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Eighth Managing Director

Köhler assumes office with promise to tackle issues of priority for world economy

Horst Köhler took office on May 1, 2000, as the eighth Managing Director of the IMF. The IMF Executive Board had unanimously selected him as Managing Director and Chairman of the Board on March 23 (see *IMF Survey*, April 3, page 97). Köhler told the press on assuming his new position that he is "excited to be in Washington and to get to work here and look at what the priorities are." Asked to comment on the issues that had been raised by critics of the IMF at the time of the spring meetings, he said, "We have to take these kinds of discussions seriously and to give answers based on solid judgment."

Immediately prior to taking up his position at the IMF, Köhler served as President of the European Bank for Reconstruction and Development in London, a position to which he was appointed in September 1998. From 1990 to 1993, he served as Germany's Deputy Minister of Finance, with responsibility for international financial and monetary relations, and from 1993 to 1998, he was president of the German Savings Bank Association.

IMF Managing Director Horst Köhler (center) arrives at IMF Headquarters to begin his first full day of work. To the right is First Deputy Managing Director Stanley Fischer.

A German national, Köhler holds a doctorate in economics and political science from the University of Tübingen, where he was a research assistant at the Institute for Applied Economic Research. He is married and has two children. ■

Unanimity on need for market reform

Moscow conference participants discuss investment climate and growth prospects

Russia's recent elections of a new parliament and a new president have prompted intense analysis of the country's economic priorities and the best way to achieve them. Russian economists and other observers are now debating the best path to sustained economic growth and a fertile investment climate that will raise the economic well-being of the country's citizens.

To promote this debate, more than 450 Russian experts in economics, law, sociology, and management from government, the Duma, and the private sector gathered in Moscow on April 5–7 to discuss the investment climate and prospects for economic growth in Russia at a conference sponsored by the State University Higher School of Economics, in collaboration with the IMF and the World Bank. As IMF Acting Managing Director Stanley Fischer observed in his opening remarks, "Those who attended came from a remarkably wide range of thinking . . . and strengthening reform is on everybody's mind."

Over the three days of discussions, a striking level of agreement emerged on the need for market reforms. Professor Yevgeny Yasin, academic supervisor of the Higher School of Economics and the conference's main organizer, confirmed that although the participants came from a wide range of professions and academic backgrounds, they reached a (Please turn to the next page)

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On May 4, the National Bank of Ukraine released a report by PriceWaterhouseCoopers of its foreign reserves management during 1996–97. The text of the report is available on the IMF website (www.imf.org).

Moscow conference notes progress on reform

(Continued from front page) remarkable degree of unanimity on the main considerations underpinning the discussions. These were

- After nearly ten years of experience with transforming the economy, basic mainstream reforms do work.
- Despite many setbacks to economic transformation, the achievements should not be underestimated.
- The way to equitable growth is through structural reform and strengthened social safety nets.
- And, vitally important, reform works best when the country "owns" its economic program.

On the dais (left to right) are Lev Yakobson, Alexander Shokhin, Stanley Fischer, Yevgeny Yasin, Aleksei Kudrin, and Yaroslav Kuzminov.

None of the speakers advanced some of the arguments that might have been heard in recent years—namely, that high inflation is needed for growth or that cheaper credits are needed for industry.

The conference represented the more public side of a quiet process under way at the direction of President Vladimir Putin, who has charged the Center for Strategic Research—a think tank headed by reformist German Gref—with hammering out a plan to prioritize and streamline the Russian economy. This task will range from overhauling the cumbersome tax code to slimming down Russia's infamous bureaucracies. The strategic economic plan is due to be presented shortly.

The first stage of the conference featured four working groups that focused on macroeconomic conditions for economic growth, institutional and structural limitations to growth, social policy and economic development, and state regulation of the economy. Forty-seven working papers, prepared by Russian experts and staff of the international financial institutions, provided the basis for presentations and discussions. The working groups culminated in an open plenary session where working group chairs from the Higher School of Economics—Professor Yevgeny Gavrilenkov, President Alexander Shokhin, Professor Lev Yakobson, and Chancellor Yaroslav Kuzminov—provided summaries. Fischer, Yasin, and Johannes Linn, Vice President for Europe and Central Asia at the World Bank, also addressed the plenary. Many spoke positively about the prospects for the Russian economy. Gavrilenkov commented that "while discussions during the workshops were often animated and divergent views were expressed, all participants agreed that the Russian economy is growing and on the upswing and that IMF estimates of a 4–5 percent growth rate over the medium term could be considered most conservative."

