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Joint communiqué

Camdessus and Russian leaders agree on key elements of economic program

IMF Managing Director Michel Camdessus visited Moscow from March 27 to March 29 and met with Russian Prime Minister Yevgeny Primakov and other senior officials. On March 29, Camdessus and Primakov issued a joint communiqué, the text of which follows.

Russian Prime Minister Yevgeny Primakov (left) and IMF Managing Director Michel Camdessus meet in Moscow.

The parties have agreed on a primary budget surplus of 2 percent of GDP to be realized in 1999 and most of the measures needed to achieve it. They also agreed on the other key elements of the program of the government and the central bank of Russia for 1999 and beyond. Mr. Camdessus has reaffirmed that the IMF will continue its constructive cooperation with Russia. The Russian side has expressed its intention to continue its cooperation with the IMF.

Agreement has been reached about the dispatch next week to Moscow of a full-scale IMF mission to work out, as soon as possible, with the government and the central bank of Russia an agreed statement on an economic policy program, which will then be submitted—in accordance with the IMF Articles of Agreement—to the Executive Board of the IMF for approval and will provide the basis for an extension of IMF financial support to Russia. ■

$4.9 billion credit

IMF approves credit disbursement for Brazil to support revised adjustment measures

On March 30, IMF First Deputy Managing Director Stanley Fischer announced that the IMF Executive Board, in support of the Brazilian government's revised economic program, had approved the completion of the first and second reviews under Brazil's Stand-By Arrangement. Following is the text of News Brief 99/14.

"Brazil may now borrow a further SDR 3.6 billion ($4.9 billion), which would bring its total borrowings from the IMF under the program to SDR 7.1 billion ($9.6 billion). The authorities also expect to draw $4.9 billion under a facility arranged by the Bank for International Settlements and a loan from the government of Japan. External financing prospects have further improved as a result of recent or expected disbursements under special programs from the World Bank and the Inter-American Development Bank and the commitment made by Brazil's major private bank creditors to maintain their exposure to Brazil," Fischer stated.

Brazil's economic program was revised following the devaluation in mid-January 1999. The two pillars of the revised program are strengthened fiscal adjustment, and the replacement of the exchange rate as the nominal anchor of the system by a monetary policy targeted at inflation. The informal inflation-targeting framework to be followed during the next few months will have the goal of preventing the first-round price-level effects of the devaluation from generating sustained inflation. A more formal inflation-targeting framework will *(Please turn to the following page)*

IMF Executive Board approves credit for Indonesia. See page 98.

Brazil to receive further support for revised economic program

(Continued from front page) be adopted later in the year once the necessary groundwork has been put in place.

Fiscal policy aims to reduce the ratio of net public debt to GDP to below 45 percent by the end of 2000, 2 percentage points lower than originally targeted. To this end, the revised program embodies more ambitious targets for the public sector's primary balance. In addition, real interest rates are likely to be significantly lower in 1999 than was expected before the devaluation. More than half of the projected increase in the primary balance is at the federal government level. Virtually all the program's revenue measures are either already in place or have been passed by the Brazilian congress and will be implemented in the next months as planned.

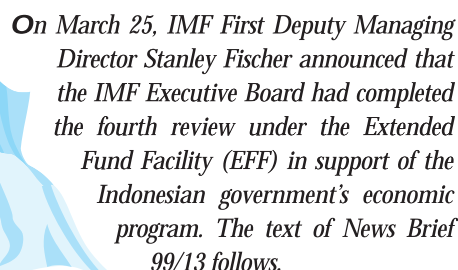
The original program's comprehensive structural reform agenda—in such areas as social security, civil service reform, tax policy, budgetary procedures, and fiscal transparency—has been enhanced. The government is also proceeding with its substantial privatization program.

Although real GDP is now projected to decline in 1999 by more than previously expected, economic activity should begin to pick up in the course of the year on the strength of the expected increase in exports and the decline in interest rates. The balance of payments should also improve, as capital inflows recover and Brazil capitalizes on its improved competitiveness. The government intends to cushion the impact of the decline in activity on the poor and vulnerable by safeguarding well-targeted social programs from budget cuts.

Fischer commended the Brazilian authorities for the recent strengthening of policies and welcomed both the commitment of the commercial banks to maintain their exposures to Brazil and the improvement of market sentiment. He emphasized that the firm implementation of the economic program remains the key to its success. ■

$1 billion augmentation

IMF augments support for Indonesia, approves release of new credits



On March 25, IMF First Deputy Managing Director Stanley Fischer announced that the IMF Executive Board had completed the fourth review under the Extended Fund Facility (EFF) in support of the Indonesian government's economic program. The text of News Brief 99/13 follows.

"The IMF's Executive Board approved the completion of the fourth review [see News Brief No. 98/31, *IMF Survey*, August 31, 1998, page 269], augmentation of the program by SDR 714 million (about $1 billion), and release of the next SDR 337 million (about $460 million) credit tranche. Including this release, total purchases by Indonesia since the onset of the Asian crisis will amount to SDR 6.8 billion (about $9.3 billion), with a further SDR 2.2 billion (about $3 billion) available in the period to November 2000," Fischer said.

Policy implementation has continued to be satisfactory since the last review was completed in December 1998, and the major macroeconomic targets under the program for 1998/99 have been met. Monetary policy has remained firm, while fiscal policy has started to provide the intended stimulus to the economy, primarily through increased spending on the social safety net. However, market sentiment remains fragile, partly reflecting political uncertainties and civil unrest.

Important progress has recently been made in advancing bank restructuring, which is crucial to the eventual recovery of the economy. A major program of private bank recapitalization and closures was announced on March 13 and is being implemented smoothly. Steps have been initiated toward state bank restructuring that will need to be carried decisively forward within the next two months. Corporate restructuring also needs to be implemented more forcefully, and, toward this end, strengthened measures have been agreed to make the Jakarta Initiative fully operational as well as to implement the bankruptcy law consistent with international practice. The INDRA scheme has been revised to encourage greater participation.

Fischer emphasized that considerable risks still lie ahead for the economy. "With the implementation of key structural reforms, further consolidation of macroeconomic stability, and the additional official external financing that has been committed by Japan, the World Bank, and the Asian Development Bank as well as by the IMF, an upturn in economic activity could commence in the second half of this calendar year," he said. ■

Camdessus sees governance as key to Nigeria's reform, pledges IMF support

On March 18, IMF Managing Director Michel Camdessus addressed a conference in Abuja, Nigeria, entitled "Nigeria: The Way Forward," in which he described the IMF's perspective on supporting Nigeria's economic recovery. Following are edited excerpts of his remarks.

It is a great pleasure for me to participate in this conference at this momentous time, when Nigeria has created a new opportunity for economic progress, national harmony, and democracy. Hopes are high that Nigeria will recover the momentum of development and assume once again its leadership in Africa and among developing countries worldwide.

Let me pay tribute to the head of state, General Abdulsalam Abubakar, who has done so much to bring about this unique opportunity. His determination to begin the social, political, and economic transformation has laid a cornerstone on which the incoming government and the people of Nigeria can build in the months and years ahead. President-Elect Olusegun Obasanjo faces a formidable task. He knows that democracy and economic progress go hand in hand, that they can be naturally reinforcing, but that they are fragile and need to be backed by all forces in society. We wholeheartedly offer him and your country our full support as you design and implement a strategy for guiding the economy along a new path.

Domestic and external environment

There is no mistaking the sense of hope and expectation that exists today, in Nigeria and abroad. Equally impressive is the spirit of realism that exists in the face of the enormous challenges that confront Nigeria. I need hardly remind you of the difficulties, reflected so vividly in the level of real per capita income, lower now than three decades ago; in widespread poverty and regional inequality; and in declining health and education standards. This is a historic scandal indeed. All aspects of the economy––institutions, policies, and performance––need radical improvement. This difficult task is made more challenging by an external environment that is clearly not benign.

