemphasis on physical planning, weak price signals, and an absence of competition among service providers. This situation, in turn, led to serious shortages—from pharmaceuticals to pencils—and a visible deterioration of physical assets brought on by the collapse of secondary services (for example, school and hospital maintenance).

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
February 24	3.90	3.90	4.27
March 3	3.96	3.96	4.33

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (the U.S. dollar, weighted 39 percent; deutsche mark, 21 percent; Japanese yen, 18 percent; French franc, 11 percent; and U.K. pound, 11 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 109.4 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171.
Data: IMF Treasurer's Department

The old system did achieve some important goals. During the Soviet era, the health and educational sectors registered major breakthroughs in abolishing some childhood diseases and providing universal education to a multiethnic population. But over the past decade, these advances have been undermined—if not reversed—by poor decisions on how financial resources are used and widespread administrative mismanagement. These are hobbling efforts to reform an overly centralized and increasingly obsolete public health and educational system.

Russian elementary school pupils. Russia's educational spending has increased, but more efficient and market-oriented approaches are needed.

Faced with an emerging crisis, the authorities in most of the transition countries have chosen to buy time rather than act. Efforts to reduce spending and administrative overhead, for example, have been subordinated to full employment policies, according to Horton. Indeed, the very stability, or growth, of employment in the health and education sectors throughout the region indicates that financial restructuring and improvements in the provision of services have yet to occur.

Traditional spending priorities in the health and education sectors remain largely unchanged. A recent World Bank study on Kazakstan, for example, notes that despite economic difficulties, spending on vocational education rose to 14.3 percent of total outlays in the education sector in 1994 from 12.7 percent in 1992—even though such training is frequently considered too narrow and expensive, compared with the costs of general education and the changing structure of the economy. At the same time, spending on primary and secondary health services in Kazakstan has lost out as the government continues to fully fund the operations of highly specialized research institutions. Similarly, in Moldova, training and materials accounted for a modest 1 percent of total education spending in 1995. And while funding for preventive health care has been squeezed, Moldovan outlays for hospital care reached 85 percent of total health spending in 1995—compared with 55 percent in France and 45 percent in Germany.

Disincentives play an important role in frustrating education and health reform in many transition countries. Because firms are not allowed to retain savings, for example, administrators have little reason to reduce or use existing capacity in the most cost-effective manner. As a result, the inherent bias within most adjustment programs rewards cost-cutting efforts that end up lowering the quality of output—maintaining the number of hospital beds even as nursing personnel are reduced—when such resources would be better used to purchase higher quality medicines and newer textbooks. And throughout the area, energy expenditures have increased while modernization and streamlining of the underlying physical capacity have been postponed.

Transitional Policies

Throughout the transition period of the early-to-mid-1990s, a relatively constant or increasing share of total public expenditures was devoted to health and education in most countries of the former Soviet Union. With the exception of Georgia, which experienced extreme macroeconomic and fiscal shocks and severe civil strife, health and education expenditures rose as a percent of total expenditures in these countries. Between 1992 and 1995, health and education expenditures attracted a growing share of total spending in Belarus, Kazakstan, Moldova, Russia, Tajikistan, and Ukraine, while in the other transition countries for which data are available, these expenditures have remained stable.

Real expenditures have also increased across the board—with substantial jumps recorded in Estonia, Latvia, and the Kyrgyz Republic. In the Kyrgyz Republic, for example, real spending rose by nearly 15 percent during 1993–95—in the face of a 35 percent fall in total government expenditure. Likewise in Latvia, health care spending rose by more than 20 percent in real terms in 1995.

Editor's Note: With this issue, we introduce a new design for the *IMF Survey*. The redesign is aimed at greater visual appeal and readability, while reflecting the publication's timeliness and vitality.