But in a paper titled "Economic Strategy and Investment Climate," Yasin and his coauthors (Sergei Aleksashenko, Yevgeny Gavrilenkov, and Arkady Dvorkovich) pointed out: "Certain positive tendencies in the development of the Russian economy . . . emerged after a period of difficult market reforms. This does not give ground for complacency, though. Transformations are not over. We have a market economy, but not a free one and, therefore, it is inefficient. That is why new crises are ahead unless market transformations progress."

All the participants agreed that the preservation of macroeconomic stability and the broadening and acceleration of structural reforms are essential to achieve high productivity and sustainable output growth. They concurred that the key challenge now is to improve the investment climate, and that savings, which are more than adequate, must be kept in the country through proper incentives.

"An improvement in the investment climate could reap big rewards for the economy," Fischer said in his address. "It could also help reverse capital flight, which has averaged $10–20 billion a year since the early 1990s. Russia's economy, and Russia's financial needs, will look very different when Russian savings, instead of fleeing abroad, are used to finance productive investments in the domestic economy. The failure to strengthen the rule of law and improve governance, in both the public and corporate sectors, is at the heart of weak investment, the failure of enterprises to restructure, and capital flight."

A number of broad conclusions, as well as specific measures, emerged from the conference:

State University Higher School of Economics

The State University Higher School of Economics was established in 1992 by the Russian government to assist economic reforms in Russia by training professionals in modern economics and other social sciences, as well as by providing academic research, consultancy, and policy advice in these fields. The Higher School of Economics is an autonomous university that serves as a training and scientific research center for the Ministry of Economy of the Russian Federation. It has regional branches across Russia and maintains exchanges with the London School of Economics, the Sorbonne, and Harvard University, among other institutions.

• Strengthening the rule of law and weeding out corruption requires that laws be made clear, discretion in interpretation be removed, and federal laws be enforced throughout Russia. The judiciary needs adequate financial compensation, and courts and judges must have increased independence. Compensation for damage caused by state actions must be ensured. Transparency of the public sector must increase, especially in activities not currently subject to treasury control, such as the Road Fund.

• Industrial restructuring must advance, and corporate governance must be improved. This includes completing the privatization process, promoting competition, and tackling noncompetitive industries. Fostering a level playing field requires the protection of property rights and minority shareholders. Also, the legal responsibilities of managers must be raised and international accounting standards introduced.

• The entrenched problems of nonpayments and barter must be rooted out. Tax offsets and negotiated tax payments must be eliminated at all levels of government. As Shokhin pointed out, archaic taxes—such as the turnover taxes—must be removed. Cash collections from natural monopolies must be raised, and rules need to be established to permit nonpaying customers to be disconnected. The bankruptcy process will need to be strengthened in a number of areas, including through more forceful use by tax authorities.

• Bank restructuring and an increase in central bank transparency must be advanced. Gavrilenkov noted that, during the conference, participants unanimously agreed on the need to restructure the banking sector. Banks must become more effective intermediaries between savings and investment and should not provide directed credits to particular enterprises or sectors. Insolvent banks must be dealt with more forcefully. A competitive private banking sector must be fostered, including through promoting the entry of foreign banks. Banking supervision needs strengthening, and central bank accounting procedures and disclosure practices must be improved and subsidiaries divested.

• There is a need to reform the public sector through tax, expenditure, and civil service reforms. Gref noted that deregulation appeared to be one of the most important issues. Functions and organization of government beg reexamination and consolidation, and the roles and relationships of different levels of government should be clarified. Administrative systems bear strengthening, as do regulatory frameworks and the governance of institutions. Civil service reform is needed, as well as a strengthening and streamlining of the tax administration. A correct balance between the rights of taxpayers and the tax authorities should be sought, while most tax exemptions, particularly for the value-added tax and enterprise profit tax, should be eliminated. Further, the burden of personal income taxes warrants review.