- The global economy has faced setbacks in the past two years, notably in the international financial markets. Despite some positive developments, such as the continued strength of the United States and signs of recovery in Asia, many downside pressures remain. In particular, recent oil prices were at their lowest level for a generation, and the prospects for an immediate strong recovery are not promising.
- The confidence of investors on whom Nigeria will need to rely in the years ahead has been undermined by the global crisis in emerging markets, the spread of armed conflict in Africa, and, in Nigeria, concerns based on many years of weak policy and governance.

Nigeria and the IMF at a glance

IMF member since March 30, 1961.

IMF quota: SDR 1.8 billion (about $2.4 billion), or 0.84 percent of total IMF quotas.

Voting power in the IMF: 0.84 percent of total (17,782 votes).

IMF Governor: Mallam Ismaila Usman, Minister of Finance.

Alternate Governor: Paul. A. Ogwuma, Governor of the Central Bank of Nigeria.

Executive Director in the IMF: José Pedro de Morais (Angola). He also represents Angola, Botswana, Burundi, Eritrea, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Sierra Leone, South Africa, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe.

Currency: naira.

Exchange rate arrangements: Effective January 1, 1999, the authorities abolished the official exchange rate (₦22 = US$1); all transactions now take place at market-based exchange rates in the Autonomous Foreign Exchange Market, established January 1995 (current exchange rate: ₦86 = US$1).

Financial assistance

Although Nigeria has had three IMF Stand-By Arrangements since 1987, it has not drawn on IMF resources.

Staff-monitored program

At the end of February, the IMF approved a staff-monitored program for Nigeria covering January 1–December 31, 1999, with the provision that the present transitional government recommend its continued implementation to the new government that will take office at the end of May. The objective of the staff-monitored program is to establish a track record of policy performance that could form the basis for possible discussions on a medium-term program supported by an IMF financial arrangement at a later stage.

Reform prospects

The domestic economic situation is extremely difficult. The external environment is not promising. But should we be pessimistic about Nigeria's prospects? I believe not. I perceive at least four reasons for hope:

First, realism. A few weeks ago in the budget address, General Abubakar recognized just how great the challenges were. Second, Nigeria's enormous potential––its people and their entrepreneurial spirit, the country's natural resource base, and its agricultural potential––remains undiminished.

Third, the advent of a newly elected government offers a window of opportunity to begin to implement the programs and policies that will push the country along the path of recovery and development. The objectives that President-Elect Obasanjo has espoused—an open, fair, and transparent government in which the legislature and the judiciary will not be hindered in the discharge of their proper and constitutional duties—are formidable and deserve our support.

Fourth, the spirit of "Vision 2010" and the economic summit of November 1998 are impressive not only for their farsighted analysis and recommendations, but also for the active participation of the private and public sectors.

What should be done to establish sustainable, high-quality growth? Everyone—all political forces, the private sector, nongovernmental organizations, churches, and trade unions—must participate in the historic task of laying the foundation on which the Nigeria of the new century will grow and prosper for the benefit of all, particularly society's poorest.

Reform strategy

A strategy is needed to create an environment in which Nigerians feel secure in saving and investing in their own economy and where foreigners will feel comfortable in investing once again. Within this strategy, I see a few core elements: good governance, liberalizing the economy and integrating it with the rest of the world, and macroeconomic stabilization.

Good governance. The first element is good governance. I am referring to the integrity and soundness of the institutions of government, the administration, and the judiciary, but also of the corporate world and society at large, which should be held to equally high standards of conduct. The corruption that plagues Nigerian society is a symptom of a deep-rooted disease that you are determined to bring to an end. This formidable task means fundamental reform at all levels of the economy, society, and government. Let me suggest a few building blocks on which Nigeria can begin to construct a society characterized by good governance.

- *A democratically elected government.* This has the support of the public to restructure social and economic institutions. It will be fully realized within the next two months.
- *Respect for the rule of law.* This calls for a transparent legal framework and a strong, impartial judicial system that gives confidence to savers and investors that contracts are sacrosanct and will be enforced, that rights will be protected, and that property will be secure. I also support President-Elect Obasanjo's call for an anti-corruption agency, which should be independent and be directed by a person of high repute.
- *A renewed emphasis on transparency and accountability in all aspects of economic life, both public and private.* For the government, this means the prompt provision of accurate information about the economy and increasing transparency in its macroeconomic policy formulation. Checks and balances could be restored, for instance, by a stronger, independent office of the auditor general. Private and state corporations would have to comply with standards and codes of good practice in accounting, auditing, and corporate governance and with other legitimate demands of government, such as taxation and regulation. In return, the private sector should expect to face a level playing field.
- *A clear and unambiguous commitment to social equity.* Opportunities for education and access to health care must be improved, and a social protection system should be built to support the most vulnerable during periods of economic stress and adjustment. Among the necessary efforts to improve the quality of public expenditure is greater scrutiny of large capital projects in the public sector. The concept of equity should also cover disparities among regions, such as those in the oil-producing areas. The different groups in society should not only receive fair treatment in the allocation of budgetary resources, but they should also be able to perceive that fair principles are used.

Our experience around the world, especially in the past two years of crisis in many emerging markets, underscores a basic point: without good governance, countries are at greatly increased risk of economic instability and recession.

Without good governance, countries are at greatly increased risk of economic instability and recession.

Economic liberalization. The second element consists of the changes in economic structure and institutions that are needed to build a competitive and efficient economy that is open to the outside world. The private sector should be allowed to become the engine of growth through a diversification that also lessens Nigeria's dependence on the oil sector for foreign exchange earnings and government revenues. The agenda is extensive.

- Deregulation and privatization have been started, but more is needed to improve the quality of essential services, lower the costs of doing business in Nigeria, and free the energy and entrepreneurial drive of the private sector.
- The trade and exchange systems must be liberalized to ensure that the private sector's decisions are not based on distorted prices.

• A sound financial sector will also be essential to Nigeria's economic revival. Domestic financial institutions should be subject to the highest standards of governance and transparency and operate within a clearly defined framework of regulation and supervision.

All of these––particularly a robust financial system––are prerequisites for Nigeria's fuller integration into the global economic and financial system.

Macroeconomic stabilization. The third element is to build the foundations of rapid, sustainable economic growth through firm, credible macroeconomic policies designed to establish and maintain stability. This task is made both more difficult and more crucial by the current state of the oil market. Low oil prices have cut deeply into government revenues so that, even with prudent expenditure management, the fiscal deficit has increased significantly. In these circumstances, a tight monetary policy will be central in maintaining stability and avoiding a return to high inflation, even if initially it gives rise to high interest rates.

Next steps

What should be done, especially in the next few months, to build on the cornerstone that has been laid? Nigeria's destiny lies in its own hands, and I know you all share that view. I shall not elaborate further on the agenda that lies ahead, but I can promise that the IMF is ready to work with the Nigerian authorities to design the more specific policies that will be needed. I am also confident that, once Nigeria has clearly begun to put its house in order, you will find support from the Nigerian people and from all your friends abroad.

Role of the international community. Let me direct a few words to the international community. This is a time of opportunity, a time for a New Deal. With resolute implementation of policies and the reestablishment of financial discipline, Nigeria has the potential to regain access to capital markets and attract new foreign direct investment. But such confidence building will take time and, for some years, will require significant external financial support. If Nigeria undertakes sustained reform by following through on the commitments it has already made in the framework of our "staff-monitored program," this is a window of opportunity for Nigeria and for all of Africa. I invite donors and creditors to join with us in the IMF in extending new support, with as large a concessional component as possible.