Health and Education Expenditures in Selected Transition Economies

	1992	1993	1994	1995	Ratio[1]
	(Percent of total general government expenditures)				
Armenia	...	11.4	4.8	9.7	84.8
Azerbaijan	...	...	...	15.5	...
Belarus	19.3	17.9	22.0	22.7	117.2
Estonia	29.7	32.5	32.1	...	108.2
Georgia	15.1	3.3	1.3	10.9	72.6
Kazakstan	18.2	30.0	25.5	25.3	139.4
Kyrgyz Republic	...	16.8	29.6	30.7	182.0
Latvia	...	28.6	26.3	26.9	93.9
Lithuania	...	25.9	25.5	25.8	99.6
Moldova	31.1	32.3	39.4	34.9	112.4
Russia	13.2	18.0	19.2	19.6	148.3
Tajikistan	25.7	23.9	27.0	46.3	180.2
Turkmenistan	...	...	27.7	20.3	73.3
Ukraine	18.0	15.1	19.4	23.7	132.0
Uzbekistan	29.9	25.0	32.1	28.3	94.5

[1]Final year to initial year.

Data: National authorities; IMF staff estimates; and IMF, *Government Finance Statistics Yearbook*

Employment in health and education has been maintained throughout the region, despite a substantial decrease in real resources. In Azerbaijan, Belarus, Estonia, Russia, Turkmenistan, and Uzbekistan, employment in the health and education sectors has actually increased. In Armenia, Georgia, Kazakstan, the Kyrgyz Republic, Latvia, Moldova, and Ukraine, health and education staffing cuts have been relatively modest. Excessive capacity and overstaffing can be seen from various ratios. For example, in 1994 Kazakstan had 8.8 students per teacher, while Moldova had 13 students per teacher in 1995. Comparable ratios in Germany, Turkey, and the United Kingdom were 17:1, 29:1, and 20:1, respectively

Wage trends provide a more complex picture. While average compensation remained broadly unchanged in most of these countries, real wages decreased. In some instances—such as Azerbaijan, Armenia, and Georgia—the drop was largely a result of civil strife. But even where declines have been more modest, relative compensation in the health and education sectors has remained low—a direct result of government efforts to halt the rise in unemployment by postponing long-term efforts to reduce administrative overlap and close or consolidate administrative activities. In those instances where the authorities have taken steps to reduce operating costs by cutting jobs, resulting layoffs are largely confined to maintenance staff or suppliers. In certain instances, wages have been lowered further to pay for higher electric and gas bills, even while underlying physical capacity remains intact.

Inevitability of Reform

Economic and political pressures cannot justify delays in reform indefinitely, concludes the IMF paper. While the scope for net expenditure savings may be limited by the need for investment, maintenance, and supplies, and higher wages to attract the most skilled workers, far-reaching changes must still be undertaken. The future viability of the educational and health systems throughout the countries in transition will demand steps to employ scarce resources more efficiently. Improvements in service quality may even result in net expenditure savings if the authorities are prepared to implement serious cost-saving measures, including reductions in excess physical capacity. A full-employment policy based on low wages is not a viable solution to the educational and health challenges facing transition countries. Fiscal pressures will continue to increase until major deficiencies in management, planning, and financing are corrected.

A viable reform strategy will require:

- promoting substantial investments in updated curricular materials and textbooks and a major upgrade of skills in the teaching and medical professions, including more advanced technology;
- accelerating efforts to train and employ larger numbers of highly skilled workers for jobs in the emerging service and high-technology sectors;
- streamlining sectoral planning and operating responsibilities among economic ministries, sectoral ministries, specialized agencies, research institutions, and local governments;
- replacing physical norms—based on inputs, such as teachers per person or regional square meters of hospital space—with more flexible techniques that place greater reliance on local and regional needs;
- supporting policies that encourage a larger private sector role in the provision of educational and health services; and
- increasing prices on gas and electricity to world market levels in energy-rich transition countries to generate sufficient revenues for health and education.