• The social safety net for the poor, elderly, very young, and those unable to work requires strengthening to support restructuring and growth while reducing poverty. This implies the careful targeting of limited resources.

Housing subsidies must be reviewed, and reform must begin on the health care and pension systems. Equally essential to help the new generation cope with the market economy is investment in education, Yakobson emphasized. "The most recurrent themes [in the social policy working group] were the labor market and the recognition that education policy should help the new generation adapt to new conditions," he said.

Conference coordinator Yevgeny Yasin (right) confers with Stanley Fischer of the IMF.

• Agricultural and land ownership reforms are needed to facilitate the development of a genuine land market that ensures full rights to own, buy, sell, rent, and mortgage land.

To underpin reform generally, a broad base of support must be developed, and vested interests must be resisted. This is the key to building ownership of Russian reforms within Russia and to improving the country's prospects for success.

The conference left open issues that will require further consideration, including the appropriate size of the public sector and how to deal with natural monopolies, but many lessons were learned, and there was no shortage of good ideas. The question now is whether it will be possible for Russia to develop its own economic reform program—a program worked out by Russians, effectively supported by civil society, and owned by Russia. ■

Kathleen White
IMF External Relations Department

The full text of Fischer's address is available on the IMF's website (www.imf.org). Conference papers, when finalized, are expected to be posted on the IMF's website and the website of the Higher School of Economics (www.hse.ru).

Correction: In the table of IMF arrangements as of March 31 that appeared on page 143 in the April 24 issue of the *IMF Survey*, Argentina was inadvertently omitted from the list of IMF members with Stand-By Arrangements. The entry for Argentina should have read: *Date of arrangement*: March 10, 2000; *Expiration date*: March 9, 2003; *Amount approved*: SDR 5,398.61 million; *Undrawn balance*: SDR 5,398.61 million.

Press briefing

Exchange rate regime depends on circumstances, underlying policy support, IMF study finds

The exchange and payments crises of the 1990s, the general increase in capital mobility, and the boom-bust character of capital flows to developing countries raise anew the issue of appropriate exchange rate arrangements, according to an IMF study to be published in the IMF Occasional Paper series. The study—*Exchange Rate Regimes in an Increasingly Integrated World Economy*—was prepared by a team from the IMF's Research Department. On April 14, IMF Economic Counsellor and Director of the Research Department Michael Mussa held a press briefing to discuss the study. Participating in the press briefing were two principal contributors to the study—Alexander Swoboda, Senior Policy Advisor, on leave from Geneva's Graduate Institute of International Studies; and Paul Masson, Senior Advisor, currently on sabbatical at Georgetown University and The Brookings Institution.

Michael Mussa

Mussa explained that the International Monetary and Financial Committee asked IMF staff to reexamine the issue of exchange regimes in light of important changes that have been taking place in the world economy. In particular, the staff was asked to study the implications of the increase in international capital mobility and in the participation of many developing countries—so-called emerging market countries—in the international financial system.

Alexander Swoboda

"We took our task to be a comprehensive one," Mussa said. "The IMF is a virtually universal organization, and we wanted to look at the issue of exchange regimes across the entire membership—from the largest industrial countries, whose national currencies form the main foundation of the international monetary and financial system, to the smallest members of the IMF."

Not surprisingly, Mussa said, with such a wide range of countries at varying levels of development and with varying degrees of financial sophistication, one cannot expect to reach a uniform conclusion about a single exchange rate regime that would apply universally to all of those countries. Perhaps the single most important conclusion of the analysis, he said, is that "there is no single exchange rate regime that is best for all countries, at all times, in all circumstances."

This conclusion does not mean, of course, that "anything goes," Mussa cautioned. Certain types of exchange rate regimes, he said, do seem better suited to some countries, in some circumstances, at some times.

Key currency relationships

The launch of the euro in January 1999 marked a new phase in the evolution of the postwar international financial and exchange rate system, Swoboda noted, including a rearrangement of the relationships between the system's key currencies. The IMF study suggests that the volatility observed in the past—notably between the U.S. dollar and the deutsche mark—is likely to continue in the future between the euro and the other currencies, particularly the U.S. dollar. The euro area as a whole is a more closed economy than its components, he said, and the European Central Bank (ECB) has a clear mandate to focus monetary policy on inflation rather than on the exchange rate.