It will also be necessary for Nigeria to normalize its relations with its international creditors, through the resolution of its external debt, and I anticipate that an approach to the Paris Club would be a part of the overall package. But, if discussions with the Paris Club are to succeed, then Nigeria will need to demonstrate its intention to develop a new kind of relationship with its creditors by rigorously and faithfully complying with the terms of the agreed arrangements. Although Nigeria's debt burden is heavy, a resolution of its debt problem should be seen not as a panacea, but as an opportunity, accorded by the creditors, for Nigeria to rebuild itself. However, this opportunity will be lost unless it leads to a recovery of saving, private investment, and capital inflows.

IMF's role. What will the IMF be able to do? We are willing to place the full range of our services and instruments at your disposal: policy advice to help design a program of economic reform, technical assistance and training to strengthen and rebuild the institutions of government, and financial assistance to reduce the severity and duration of the pain that may well lie ahead.

Already, the first steps have been taken. Just a few weeks ago, we were delighted to receive from the Nigerian authorities a memorandum describing a program of economic and financial policies that would be implemented in the coming months of the transition and that would be recommended to the incoming government. Let me clarify the nature of the program, which is perhaps less well known than many of our loan facilities.

A "staff-monitored program" is designed to establish a record of policy implementation and to signal to our Executive Board, and through it to the world at large, that Nigeria is committed to and capable of sustaining a certain policy course that the international community can and must support. The program is not associated at the beginning with financial assistance, but the IMF staff will monitor its implementation. If performance is satisfactory, we would be ready to transform it at Nigeria's request into a multiyear loan arrangement, which would enable Nigeria to approach the Paris Club for resolution of its external debt. We will be working hard to support your efforts in this critical phase of what should become a true renaissance.

I know that neither you nor President-Elect Obasanjo harbors any illusions about the challenges in implementing the strategy on which you have embarked. But as the country takes its destiny firmly into its own hands, I have little doubt that the potential, the will, and the means exist to ensure, in President-Elect Obasanjo's words, that "Nigeria will rise again." ■

Photo Credits: Denio Zara and Padraic Hughes for the IMF, page 111.

With resolute implementation of policies and the reestablishment of financial discipline, Nigeria has the potential to regain access to capital markets and attract new foreign direct investment.

Working Paper

Study examines causes, consequences, and policy responses to capital flows

What caused the massive surge in capital flows to the emerging markets during the 1990s? What were the benefits and problems created by these flows? These and other issues, including recent patterns of such flows, their effects on recipient countries, and the pros and cons of alternative policy responses are considered in *Large Capital Flows: A Survey of the Causes, Consequences, and Policy Responses,* by Alejandro López-Mejía of the IMF Institute.

After the debt crisis of 1982–89, significant flows of financial capital returned to many developing countries, López-Mejía finds. In 1996 net private capital flows to these countries reached $190 billion, almost four times what they were in 1990. Most of this surge was concentrated in Asia and Latin America, where a dozen countries accounted for 75 percent of total capital flows, while 140 of the 166 developing countries accounted for less than 5 percent of inflows. The heightened interest of investors in some developing countries has led to increased financial integration, which boosts investment and consumption in those countries, with benefits both for them and for the global economy.

Nevertheless, large capital flows are not an unmitigated blessing, according to the author. They can lead to rapid monetary expansion, inflationary pressures, real exchange rate depreciation, risks to the financial sector, and widening current account deficits. In addition, as the experiences of Mexico (1994–95), Asia (1997), and Russia (1998) have shown, financial integration can lead to large reversals of the inflows because of changes in expected asset returns, investor herding, and contagion effects.

The author goes on to summarize what is currently known about the causes, consequences, and appropriate policy responses to large capital inflows.

Causes of capital flows

The primary forces driving investor interest in emerging markets are the search for higher returns and risk diversification. Although these forces have always driven investors' decisions, other internal and external factors have also increased the responsiveness of private capital to opportunities in emerging markets. As regards internal factors, private risk-return characteristics for foreign investors have improved through two channels. First, external debt restructuring in a wide range of countries has resulted in increased creditworthiness. Second, productivity gains deriving from structural reforms and heightened confidence in macroeconomic management have also pulled investors into emerging markets. Among external factors have been cyclic conditions in industrial countries. In particular, along with recessions in industrial countries in the early 1990s, a decline in world real interest rates made profit opportunities in emerging economies relatively more attractive and reduced the default risk of debtor countries. Other external factors, such as falling communications costs, strong competition, and rising costs in domestic markets, as well as the growing importance of institutional investors looking for risk diversification and higher rates of return on capital, have also increased capital flows to emerging markets.

Related to capital flows to emerging markets are reversals of these flows. In addition to the experiences of Asia, Mexico, and Russia, major reversals of capital flows have occurred in a number of other developing countries. A common cause for most of these reversals has been a lack of confidence in domestic macroeconomic policies, leading to speculative attacks on the currency and to balance of payments crises. Balance of payments crises can also be associated with financial vulnerabilities, sudden shifts in agents' expectations, and contagion effects. Contagion effects are important contributors to the recent volatility of international capital markets and can occur through several channels, López-Mejía argues.

A common cause for most of these reversals has been a lack of confidence in domestic macroeconomic policies.

Consequences of capital flows

A principal benefit of investor interest in developing countries has been increased financial integration, to the advantage of both developing and industrial countries. Financial flows boost growth in developing countries by financing investment and consumption. They also reduce the volatility of consumption by augmenting opportunities for risk diversification and by allowing international borrowing to offset temporary declines in income. Nevertheless, large capital inflows might also imply an excessive expansion of aggregate demand and may have negative effects on the financial sector.

Expansion of domestic demand—macroeconomic overheating—is likely to be reflected in inflationary pressures, real exchange rate appreciation, and widening current account deficits. According to standard open-economy models, a decline in the world interest rate induces income and substitution effects in the capital-importing country, generating increases in consumption and investment, a decline in savings, and a deterioration of the current account. Ultimately, however, the effects on inflation and the real exchange rate will largely be determined by the exchange rate regime and the amount of international reserve accumulation. As predicted by the models (sampling 20 developing

countries with high capital inflows), the current account deteriorated in all countries except Chile, India, and Sri Lanka during the capital inflow period, although many countries used these inflows to accumulate international reserves. The exchange rate appreciated in 12 of the 20 countries in the sample.

Capital inflows also affect the financial system that intermediates them. First, the quasi-fiscal deficit increases as a result of the sterilization policy that sells high-yielding domestic bonds and buys foreign exchange earning lower interest rates. Second, the financial system might become more vulnerable because of a rise in lending—usually strengthened by a surge in asset prices—that may exacerbate the maturity mismatch between bank assets and liabilities and reduce loan quality. Increases in bank credit were a generalized outcome of capital inflows.

Finally, microeconomic distortions can exacerbate the boom-bust cycle during capital flows. An important puzzle for the study of development economics is how a developing country can shift from a path of reasonable growth before a financial crisis to a sharp decline in activity after the crisis. The author of this study adduces a number of reasons to explain the influence of capital flows on this phenomenon.

Responses and lessons

Countries that have managed to overcome overheating and the adverse financial sector effects of capital inflows have relied on more than a single policy measure, López-Mejía observes. The appropriate combination of policy options depends on the causes of the inflows, the availability of different instruments, the nature of domestic financial markets, and the macroeconomic and policy climate of the recipient country. Policymakers typically have at their disposal countercyclical measures (monetary policy, nominal exchange rate flexibility, and fiscal policy), structural policies (trade policy, banking supervision and regulation), and capital controls (including the encouragement of gross outflows).