Copies of IMF Working Paper 96/126, *Health and Education Expenditures in Russia, the Baltic States, and the Other Countries of the Former Soviet Union*, by Mark A. Horton, are available for $7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

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Inflation-Indexed Bonds Attract Growing Interest

Following is an updated analysis that was featured in the October 1996 edition of the IMF's World Economic Outlook. *The analysis appears as part of IMF Working Paper 97/12,* The Rationale and Design of Inflation-Indexed Bonds, *by Robert Price.*

Although inflation-indexed bonds have been advocated by many economists as a useful tool for debt management and monetary policy, indexed bonds remain relatively uncommon. A belief that indexation is in general likely to perpetuate inflation—for example, through wage-price spirals or effects on expectations, and through subsequent pressures for accommodation by monetary authorities—is a major reason governments have been reluctant to offer them. The experience of countries that adopted comprehensive indexation beginning in the 1960s and 1970s bolstered this view. Examples include Argentina, Brazil, Chile, Colombia, and Israel. In these cases, indexation was seen as a way to cope with inflation, and indexation of financial markets, in particular, as an expedient to promote domestic saving and capital formation. By the 1980s, however, inflation performance in a number of these countries had deteriorated, in some cases to the point of hyperinflation, and a number have since taken steps to reduce the scope of indexation. Since the early 1980s, many industrial countries have also abolished wage indexation, which was widely perceived to have contributed to the escalation of inflation in the 1970s.

Advocates of the indexation of government debt instruments argue that it removes the incentive to inflate. Attempts to reduce real debt burdens by generating unanticipated inflation are self-defeating when government liabilities are indexed. Governments therefore are more likely to focus on reasonable price stability as the appropriate monetary policy objective. Indexed bonds may thus enhance monetary policy credibility and in so doing reduce funding costs by the amount of the inflation risk premium incorporated in conventional bonds. Advocates point out that indexation in itself does not foster inflation. Monetary and fiscal policies are at the root of inflation, regardless of indexation; any potential inflationary effects of indexing that occur can be countered by monetary and fiscal policy actions. Advocates generally do not argue for indexing the entire government debt, since there is still a public demand for nominal debt.

Beginning in the early 1980s, a new group of issuers in the industrial countries, led by the United Kingdom in 1981 and followed by Australia, Canada, New Zealand, and Sweden, began issuing indexed bonds and integrated them into existing debt-management programs. In these countries, indexed bonds now trade alongside nominal bonds, albeit in much smaller volumes. The introduction of indexed bonds was justified chiefly on the basis of savings in debt-service costs, the development of capital markets and the promotion of saving, and benefits to the implementation and credibility of monetary policy. The United States began offering indexed bonds in January 1997, for similar reasons.

The nominal return on indexed bonds includes a real return plus compensation for the ex post erosion of purchasing power; the nominal return on conventional bonds comprises the same expected or required real rate of return plus compensation for expected inflation and an inflation risk premium. While the real return on an indexed bond is assured at the time of purchase, the nominal return is uncertain; for nominal bonds, the nominal return is certain, while the real return is uncertain. In principle, indexed bond payments could be tied to any inflation-related index, including a consumer price index, a wage index, or an exchange rate index. In practice, most issues have been tied to a broad index of domestic prices, typically the consumer price index. Such indices are widely disseminated and understood, available with a short lag, and rarely revised. A drawback, however, is that consumer price indexes typically overstate true inflation because of measurement biases.

Indexed bonds are used as a debt-management tool by industrial countries.

Indexed bonds can be viewed as a public good with a potential to improve economic welfare. By providing such instruments, governments can fill a void in financial markets, offering securities free from both credit risk and purchasing power risk. Other assets, such as real estate, equities, and commodities—once thought to be good inflation hedges—have proven not to be so when measured by the past correlation of returns on inflation. Indexed bonds can also provide a form of purchasing power insurance to investors. Buyers will be likely to be willing to pay a premium (in the form of a smaller return than on nominal bonds) in return for shifting the burden of inflation risk to the issuer. The government's borrowing costs will then decline by the amount of the inflation risk premium, which is absorbed by the issuer. A government issuer, however, may be neutral to inflation risk, for example, because its real budget position is less affected by inflation, or perhaps because it exerts some control over the inflation outcome.