The study also looked at the medium-run prospects for more active management of the major currency exchange rates, Swoboda said. Proposals have ranged from a "world central bank" at one end of the spectrum to absolute, clean floating at the other extreme, with some form of target zone somewhere in the middle. But the study predicts that relations between the three major currencies will be much closer to the pure floating end of the spectrum. Given the high degree of capital mobilization, there is just not enough political commitment to stabilize exchange rates in a narrow range in a world of high capital mobility, he said, and "we do not see the U.S. Federal Reserve or the ECB sacrificing domestic objectives for the pursuit of exchange rate stabilization."

Photo Credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF; Michele Iannacci for the World Bank, pages 150 and 151.

There is a trade-off between stabilizing the exchange rate and stabilizing the domestic economy in the three major currency areas, Swoboda said. Volatility is not necessarily a cause for concern if it reflects a change due to the major economies being at different points in the business cycle, rather than a gross misalignment between their currencies. However, large and prolonged misalignments of the major exchange rates are a cause of serious concern both for the major countries themselves and for the rest of the world, he stressed. There is definitely a role for IMF surveillance and for concerted action on the part of the Group of Three and the Group of Seven to avoid the most severe forms of imbalances.

Exchange regime for developing countries

The current international environment is characterized by a substantial degree of flexibility, Masson said, and developing countries' choice of exchange rate regimes has to be conditioned to that environment. However, the individual circumstances of each developing country will also influence the choice of exchange rate regime, ranging from substantial flexibility to a currency board or monetary union. In the middle range of choices, Masson noted, are various forms of regimes—like crawling bands and adjustable pegs—that are characterized neither by substantial flexibility nor by a commitment to a fixed and unchanging peg.

It has been argued that this middle range of regimes is likely to disappear because it is unsustainable, especially for those countries pursuing closer integration into international capital markets. The study, Masson said, acknowledges that greater capital market integration does make the requirements for sustaining exchange rate regimes that are not at either extreme more demanding. But the policy requirements for maintaining a successful and stable floating regime, or continuing with a strong commitment to a fixed peg, are more demanding.

Although developing countries appear to be moving toward increased flexibility, Masson said it is likely that the current range of regimes will continue in the future. Some of the considerations influencing the choice of exchange rate regime include, for instance, the degree of diversification of trade, where the flexibility among the major currencies will cause some problems for single-currency pegs, given that pegging to one of the major currencies will imply substantial fluctuations relative to the others.

Single-currency pegs, however, are at present, and will no doubt continue to be, highly desirable regimes for countries with a strong concentration of trade with one of the major blocs. For countries moving to greater exchange rate flexibility, an alternative to the exchange rate as a nominal anchor needs to be developed, as well as institutions to sustain that alternative anchor.

For countries moving to greater flexibility, it is unlikely that benign neglect of the exchange rate—that is, a perfectly free float—is going to be desirable, Masson said. Sustainable free-floating regimes require deep foreign exchange markets, and developing countries typically lack this feature. So, some degree of intervention and concern for movements in the exchange rate in setting monetary policy is likely to persist.

Paul Masson

In response to a question about the temptation to stop a currency from appreciating through a de facto pegging of the exchange rate and whether such an action could create the same problems that led to the Asian crisis, Mussa said that, with the exception of Malaysia, the Asian currencies are formally floating. "We remain concerned, however," he said, "that if there were a return to de facto pegging, this could re-create some of the problems we saw develop in Asia."

"So it is important," he stressed, "if you have a floating exchange rate regime, that the exchange rate really does float in response to market forces and that businesses—when they are trading, and particularly when they are borrowing and lending and engaging in capital market transactions—recognize that there really is a foreign exchange risk. That is to say, the exchange rate will move, and businesses do not have an implicit guarantee that the government will step in to rescue them if they make bad judgments about structuring their businesses and balance sheets." ■

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
April 24	4.25	4.25	4.83
May 1	4.29	4.29	4.88
May 2	4.29	4.29	4.97

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 May 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 (through May 1, 113.7 percent; effective May 2, 115.9 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

ABCDE conference

New strategy emphasizes country ownership, comprehensive framework for development