Successful policy responses have varied across countries, but have generally used monetary policy in the early stages of the inflow period, the author notes. As inflows persisted and costs associated with different types of sterilization were realized, successful policies began to rely on nominal exchange rate flexibility. In several cases, the costs of the appreciation of the real exchange rate were mitigated by the imposition of capital controls to moderate the volume of inflows and lengthen their maturities. It appears that capital controls had the desired effect of lengthening maturities in Chile, Colombia, and Malaysia, where short-term capital inflows declined sharply. This is an important policy outcome because the short maturity of debt was identified as a main determinant of the volatility and reversals of capital flows in the Mexican and Asian crises. Thus, an appropriate management of private sector debt—an issue largely ignored in the experience of the 1990s—might require innovative techniques, such as prudential regulation or capital controls on inflows of short maturity.

Experiences in several countries show that individual policies can interact to produce unintended effects on the composition of capital inflows. In particular, the policy mix of a pegged exchange rate, heavy sterilization, and no capital controls to discourage short-term flows can explain the change in the composition of capital inflows in the period leading up to the Asian crisis. Indeed, in 1994–95, Asian countries, most notably Thailand, increasingly started to attract short-term flows. Consequently,

IMF expands public access to archives

The IMF is further expanding public access to documentary materials in the IMF's archives, including Executive Board documents that are more than 5 years old and other materials that are more than 20 years old. The IMF moved in 1996 to declassify all materials in its archives that are more than 30 years old, except for some documents that contain highly confidential information.

Expanded access to archived material is set to take effect on September 8, 1999, according to a decision by the Executive Board. Additionally, the Board's decision includes a required review of records to determine whether they remain of a confidential nature.

The decision to open the archives further to public review is part of an ongoing initiative by the IMF toward greater openness with respect to its operations and activities. These initiatives have included the release of Public Information Notices on the IMF's Article IV consultations with member nations and disclosure of a range of background documents for those consultations.

It is anticipated that the Board will again review the archive policy in two years, with a view toward possible further liberalization of access guidelines. Meanwhile, IMF staff is reviewing additional categories of material that could be released under the five-year rule.

Researchers interested in using the archives after the September 8 opening date are requested to contact the IMF's Records Division well in advance. The division may be contacted by telephone: (202) 623-8625, fax: (202) 623-7175, e-mail: records-division@imf.org, or mail: Records Division, Room C-532, Secretary's Department, International Monetary Fund, 700 19th St., NW, Washington, DC 20431, USA.

Press Release No. 99/8, March 19

foreign direct investment and portfolio investment accounted for a declining share in total private flows.

In the presence of structural forces driving capital inflows, fiscal restraint becomes crucial, López-Mejía emphasizes. In fact, it avoids the costs associated with the different types of sterilization policies, is a substitute for exchange rate flexibility, and thus limits the appreciation of the real exchange rate. Few countries, however, have relied on fiscal policy because it is usually too inflexible to be effective in responding to fluctuations in capital movements. But in countries where the fiscal stance was tightened, the real exchange rate depreciated and the economy experienced larger growth.

Beyond the benefits of fiscal contraction as an instrument for short-run stabilization, a conservative fiscal stance should be central in the face of increased financial integration. In the context of high financial integration, the direction and magnitude of capital flows become sensitive to perceptions of domestic public solvency and limit fiscal flexibility during inflow periods. Moreover, during long periods of volatile capital flows, preemptive tightening of fiscal policy is important because it helps insulate core revenues and expenditures from being adjusted following macroeconomic shocks. In addition, even if the fiscal stance has to be tightened further in the face of large and volatile capital flows, the required changes will be smaller. This is an important virtue since fiscal policy is inflexible in the short run and because it avoids significant adjustments to taxes and expenditure programs that could hamper economic and social objectives. ■

Copies of IMF Working Paper 99/17, *Large Capital Flows: A Survey of the Causes, Consequences, and Policy Responses*, by Alejandro López-Mejía, are available for $7.00 each from IMF Publication Services. See page 105 for ordering information.

Exchange rate policy

EMU has exchange rate policy implications for transition countries seeking EU membership

The establishment of European Economic and Monetary Union (EMU) will have important consequences for Central and Eastern European countries aspiring to join the European Union. Although participation in EMU is not a formal requirement for EU accession, it is reasonable to assume that, by the time of accession, new member countries will have satisfied the requirements of stage 2 of EMU, including convergence toward EMU reference values and adherence to the new exchange rate mechanism (ERM2) created for nonparticipating EU members. In a recent study, *Implications of EMU for Exchange Rate Policy in Central and Eastern Europe*, George Kopits of the IMF's Fiscal Affairs Department examines the desirability for, and the ability of, the leading candidates in Central and Eastern Europe—Czech Republic, Estonia, Hungary, Poland, and Slovenia—to participate in ERM2 and eventually in EMU. Although this study focuses on these economies, Kopits suggests that the main points are applicable to other candidate countries as well and, in some respects, are relevant for all transition economies in the region.

Basic requirements

New EU member states are expected to adopt the *acquis communautaire* of stage 2 of EMU, including adherence to the relevant provisions of the Stability and Growth Pact and convergence toward EMU reference values for government deficit and debt and for inflation and interest rates. Further, nonparticipating EU members (that is, those that have opted out, or been left out, of EMU) are expected to adhere to ERM2, which requires parity between a member's currency and the euro within a margin of plus or minus 15 percent. Also, they will be expected to have completed capital account liberalization. Kopits suggests, therefore, that a basic—albeit implicit—prerequisite for EU accession would be for candidate countries to demonstrate the ability to operate within the ERM2 regime and, eventually, to participate in EMU.

Case for participation in EMU

Entering the EMU currency area entails both costs and benefits for candidate countries. On the plus side, participation would reduce the costs of economic transactions between the accession countries and the existing currency area. Also, the currency risk premium, reflected in the interest rate, would fall and eventually vanish. The combined effect would be a permanent rise in trade, investment, employment, and growth.

An important potential cost of joining a currency area is that it impairs a country's ability to absorb asymmetric real shocks in the absence of an independent monetary and exchange rate policy. The loss in macroeconomic stability could be a problem for some economies in transition that may experience fiscal stress during accession to the European Union, as they attempt both to finance the costs of meeting the single-market requirements and to converge toward budget balance—or at least a deficit of less than 3 percent of GDP.

However, Kopits notes, the strong relationship in a currency area between trade intensity and cross-country correlation of business cycles should reduce this potential cost. As trade intensifies, the probability of asymmetric shock declines; and, conversely, participation in a currency area leads to trade expansion and thus to more synchronized cycles.

The lead candidate countries are relatively small and have already reached a considerable degree of integration with the European Union. In fact, Kopits observes, they are at least as open to trade with the European Union as a number of noncore EU members. Their economic structure is only moderately more biased toward agriculture and industry relative to services than that of noncore EU members, except Greece. Therefore, on the basis of their size, trade integration with the European Union, and similarity in economic structure, the benefits for the lead candidate countries are likely to outweigh the cost of joining ERM2 and, eventually, the euro currency area. In addition, Hungary and, to a lesser extent, Poland should gain more than the other candidates from the decline in the currency risk premium and the interest cost associated with a relatively high level of public debt.

Exchange rate system and macroeconomic framework

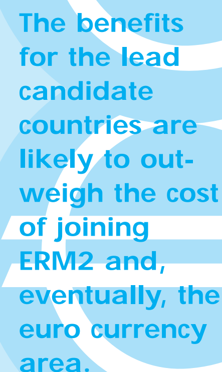
The five candidate countries rely on a wide range of exchange rate arrangements. At one end of the spectrum, the Czech Republic follows a managed float subordinate to the inflation target set by the central bank; Slovenia's floating rate is managed within an undeclared margin against the deutsche mark, while the central bank targets a broad monetary aggregate. Hungary and Poland, taking the middle ground, followed a preannounced crawling peg, with the aim of progressively lowering the rate of depreciation. At the stringent end, Estonia has a currency board arrangement with a fixed peg to the deutsche mark and, in effect, automatically participates in the euro currency area.