Indexed bonds may also promote financial savings. Where inflation is high or volatile, such bonds may be the most promising vehicle for encouraging domestic financial savings, compared with real or foreign asset accumulation. By extension, they may help to foster the growth of domestic capital markets. Because unantici-

pated inflation entails unintended transfers of wealth from lenders to borrowers, indexed bonds have also been promoted on purely distributional grounds, especially because some lenders—such as pensioners or near-retirees—are often presumed to be disadvantaged and less able to protect themselves from inflation.

Indexed bonds will provide cheaper financing than nominal bonds, especially if lenders overestimate future inflation. Thus, if inflation expectations are to a large extent backward looking, indexation will be particularly attractive to a government that is confident of reducing inflation. During the 1970s, when markets consistently underestimated inflation and real returns on bonds in many countries were negative, borrowers were better off issuing nominal debt since the real value of this debt was eroded by inflation. Governments gained from the inflation tax. By the 1980s, however, when nominal and real interest rates in many countries were stubbornly high and inflation expectations were slow to fall, governments would have profited by switching to indexed debt. But while the public's inflation expectations may well be wrong from time to time, systematic errors are unlikely to persist for long periods. It is more likely that such forecasting errors cancel out over the long run. Nonetheless, the perception that inflation expectations were excessive was one reason indexed bonds were introduced in the United Kingdom and recently reintroduced in New Zealand. In both cases, the authorities cited a lack of credibility in their inflation-fighting policies.

Another debt management argument is that a treasury would stabilize its real debt-servicing costs by issuing indexed debt, better matching government tax revenues, which tend to move in line with inflation. Issuers would also achieve a more predictable pattern of real cash outflows. The result would be a more predictable overall real budgetary position.

Indexed bonds can also provide useful information on inflation expectations and real interest rates, aiding the implementation of monetary policy and providing evidence on its credibility. Real yields are quoted directly on indexed bonds, and the spread between nominal and indexed bond yields provides a readily available measure of the market's inflation expectations. Several problems have been identified with such measures, however. First, the existence of an unobserved inflation risk factor and a possible liquidity premium on indexed bonds (the latter because issues are relatively small and trade infrequently) makes disentangling the pure expectations component difficult. Furthermore, lags in the application of the index and possible differences in tax treatment between the two types of bonds distort the information content on inflation expectations. Notwithstanding these drawbacks, alternative measures of inflation expectations through sampling techniques or models are likely to prove costlier, less accurate, less timely, and more difficult to interpret than information provided through indexed bonds.

The growing use of inflation-indexed bonds as a debt management tool by industrial countries attests to several of their possible benefits. These include lower borrowing costs through the capture of the inflation risk premium to investors who value this form of insurance, and providing a measure of inflation expectations useful in implementing monetary policy. Indexed bonds may also encourage financial savings, particularly in developing countries and economies in transition, through the completion and deepening of capital markets. ■

Copies of IMF Working Paper 97/12, *The Rationale and Design of Inflation-Indexed Bonds*, by Robert Price, are available for $7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

Ukraine Moves to a Market Economy

Ukraine's economy has undergone a massive restructuring as a result of a major macroeconomic stabilization program implemented over the past two years. Inflation, which had reached more than 10,000 percent in 1993, has fallen sharply and a new currency has been introduced. The economy continues to contract, however, despite the huge potential of the country's agricultural and industrial sectors. The Ukrainian leadership now faces the challenge of reviving output so that the reform program can be pursued and the population convinced of the long-term benefits of its current sacrifices.