All five countries have liberalized their external current account, and average nominal and effective rates of protection are low by international standards. Most candidate countries have also achieved a fair degree of openness in the capital account.

To conduct monetary policy and support their exchange rate arrangements, the accession countries have been relying increasingly on indirect market-based instruments. Along with central bank independence, they have strictly limited or prohibited direct financing of government budget deficits, and all have legal reserve requirement systems. Besides intervening through outright foreign exchange sales or purchases, each country has sought to contain the monetary impact of capital movements through sterilized intervention.

In most of the countries, exchange rate policy has been increasingly governed by the twin objectives of price stability and external competitiveness and, more generally, by the need to strengthen the credibility of macroeconomic policies.

The current macroeconomic situation in these countries is broadly characterized by sustainable



The benefits for the lead candidate countries are likely to outweigh the cost of joining ERM2 and, eventually, the euro currency area.

Recent Publications

Working Papers ($7.00)

99/23: *Growth Gains from Trade and Education*, Se-Jik Kim and Yong Jin Kim

99/24: *Capital Controls and Trade Liberalization in a Monetary Economy*, Byung K. Jang

99/25: *Financial Liberalization, Credit Constraints, and Collateral: Investment in the Mexican Manufacturing Sector*, R. Gaston Gelos, and Alejandro M. Werner

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99/30: *The Length and Cost of Banking Crises*, Edward J. Frydl

99/31: *Exchange Rate Movements and Tradable Goods Prices in East Asia: An Analysis Based on Japanese Customs Data, 1988–98*, Shinji Takagi and Yushi Yoshida

Economic Issues (free)

No. 17: *Liberalizing Capital Movements: Some Analytical Issues*, Barry Eichengreen, Michael Mussa, Giovanni Dell'Ariccia, Enrica Detragiache, Gian Maria Milesi-Ferretti, and Andrew Tweedie

Other Publications

Summary Proceedings of the Fifty-Third Annual Meeting of the Board of Governors (free)

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growth, underpinned by rapidly increasing labor productivity, and by a deceleration in inflation to low double-digit or high single-digit rates.

Determinants of exchange rate movements

Although the five economies have attained a high degree of external openness, none has yet completed the transition process. And for some—notably the Czech Republic and Slovenia and some sectors in Poland—considerable restructuring remains to be done. In these conditions, Kopits says, the main relevant sources of movements in the nominal exchange rate are productivity performance, wage formation, fiscal and monetary policy stance, soundness of financial institutions, and outside shocks.

The scope for the productivity effect—upward pressure on the nominal exchange rate or the price level fueled by gains in labor productivity in the tradables sector—is great in the economies in transition, which have emerged from decades of inefficiency under socialist central planning. The effect is compounded by a surge in foreign direct investment. However, in four of the five countries, the productivity effect has been overwhelmed by weak or inconsistent policy. While wage indexation has been a major deficiency in Poland, and to a lesser extent in Slovenia, public sector deficits and indebtedness have been the principal source of Hungary's vulnerability. Insufficient financial and enterprise restructuring has rendered the Czech economy vulnerable. In contrast, wage flexibility and fiscal discipline, as well as substantial restructuring, have provided strength to Estonia.

The financial crises in Asia and Russia, and most recently in Brazil, have tested the resilience of these exchange rate regimes in the face of exogenous shocks. Among the candidates, the study shows that the Czech Republic was hit the hardest by the first crisis and Hungary by the second, while Poland experienced a milder effect from both. The Brazilian crisis has had no significant repercussion for any of the candidates.

Overall, these countries have been served well by their respective exchange rate regimes, when supported by appropriate flanking policies, Kopits observes, and none is inconsistent with convergence to the ERM2 regime. All are poised to move toward the ERM2 regime, admittedly from different starting points.

Path to ERM2

All five countries—to varying degrees—will need to make steady progress toward increased wage flexibility, containment of fiscal imbalances supported by a prudent monetary stance, and financial sector restructuring. In addition, Kopits observes, each accession country should follow a phased process—some are further along the path than others—to acquire sufficient operational experience in managing a stable exchange rate regime.

• In the first phase, which virtually all lead candidates have completed, the regime should be predictable; the nominal exchange rate should be kept within relatively narrow margins and subject to few, if any, one-off adjustments. Monetary policy should be aimed at a decelerating rate of inflation, consistent with the exchange rate policy.

• In the second phase, which some countries have reached, the candidate should approach fixed parity exclusively with the euro and widen the official margins substantially. A wide band should help shift some exchange rate risk to potential speculators against the currency. However, accession countries should exercise caution in widening the band during a period of turbulence in the foreign exchange market.

• In the final stage, prior to formal adoption of the ERM2, the accession country should consider shadowing the euro unilaterally as closely as possible, but without adhering to it at all costs. To preserve credibility, the authorities should declare the country's commitment to reinstate the former parity following a temporary deviation due to a speculative attack.

Although it would be unrealistic to formulate a precise timetable for formal entry in the ERM2 or for EU membership, Kopits suggests that it is plausible for the lead accession countries to aim at convergence within five years. At the same time, however, these countries will be subject to upward exchange rate pressures stemming from long-term productivity growth in the tradables sector and from capital inflows induced by successful reform and stabilization.

Two policy dilemmas arising from these pressures on the exchange rate will need to be addressed jointly by accession countries and EU members. The first dilemma concerns the difficulty faced by the candidates in simultaneously adhering to parity with the euro within ERM2 and converging to the EMU reference values for inflation and interest rates. Periodic revaluations are more likely to be an acceptable solution than relaxation of the reference values. The other dilemma centers on the requirement of full capital account liberalization while the candidate countries remain vulnerable to destabilizing capital flows prompted by rapid shifts in investor sentiment. Thus, a case can be made for delaying removal of controls on short-term movements until after EU accession. ■

Copies of IMF Working Paper 99/9, *Implications of EMU for Exchange Rate Policy in Central and Eastern Europe*, by George Kopits, are available for $7.00 from IMF Publication Services. See page 105 for ordering information.

IMF SURVEY

IMF sets new standards for dissemination of data on international reserves

The IMF has taken action to strengthen the specifications for dissemination of data on international reserves under its Special Data Dissemination Standard (SDDS).

Background

The strengthening of the SDDS is part of the ongoing efforts to improve the architecture of the international financial system. Recent financial crises have underscored the importance of more comprehensive and timely information on international reserves to help promote informed decision making in the public and private sectors and thereby improve the functioning of global financial markets. The proposals for reserves data under the SDDS were developed in response to guidance from the IMF Interim Committee. They are intended to establish new standards for the provision of information to the public on the amount and composition of reserve assets, other foreign exchange assets held by the central bank and the government, short-term foreign liabilities, and related activities that can lead to demands on reserves (such as financial derivatives positions and guarantees extended by the government for private borrowing).

The reserves data template, spelling out the information to be provided, reflected the experience in member countries, the results of two previous Executive Board discussions, and comments received through consultations with data users in the public and private sectors and statistical compilers. From the outset, there was widespread interest in increasing transparency in this area. However, many IMF members have expressed concerns about the resource costs of compiling and disseminating more detailed, frequent, and timely data and the possibility that this would reduce the effectiveness of exchange market intervention operations. The final decisions reflected a balancing of these objectives and concerns. The template was finalized in cooperation with a working group of the Committee on the Global Financial System of the Group of 10 central banks. The Group of 10 central banks have also adopted the template for use in the data dissemination activities of that committee. Copies of the template may be found on the websites of the IMF (www.imf.org) and the Bank for International Settlements (www.bis.org).

The SDDS is a standard of good practices in the dissemination of economic and financial data, to which IMF member countries may subscribe on a voluntary basis. It is intended for use mainly by countries that either have or seek access to international financial markets, to signal their commitment to the provision of timely and comprehensive data. As of March 1999, there were 47 subscribers to the SDDS.

IMF Executive Board discussion

Executive Directors welcomed the revised staff proposals to strengthen the prescriptions for the international reserves data category under the SDDS. In particular, Directors appreciated that the revised proposals represented an attempt to balance the objective of strengthening reserves data dissemination against concerns about the costs of observing the new standards and the confidentiality of information on intervention operations.

In commenting on the reserves data template, a few Directors regretted that the template did not contain as much information as the initial staff proposals in December 1998. Some other Directors suggested that the degree of detail being requested, particularly on reserve-related liabilities and other potential drains on reserves, was still excessive. On the whole, however, most Executive Directors were satisfied that the template provided a good basis for efforts to enhance the availability to the public of more frequent, timely, and comprehensive information on reserves and related items.

Most Directors considered that recent international financial crises demonstrated the importance of disseminating information on reserves and related items with a short lag and a relatively high frequency. In that context, several Directors noted that publication of reserves data on a weekly basis, with a lag of only a few days, had become increasingly common among emerging market countries active in international capital markets; these Directors encouraged other members to follow such practices. However, since the reserves template called for much more detailed data, many Directors also stressed that there would be a need for countries to adapt their internal reporting systems to generate the information needed under that template. Several Directors suggested that more consultation on the template, particularly with developing countries, would be useful. Directors looked forward to the completion of the operational guidelines for compilers after the spring meetings. They also considered that it was appropriate for the SDDS prescriptions for the periodicity and timeliness of data dissemination in connection with the new template to be well balanced and to reflect the consensus among members.

In that context, most Directors agreed that the SDDS prescription should be for dissemination of full data corresponding to the new template on a monthly basis, with a lag of no more than one month, although

Public Information Notices (PINs) are issued, at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies. They are also issued following policy discussions in the Executive Board at the decision of the Board. The IMF issued its first PIN on May 27, 1997 (see *IMF Survey*, June 9, 1997, page 181). PIN 99/25, issued on March 26 and reproduced here, is the first one to be issued in the second category. PIN 99/25, as well as the reserves data template, is also available on the IMF's website (www.imf.org).

data on total reserve assets would still be prescribed for dissemination on a monthly basis with a lag of no more than one week. The dissemination of data for the full template on a weekly basis, with a one-week lag, was to be encouraged. This proposal is therefore adopted.

Bearing in mind the advantages of more frequent and timely data, as well as the concerns of some members about the costs of disclosure, Directors agreed that the prescriptions for the periodicity and timeliness of reserves data dissemination should be reassessed in the context of the Third Review of the SDDS, around the end of 1999. A few Directors were of the view that the issue of periodicity and timeliness should be revisited after sufficient experience had been accumulated under the enhanced SDDS and more progress made in addressing the issue of symmetry in data dissemination between the public and private sectors.

Directors indicated that the transition period for observance of the new standards should be through March 31, 2000.

Executive Directors were generally satisfied that it had been possible to reach conclusions on this matter. At the same time, a number of Directors noted that the SDDS prescriptions for reserves data were a minimum standard that many members already exceeded. They underscored their hope that for such countries the present decision would not lead to any reduction in the frequency, or increase in the lag, in reporting or a reduction in the quality of data.

Many Directors stressed that it would be important for efforts to strengthen the dissemination of information on public sector financial operations to be accompanied by improvements in the availability of information on the activities of private institutions in international financial markets. ■

Press releases

Following are excerpts of recent IMF press releases. Full texts are available on the IMF's website (http://www.imf.org) under "news" or on request from the IMF's Public Affairs Division (fax: (202) 623-6278).

Republic of Yemen: ESAF and EFF

The IMF has approved loans and credits totaling SDR 47 million (about $64 million) to support the Republic of Yemen's second annual programs under the Enhanced Structural Adjustment Facility (ESAF) and Extended Fund Facility (EFF). Of the total, SDR 36 million (about $49 million) is available under the ESAF, and SDR 11 million (about $15 million) is provided under the EFF.

The latest disbursements are from a three-year loan and credit package totaling the equivalent of SDR 370.7 million (about $506 million) that was approved for Yemen on October 29, 1997 (see Press Release No. 97/49, *IMF Survey*, November 17, 1997, page 363). Of that total, SDR 264.8 million (about $362 million) represents commitments under the ESAF, and SDR 105.9 million (about $145 million), under the EFF. Two ESAF disbursements totaling SDR 88 million (about $120 million) have been made, and two EFF loans, amounting to SDR 18 million (about $25 million), have also been disbursed.

Medium-term strategy and 1999 program

The fall in oil prices reinforced Yemen's commitment to the medium-term strategy pursued since 1995, with its emphasis on financial discipline and market-oriented reforms to encourage private non-oil-sector growth while protecting health and education expenditure and social safety net outlays. In line with this medium-term strategy, the weight of adjustment will be on fiscal policy in 1999. With some improvement in private savings expected from ongoing financial sector reform, a reduction in the external current account deficit by about 2.5 percent of GDP is targeted. Monetary policy will aim at an inflation rate of about 9 percent, including the effects of increases in wheat and flour prices.

Structural reforms

Yemen has already begun the next phase of a broad structural reform program, with key steps taken early in 1999 and many additional measures aimed at further developing the market-oriented regulatory and legal frameworks needed to attract domestic and external investment, and to stimulate economic growth, on the agenda for the remainder of the year. Structural reforms already taken, or expected, in 1999 include deepening civil service reforms central to the implementation of the remainder of the program; additional income tax and sales tax reform; financial sector measures, including a significant strengthening of bank supervision; customs reform; privatization of public enterprises; elimination of import bans; pension reform; creation of the Aden free trade zone; and judicial reform.

Addressing social needs

The government will continue to increase the provision and targeting of social assistance programs in Yemen. To mitigate the impact of subsidy cuts on the poorest segments of the population, direct assistance through the government's Social Welfare Fund will be strengthened. Budget expenditure on social needs, including health, education, and welfare, is

Republic of Yemen: Selected economic indicators

	1995	1996	1997	1998	1999
			(percent change)		
Real GDP	8.6	5.6	5.2	2.7	5.3
Consumer prices (12-month change, end of period)	62.5	27.3	6.3	11.1	9.2
			(percent of GDP)		
Overall fiscal balance (cash basis)	–3.2	–1.6	–0.9	–6.0	–4.0
Current account balance	4.0	2.0	0.4	–5.2	–2.7
			(months of imports)		
Gross official international reserves	3.2	4.6	5.3	4.2	4.8

Data: Yemeni authorities and IMF staff estimates

targeted to increase from less than 7 percent of GDP in 1997 to close to 12 percent over the medium-term.

Yemen's membership in the IMF dates from May 22, 1990; its quota is SDR 243.5 million (about $333 million); and its outstanding use of IMF credit currently totals SDR 238 million (about $326 million).

Press Release No. 99/9, March 23

Zambia: ESAF

The IMF has approved a three-year arrangement for Zambia under the Enhanced Structural Adjustment Facility (ESAF), equivalent to SDR 254.5 million (about $349 million) to support the government's 1999/2001 economic and financial program. The first annual loan of SDR 40 million (about $55 million) is available in four equal installments, the first of which will be available on March 31, 1999.

Program for 1999

The government's objectives for the 1999 economic and financial program are to achieve real GDP growth of 4 percent, reduce inflation to 15 percent, and strengthen gross reserves to the equivalent of 1½ months of imports. The principal structural reforms in 1999 relate to privatization, public service reform, and a strengthening of the banking system.

In line with the medium-term objectives, the fiscal program for 1999 aims at reducing the overall budget deficit to 3 percent of GDP. Total expenditures (excluding the contingency reserve) are budgeted to increase to 29 percent of GDP.