In response to this challenge, the IMF and the World Bank held a joint seminar in July 1996, bringing together government officials, academics, and staff members of international organizations to discuss a medium-term strategy for Ukraine (see *IMF Survey*, August 12, 1996, page 267). The aim of the seminar was for IMF and World Bank staff—along with outside experts—to present policy prescriptions that could form the basis for an economic program for Ukraine, to be supported by IMF and World Bank loans. The papers presented at this seminar have been compiled into a volume, *Ukraine: Accelerating the Transition to Market*. The papers cover the medium-term macroeconomic framework; wages, poverty, and social safety net reform; private sector development; trade policies and sectoral reforms; and good governance and the effects of corruption.

Copies of *Ukraine: Accelerating the Transition to Market*, edited by Peter K. Cornelius and Patrick Lenain, are available for $23.50 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

Toward a More Efficient CPI Measure

(Continued from front page) each shop. This sampling within shop increases the costs of data collection substantially. Armknecht observes that significant efficiencies can be achieved by sharing statistical information from the detailed records of the U.S. censuses of business enterprises and the census of population and housing. Such data sharing between the Bureau of Labor Statistics and the Bureau of the Census for statistical purposes is currently prohibited by U.S. legislation on grounds of confidentiality. Additional information from private market research firms on product sales by universal product code is also available and could be used to select national and regional samples of items. The use of these types of samples would also enable the development of price indexes for spatial (interarea) comparisons. These are not currently available because the CPI for each geographic area has a different market basket, and the index level only represents the price change from the base period in that specific area. The selection of a national market basket that could be used in all geographic areas would facilitate cross-area comparisons.

According to the Boskin Commission report, the most important factors contributing to the overstatement of inflation are the treatment of quality improvements to existing products and the introduction of new goods and services not captured by the CPI. Armknecht discusses the current procedures used in the CPI for making quality adjustments and introducing new products and offers recommendations for improvements. These include procedures for identifying new products as they emerge in the marketplace and for introducing them into the sample of items more rapidly. In addition, Armknecht recommends that the Bureau of Labor Statistics and academic researchers pursue more empirical model-based research on estimating quality effects on a product-by-product basis.

Implementing some of Armknecht's recommendations would involve changes in statistical policy. First, access to detailed information from the population and economic censuses would have to be assured and, second, the Bureau of Labor Statistics would need to update the CPI on an annual or biannual basis to introduce new weights. The use of an improved formula would also require the revision of several years of data when the weights are updated. ■

Copies of IMF Working Paper 96/103, *Improving the Efficiency of the U.S. CPI*, by Paul Armknecht, are available for $7.00 from Publication Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

Camdessus Sees Scope for India to Achieve Asian "Tiger" Status

IMF Managing Director Michel Camdessus recently concluded a brief visit to India, in the wake of India's announcement of its fiscal budget for 1997/98 and in part to assess the impact of economic reforms launched in 1991. Camdessus issued the following statement to the press on March 5.

I have been impressed by the changes that have taken place in India over the five years since I was last here. Recent growth rates averaging 7 percent, buoyant domestic saving and investment, and the strong external position stand as testimony to the depth and success of the government's reform program. Industrial deregulation has helped create a thriving private sector, while trade liberalization and an opening up to foreign investment have integrated India more full into today's rapidly evolving global economy.

Today, India is at a crucial crossroads. The strong performance of the past few years and the favorable external environment provide a unique opportunity for India to accelerate its growth to the rates seen in the Asian "tigers" and to make major inroads in reducing poverty. But India needs to act now to ensure it, too, reaps the full rewards from the globalization process. As we have seen in the East Asian economies, the potential benefits can be enormous: the expansion of savings to finance critical investment, improved efficiency from greater competition, and the spillovers of technology can all contribute to raise significantly living standards for all of India's population.

India needs to act now to ensure it reaps the full rewards of globalization.

To enable India to move on to a permanently higher growth path, I see two main tasks ahead. The first is to tackle the still-high fiscal deficit, and the second is to launch a second wave of structural reforms. Boldness is needed as the recent slowdown in industrial production and trade illustrates the risks of adopting too-gradual an approach. Let us take these two tasks in turn: consolidation of public sector finances and structural reforms (see also story beginning on page 79).