Structural reforms

The government will increase reforms in the areas of privatization, public service, and monetary and banking supervision.

The damaging impact on Zambia's economy from delays faced in the privatization of the Zambia Consolidated Copper Mines has amply demonstrated the need for a rapid completion of this process. The program also envisages further progress on the divestiture of large state-owned enterprises in the nonmining sector.

The government is also committed to implementing a comprehensive public service reform in the 1999 program. At the same time, the government intends to continue the reorganization of ministries.

Social issues

Poverty remains a most pressing problem in Zambia. The World Bank is supporting the government's effort to reform the Public Welfare Assistance Scheme, with the aim of making the scheme more community-based. The government is also seeking to alleviate poverty by reorienting public expenditure toward the social sectors, primarily health and education.

Zambia joined the IMF on September 23, 1965. Its quota is SDR 489.1 million (about $670 million) and its outstanding use of IMF resources currently totals SDR 843 million (about $1.2 billion).

Press Release No. 99/10, March 26

Zambia: Selected economic indicators

	1996	1997	1998[1]	1999[2]	2000[2]	2001[2]
	(percent)					
Real GDP	6.6	3.3	−2.1	4.0	4.5	5.5
Consumer prices (end of period)	35.2	18.6	30.6	15.0	8.0	4.0
	(percent of GDP)					
Overall balance, cash basis	−2.6	−1.9	−4.3	−3.2	−1.3	−1.2
Current account balance[3]	−3.7	−6.2	−8.0	−8.8	−10.7	−8.3
	(months of imports of goods and services)					
Gross official reserves	1.7	1.7	0.4	1.4	2.4	2.8

[1]Estimates.
[2]Program.
[3]U.S. dollar-GDP calculated on the basis of changes in real GDP and U.S. GDP deflator (base year = 1998).

Data: Zambian authorities and IMF staff estimates and projections

Available on the Web

News Briefs

99/15, April 1. IMF, Arab Monetary Fund Sign Memorandum of Understanding to Establish Joint Regional Training Program.

Public Information Notices (PINs) are IMF Executive Board assessments of members' economic prospects and policies issued following Article IV consultations—with the consent of the member—with background on the members' economies; and following policy discussions in the Executive Board at the decision of the Board. Recently issued PINs include

99/24 Israel, March 24
99/25 Special Data Dissemination Standard, March 26
99/26 Singapore, March 26
99/27 Kyrgyz Republic, March 29
99/28 Tanzania, March 31

Letters of Intent and Memorandums of Economic and Financial Policies are prepared by a member country and describe the policies that the country intends to implement in the context of its request for financial support from the IMF. Recent releases include

Indonesia, Letter of Intent, March 18
Korea, Letter of Intent, March 18

Policy Framework Papers are prepared by the member country in collaboration with the staffs of the IMF and the World Bank. These documents, which are updated annually, describe the authorities' economic objectives and macroeconomic and structural policies for three-year adjustment programs supported by Enhanced Structural Adjustment Facility resources. Recent releases include

Yemen, March 26

Full texts are available on the IMF's website (www.imf.org).

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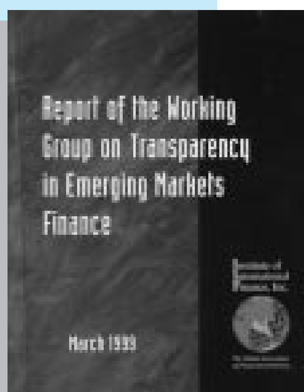
IIF recommendations

Improvements in global financial system hinge on transparency and management of risk



Investors in emerging markets should have more timely and meaningful economic data to enable them to assess risks. This recommendation for improving the global financial system was made by the Institute of International Finance (IIF) in the *Report of the Working Group on Transparency in Emerging Markets Finance,* one of two reports published on March 21 under the direction of the Steering Committee on Emerging Markets Finance. According to the report, publishing and disseminating macroeconomic data encourages country authorities to pursue sound policies because foreign and domestic participants are able to scrutinize their policies and follow economic developments. The report also sets out the strengthened data standards that the IIF considers the best practices for data disclosure.

The working group advocates improved dialogue between private international creditors and investors and the authorities of borrowing countries as a way of improving transparency, and makes a number of specific recommendations.

Data standards

Macroeconomic data transparency was widely recognized as a problem after the 1995 Mexican crisis, the report says, noting that significant progress has been made since then. However, concerns about the quality, comprehensiveness, and timeliness of data have also arisen in the wake of the more recent financial crises.

The working group report calls for the governments of emerging market economies to provide better information on capital movements, bank deposits, holdings of securities, derivatives, and reserves. It proposes that data on reserves be published weekly, with no more than a one-week lag, and that more data be provided on the composition and disposition of reserves, on other foreign currency assets held by central banks, and on potential drains on reserves, such as forward transactions. Data providers should explain their methodology and sources and ensure that their data are accurate and meaningful.

Transparency

National authorities, international financial institutions, and private sector participants in emerging markets are all responsible for full and timely disclosure of information on their activities, the report emphasizes. The report welcomes the advances the IMF has made in increasing the amount of information it publishes. Where the success of an IMF program depends on the private sector response, the report recommends that the IMF or the country concerned publish key elements of the program, including performance conditions and macroeconomic assumptions. It further recommends that the IMF permit countries to publish the IMF staff report on their Article IV consultations.

Financial sector soundness

The IIF noted that financial sector weakness was at the center of a number of recent financial crises and urged financial sector authorities in emerging market economies to disclose enough information to allow market participants to evaluate the health of the financial sector by assessing the risks and benefits of lending.

Risk assessment

A second report—*Report of the Task Force on Risk Assessment*—emphasizes the importance for private financial institutions of strengthening their management of risk. It draws together the lessons of firms' risk-management experiences during the financial crises of the last 18 months, which, it states, highlighted deficiencies in risk-management systems and financial frameworks. On the basis of the issues that arose within the firms, the task force recommends a number of ways policymakers in emerging markets can refine their risk-management practices.

- Issue long-dated domestic debt instruments and eliminate impediments to the development of local capital markets.
- Implement robust legal frameworks to enforce security interests and netting agreements.
- Increase transparency in financial markets, emphasizing the need for consolidating financial statements from affiliated companies. ■

Selected IMF Rates

Week Beginning	SDR Interest Rate	Rate of Remuneration	Rate of Charge
March 22	3.39	3.39	3.63
March 29	3.39	3.39	3.63

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 (as of January 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (currently 107 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 or check the IMF website (www.imf.org/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

Offshore banking activities can pose prudential and supervisory issues

Recent financial crises have spotlighted the importance of effective supervision and regulation in maintaining sound financial systems. For the home and host country authorities, however, offshore financial centers can pose added prudential and supervisory issues. In this interview, Luca Errico, an Economist in the IMF's Monetary and Exchange Affairs Department, and Alberto Musalem, an Economist in the IMF's Policy Development and Review Department, review the role of offshore banks and the part these banks played in recent crises. Drawing on the findings of their recent Working Paper, they argue that effective implementation of existing prudential and supervisory frameworks could go a long way toward containing risks.

IMF SURVEY: *What are offshore banking centers, and what prompted their development?*

MUSALEM: Offshore financial centers are jurisdictions, not necessarily countries, where financial institutions are exempt from a wide range of regulations normally imposed on onshore financial institutions. Deposits in offshore banks, for example, are often not subject to reserve requirements, and bank transactions are treated under favorable fiscal regimes. In many instances, offshore banks are also exempt from scrutiny with respect to liquidity and capital adequacy. Typically, offshore banks deal with other nonresident financial institutions and transact a wholesale business in a major currency other than their own.

The growth of offshore banking during the 1960s and 1970s was largely in response to the imposition of distortionary regulations, such as reserve requirements, interest rate ceilings, and capital controls in the industrial countries. A number of factors—including favorable fiscal regimes and regulatory frameworks (which lead to higher profitability), access to international capital markets, and the possibility of engaging in illegal activities such as money laundering—continue to attract business to offshore financial centers.

IMF SURVEY: *What proportion of international finance is carried out through offshore banks?*

MUSALEM: Currently, at least 69 offshore financial centers are in operation around the world. The cross-border assets of offshore financial centers grew at an estimated annual average rate of about 6 percent during 1992–97, reaching $4.6 trillion at end-June 1998. In mid-1998, offshore financial centers accounted for 51 percent of total cross-border assets. These figures, however, may underestimate the true size of offshore banking, because the reporting of offshore banking data to the Bank for International Settlements (BIS) is not yet complete.

Offshore banks chiefly engage in three types of transactions: eurocurrency (including eurodollar and euroyen) loans and deposits; the underwriting of eurobonds; and over-the-counter trading in derivatives for risk management and speculative purposes. Since eurocurrency transactions make up the bulk of offshore banking operations, the activities of offshore financial centers are predominantly of an interbank nature.

IMF SURVEY: *Do offshore banks play different roles in industrial countries and in emerging economies?*

MUSALEM: Industrial countries have dismantled the distortionary regulatory frameworks that first prompted the growth of offshore banking. They now permit competition within the context of prudential supervision and capital account convertibility. With this change, the distinction between offshore and onshore banking is becoming more and more blurred. In fact, the share of cross-border assets intermediated through offshore centers catering to industrial countries has declined over the 1990s.

Musalem: Offshore banking remains an attractive alternative to heavily regulated financial systems in emerging economies.

But offshore activities remain an appealing alternative for banks operating in the sometimes heavily regulated financial markets of emerging economies. Excluding the United Kingdom and Belgium-Luxembourg—because they cater mostly to industrial countries—the share of cross-border assets in relation to emerging markets has increased over the 1990s (see chart, page 112). Over the same period, the net cross-border liabilities of Asian offshore financial centers doubled as a percent of cross-border assets.

IMF SURVEY: *To what extent do offshore banking centers complicate supervision for home and host authorities?*

Errico: The IMF could play a crucial role in disseminating international best practices and standards for effective consolidated supervision of offshore banking.

ERRICO: Offshore banking transactions are, by their nature, less transparent than normal cross-border banking. The complex corporate relationships between onshore parent banks and their offshore establishments—that is, their offshore branches and subsidiaries—can be exploited for dubious purposes, given the opportunities for regulatory arbitrage that offshore financial centers offer. Also, gaps or disagreements in the existing regulatory and accounting frameworks, coupled with the technology for money transfers currently available, make financial surveillance more challenging and difficult.

For example, while normal cross-border banking involves home and host supervisory authorities, offshore transactions carried out through shell branches—that is, booking offices for transactions arranged and managed from other jurisdictions—may involve three supervisors,

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thus complicating supervisory coordination. Similarly, offshore activities carried out through parallel-owned banks—that is, banks established in different jurisdictions that have the same owner(s) but are not subsidiaries of one another—are impossible to detect in the absence of adequate information disclosure arrangements.

IMF SURVEY: *Are certain offshore banking activities riskier than others?*

MUSALEM: It is hard to distinguish between the different activities in terms of risk, especially in comparing off- and on-balance-sheet transactions, but there is evidence that offshore banks exploit the risk-return trade-off so frequently found in finance. Favorable regulatory treatment increases the leeway for balance-sheet management. This makes offshore banks more profitable and, in many instances, also more leveraged (more risky) than their onshore counterparts. Contagion onshore is also an issue, because onshore parent banks are in practice responsible for their offshore establishments. A large, leveraged, and underregulated offshore establishment can easily sink its onshore parent bank. The predominantly interbank nature of offshore banking also raises the issue of contagion from one bank to the next.

IMF SURVEY: *Have offshore banks played a role in recent financial crises?*

ERRICO: There are clear indications that offshore banks did play a role in recent financial crises, notably in Latin America and Asia. In Latin America, parent banks transferred part of their banking franchises to, and/or booked higher-risk assets or classified loans with, their offshore establishments to escape prudential requirements in their home countries. In Asia, parent banks onshore used their offshore establishments to channel short-term, foreign-currency-denominated funds through interbranch transfers. These transfers avoided reserve requirements, increased leverage, and added to the risk of balance-sheet mismatches.

We did not deal with this issue in the paper, but the overseas operations of Russian banks and financial companies could also be cited as germane to the Russian crisis last August.

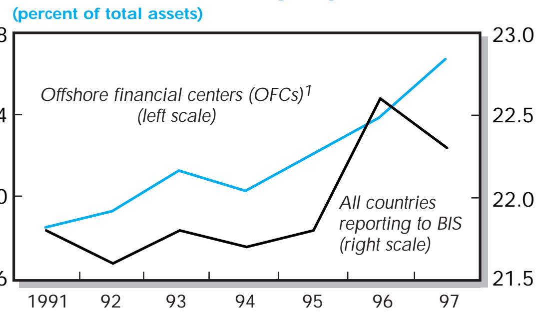
IMF SURVEY: *Is greater regulation of offshore banking called for?*

ERRICO: The international supervisory community has made several efforts to regulate and supervise internationally active banks, including banks operating in offshore financial centers. Current prudential and supervisory frameworks developed by, among others, the Basle Committee for Banking Supervision and the Offshore Group of Banking Supervisors are broadly adequate for risk management, if these frameworks are effectively and universally implemented.

We believe that fine-tuning, upgrading, and harmonization of existing regulatory measures for prudential supervision and corporate governance would be

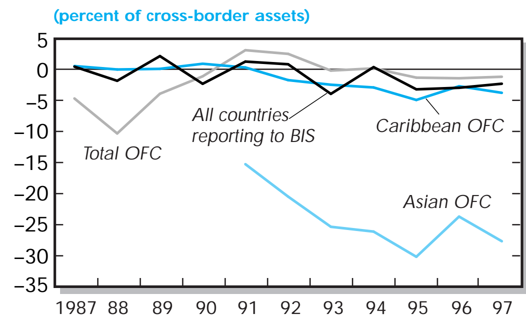
Banks' cross-border assets in relation to emerging economies

(percent of total assets)



Banks' net cross-border assets[2]

(percent of cross-border assets)



[1]Excluding United Kingdom, Belgium-Luxembourg.
[2]Negative numbers indicate net liabilities.

Data: Bank for International Settlements (BIS) quarterly data and IMF staff

preferable to greater regulation. But a number of supervisory gaps remain that, coupled with heterogeneous accounting standards, may impede effective consolidated supervision of offshore banking activities. These problems need to be addressed.

IMF SURVEY: *Is there a role for the IMF in this area?*

ERRICO: Personally, I believe there is. The IMF can play an important role within the context of ongoing efforts to strengthen the architecture of the financial system. For example, the Financial Stability Forum set up in February this year could be an effective vehicle to promote the monitoring and regulation of the offshore financial centers. The IMF could assist in this process through its surveillance and technical assistance activities.

Specifically, the IMF could play a crucial role in disseminating international best practices and standards for effective consolidated supervision of offshore banking in much the same way that it is promoting the Basle Committee's Core Principles. The IMF could also strengthen collaboration with other organizations involved with specific aspects of offshore banking, such as the Offshore Group of Banking Supervisors, the Joint Forum on the Supervision of Financial Conglomerates, and the Bank for International Settlements. ■

Copies of Working Paper 99/5, *Offshore Banking: an Analysis of Micro- and Macro-Prudential Issues*, by Luca Errico and Alberto Musalem, are available for $7.00 each from IMF Publications Services. See page 105 for ordering information.