Consolidation of Public Sector Finances

Fiscal consolidation is central to achieving sustained high growth. Fiscal adjustment will help bring down the high interest rates that threaten to choke off growth. It will also further raise the economy's saving rate, which is necessary to finance India's growing investment requirements and its pressing infrastructure needs. However, fiscal adjustment has to be well designed. For instance, it is important to ensure that the tax base is broadened so that the burden of additional taxation is more widely shared, while unproductive spending has to be curtailed to make room for the social programs that foster human capital development and protect the poor.

The budget announced a few days ago is a significant move in the right direction. It aims at a deficit that represents progress toward the government's objective of lowering the budget deficit to below 4 percent of GDP in 1998/99. Ending automatic monetization of the deficit adds to the credibility of fiscal adjustment as well as of monetary policy and the commitment to bring down inflation. The tax proposals also constitute a major step forward with tax reform, although they entail a risk that requires a willingness to take corrective measures if lower taxes result in a revenue shortfall.

It is now important to make further progress through greater expenditure prioritization, which should include civil service reform and measures to reduce the subsidy bill. In addition, fiscal adjustment has to extend beyond the central government level. State governments must also adjust. The emphasis placed in the government's Common Minimum Program on reviewing center-state fiscal relations is therefore welcome. The challenge is to endow states with greater autonomy and increased access to resources while providing appropriate incentives for good fiscal behavior.

Structural Reforms

In light of the most successful recent experiences around the world, a second wave of structural reform is of the essence if India is to achieve sustainable high-quality growth. You recall that the first wave of structural reforms was decisive, achieving results beyond initial expectations. Now, a similar effect can be produced by fostering, through a reform program, labor-intensive, export-led growth. In recent months, several steps have been adopted, particularly in the areas of foreign investment and infrastructure development. These are welcome and promising. However, the government should now seize the opportunity to provide a framework and a timetable for further reform. This could be followed by the following concrete measures:

Further liberalize trade and finance, and, in particular, remove quantitative restrictions on consumer goods. Progress toward capital account convertibility, as announced, is the natural complement and decisive factor in the full integration of India into the globalized world economy.

Accelerate the pace of financial sector reform, the broad agenda being:

• take further steps toward a more independent central bank in setting interest rates;

• introduce more competition in the banking sector;

• open up the banking and insurance sectors even more; and

• develop a long-term debt market.

Enterprise reforms, the main elements being:

• speed up privatization;

• undertake public enterprise reform to improve management through competition;

• modernize the legislative framework (for example, commercial law);

• reform procedures for the closure of firms;

• help redeploy surplus labor to those production sectors that are expanding and competitive; and, last but not least;

• facilitate private sector participation in developing the infrastructure.

There is nothing new in these measures. We have discussed them with the Indian authorities and they constitute part of our ongoing dialogue. ■

Nongold Reserves Rose in 1996

Developing country nongold reserves increased by 16 percent in 1996 to SDR 536 billion ($742.3 billion) at the end of the year, while reserves of industrial countries rose to SDR 548.8 billion ($760.1 billion), according to data in the March issue of *International Financial Statistics.*

All of the developing country regions experienced increases in their nongold reserves in 1996. The Western Hemisphere region recorded the largest increase in reserves, to SDR 107.5 billion ($148.9 billion); within the region, Brazil and Mexico experienced the largest gains. African developing countries also experienced a large gain, to SDR 20.4 billion ($28.3 billion); within the region, reserve levels in both Algeria and Kenya more than doubled.

Among the industrial countries reporting data, Canada's reserves rose sharply to SDR 14.2 billion ($19.7 billion), while Italy recorded a similarly large increase, to SDR 32 billion ($44.3 billion). The United States recorded a reserves decline during 1996 to SDR 44.6 billion ($61.8 billion) at year end.

At the end of 1996, IMF members' nongold reserves consisted of: foreign exchange, 94.8 percent; SDRs, 1.7 percent; and reserve positions in the IMF, 3.5 percent. These proportions were largely unchanged from a year earlier.

India's Prospects for Strong Growth Tied to Higher Savings

If India is to raise its per capita income and keep pace with the high-growth economies of Asia, its authorities believe that it must sustain GDP growth rates of at least 7 percent over the coming decade. To achieve this goal without relying heavily on foreign borrowing, domestic saving rates must rise. In the 1990s, however, the country's traditionally high saving rates have been volatile and, in some years, have declined.

What constellation of policies can boost India's domestic saving rate? Recent empirical evidence casts doubt on the ability of more direct policy measures—namely, tax incentives and higher interest rates—to influence saving rates substantially. What holds great promise, suggests Martin Mühleisen in an IMF Working Paper entitled *Improving India's Saving Performance*, is increased public saving together with strong structural reform, notably financial liberalization. These steps—with particular attention to promoting long-term savings—would stimulate the virtuous growth-saving cycle that India needs to achieve and sustain high growth rates.

Background

Over the past four decades India's comparatively high domestic saving rate has followed an upward, but uneven, course. In the 1990s, saving rates have been volatile—reaching a record of 23½ percent in fiscal 1990/91, and then dropping 2½ points before rebounding to 25½ percent in 1995/96. Fluctuations in the overall rate have been accompanied by substantial changes in composition. Recent increases have been driven by financial household saving, while public saving weakened to a low of ½ percent of GDP in 1993/94 from 4–5 percent in the early 1980s.

Mühleisen highlights the crucial relationship between growth and saving. Evidence from other countries suggests that higher growth tends to precede increased saving. His analysis, while noting the weaknesses inherent in the database, points to a similar relationship between per capita GDP growth and public and private saving in India. His findings also indicate that a high age dependency ratio—that is, the percent of retirees to working age population—will translate into an increased need for retirement saving. Also, as the Indian economy moves away from subsistence levels and as its financial sector deepens and affords investors a more attractive array of investment options, saving rates are expected to increase.

Over the medium term, Mühleisen projects a gradual rise in India's domestic saving rate. Assuming that the government succeeds in reducing the central government deficit to 4 percent of GDP by 2000, public saving should rise to about 3 percent of GDP early in the next decade. With the private saving rate averaging 23½ percent of GDP, an overall rate of 26½ percent of GDP is anticipated by 2000/01. In itself, such an increase would be insufficient, cautions Mühleisen. In the absence of accelerated fiscal adjustment and strong structural reform, India's domestic saving rate would need to rise to around 30 percent by the turn of the century to sustain 7 percent growth rates.

Strategy for Higher Saving

To avoid heavy recourse to foreign borrowing, India will require higher domestic saving to finance its ambitious growth target. Research elsewhere suggests that direct tax or interest rate incentives are not correlated with a substantive rise in saving rates. The relatively small percentage of Indian households that pay income taxes and the relatively high percentage of income absorbed by subsistence needs make it particularly doubtful that these incentives offer the best means to dramatically alter India's saving behavior.

A more indirect and effective strategy, suggests a growing number of cross-country studies, is the pursuit of a virtuous growth-saving cycle underpinned by fiscal consolidation and strong structural reforms. India's past experience seems to bear out the need for a strong saving rate bolstered by pertinent financial sector reforms. Inefficient investment, in part resulting from the dominance of the public sector in the economy, has hamstrung efforts to translate comparatively high saving rates into high growth. This pattern can be broken, argues Mühleisen, through determined fiscal consolidation and strong structural reforms that emphasize privatization and financial liberalization.

Initial growth will need to be financed by higher public saving, according to Mühleisen. Private saving would eventually provide the bulk of the additional investment financing, but this would follow with a lag and in response to stronger growth. Reforms of long-term saving instruments would play a key role in financial liberalization and would help ensure the effective allocation of private savings.

India: Developments in Public Saving
(Percent of GDP)

	1980/81	1992/93	1993/94	1994/95	1995/96	1996/97
Net public saving[1]	−5.3	−7.4	−8.1	−7.1	. . .	. . .
Public saving	3.4	1.5	0.5	1.7	. . .	. . .
Public investment	8.7	8.9	8.6	8.8	. . .	. . .
Balance on current operations						
Central government	−1.5	−2.6	−4.1	−3.3	−3.1	−2.5[2]
State governments	1.1	−0.7	−0.5	−0.7	−0.8	−0.8[2]

[1]Including central and state governments, and public enterprises.
[2]Budget figures.

Data: Indian authorities

Public Saving. India's public saving rate has been in steady decline over the past two decades at both the central government and state levels. While this trend has been partly reversed since 1993/94, restoring public saving to early 1980s levels requires bold action in tax policy, expenditure management, center-state relations, and public enterprise reform, says Mühleisen. A broader tax base, coupled with more productive expenditures, would help reduce current account deficits at both the center and state levels. Hardening budget constraints on state budgets would prompt the sale or closure of inefficient public enterprises and allow privatization receipts to be applied toward retiring public debt and thus allow a reduction in interest costs.

Higher public saving normally depresses private saving. For India, this effect has been found to be relatively small, with an offset factor possibly as low as 25 percent. In the short run, however, Mühleisen estimates that a 1 percent increase in the tax-to-GDP ratio could produce a 0.6 percent decline in private saving, because fiscal consolidation would be achieved partially through higher taxation with a consequent dip in disposable income.

Private Saving. Strong structural reforms can increase allocative efficiency and enhance productivity, indirectly spurring higher private saving. While reform efforts should include broad measures—such as restructuring and privatizing public enterprises, increased private involvement in infrastructure, agricultural reforms, and labor market reforms—financial reform would need to be the focal point of efforts to raise India's saving rate.

Financial sector reform offers a potentially large payoff and is particularly critical for investment in infrastructure. Despite India's burgeoning needs, infrastructure investment has declined in recent years and its underfinancing increasingly poses an obstacle to more rapid growth. An official commission looking into India's infrastructure needs cited a lack of long-term financing as the principal hindrance to investment and termed the development of domestic debt markets and the effective use of long-term savings as urgent priorities.

Unlike many countries, India has seen the share of its major long-term household saving instruments—principally pensions and life insurance—stagnate over the past 30 years. Mutual funds, which flourished briefly after the sector was opened to private sector competition, have not yet regained momentum since a stock market crash in 1992. These developments, Mühleisen observes, reflect two fundamental weaknesses: India's markets are still heavily dominated by the public sector (large life insurance, pension, and mutual fund institutions account for about one-third of total financial saving and encounter little competition in their respective sectors) and the allocation of portfolios is heavily regulated, with resulting low returns and little flexibility to react to market developments.

These weaknesses have left India's long-term saving instruments badly positioned to compete with more lucrative alternatives, notably shorter-term bank deposits and corporate paper. If India is to sustain an increase in long-term saving, it must give market participants greater flexibility in portfolio allocation and rely on private sector involvement to boost competition and develop more innovative products. More competitive and flexible instruments for pension, life insurance, and mutual fund investments would stimulate longer-term saving, while simultaneously improving the allocation of savings and ensuring that funds flow to the most productive investments. Increased investment efficiency could provide a catalyst for ensuring more dynamic growth and a faster accumulation of savings, according to Mühleisen.

Ultimately, Mühleisen concludes, India's most promising route to sustained high growth is the creation of a virtuous growth-saving cycle through public saving and structural reform. The resulting growth response would stimulate private saving, particularly through instruments of long-term saving. A sustained increase in long-term saving would, of course, require two major policy changes: the government would need to move away from relying on the captive financing now provided by public-sector-run pension funds and life insurance, and greater participation of the private sector would be needed to boost competition and introduce more innovative products. ■

Copies of IMF Working Paper 97/4, *Improving India's Saving Performance*, by Martin Mühleisen, are available for $7.00 from Publications Services, Box XS700, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org

IMF Survey:
25th Anniversary Year

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