Over the past fifty years, the approach to development assistance has undergone a major shift, moving from a narrow focus on macroeconomic stabilization and liberalization to a comprehensive framework, encompassing all aspects of the economy—including social and environmental issues and poverty reduction—and tailored to the specific circumstances of each country. Along with this comprehensive approach has come the recognition that ownership of the development process has to lie with the people and their government, not solely with donors or the aid-dispensing agencies. Much of the discussion at the Annual [World] Bank Conference on Development Economics (ABCDE), held in Washington on April 18–20, centered on these new directions for development assistance, partnership, and cooperation at the national and international levels. Following are some highlights from the conference.

Joseph Stiglitz

Development at the millennium

Development is possible but far from inevitable, Joseph Stiglitz, former chief economist at the World Bank, said in a keynote address, given on April 18. Unfortunately, he added, there is no magic formula that ensures success. Discussion continues about the extent to which policies pursued in recent years have promoted economic growth, Stiglitz said. However, there is little debate that, at least in some instances, the policies and the manner in which they have been imposed have increased economic insecurity and people's sense of powerlessness.

Paul Collier

Stiglitz said it is now recognized that long-term sustainable growth requires a consensus behind the reform policies. These policies cannot, he stressed, be imposed from the outside. This is why external financial assistance tied to externally imposed conditions has not always been successful. Meaningful democratic processes, combined with policies that promote equity, can enhance consensus building and a sense of inclusion, he suggested.

Dani Rodrik

The developmental transformation also entails more than a solution of the technical economic problems leading to increased efficiency and resource mobilization—as important as this is, Stiglitz observed. In our thinking about development, he added, we have gone beyond projects and have begun to focus on institutions, such as those that promote competition and good governance in the public and private sectors. Poverty reduction and a more equitable distribution of income have also assumed an importance not only as an end in themselves but also as a means of achieving stronger economic performance, he concluded.

New development thinking

Focusing on the effectiveness of aid in the development process, Paul Collier of the World Bank said that progress in poverty reduction depends on policy and institutional changes. In the past, the World Bank's approach to inducing such changes was to provide aid in return for explicit negotiated commitments to policy reform. The underlying theory was that aid could be an incentive to policy change, Collier explained. However, an implication of this theory was that governments would be undertaking policy changes, not because these changes were necessarily in the country's best interest, but to obtain the aid.

A further implication of using aid as an inducement for reform was that if donors "bought" the reforms, then the donors, not the recipients, "owned" them. When a government implemented and sustained a policy reform, the donors claimed the credit. Thus, even when governments implemented reforms because they really believed in them, they faced great difficulty establishing their claim to ownership with the investor community. Further, aid for reform may have weakened the government's capacity to work out and communicate its own strategy. In any case, governments had little incentive to sell policies to their electorates.

Aid for reform was well intentioned, Collier said, but it was based on a misunderstanding of how policies and institutions are changed on a sustainable basis. An alternative approach, he suggested, is to empower the domestic constituencies for change through knowledge and participation.

Home-grown development strategy

The lesson of the twentieth century, according to Dani Rodrik of Harvard University, is that successful development requires markets to be underpinned by solid public institutions. International trade can be a powerful and positive force for economic development, but reliance on trade must be balanced with a domestic investment strategy. Today's advanced industrial countries owe their success, Rodrik said, to having evolved their own specific workable models of a mixed economy. Policymakers in developing countries, Rodrik cautioned, should therefore not put too much faith in "conventional wisdom or conventional models." Rather, the domestic strategy needs to be tailored to individual country characteristics and conditions.

Although learning and imitation from abroad are important elements of a successful development strategy, Rodrik stressed that imported blueprints need to be filtered through experience and deliberation. Trade and capital flows are important for development, insofar as they allow developing countries access to cheaper capital goods. But the links between opening up to trade and capital flows and subsequent growth are weak, uncertain, and mediated through domestic institutions. What is true of today's advanced economies is also true for developing countries: economic development ultimately derives from a home-grown strategy and not from the world market. Policymakers in developing countries should avoid fads, put globalization in perspective, and focus on domestic institution building, Rodrik concluded.

Rethinking aid

In the past few years, the role of aid in effecting change has come under considerable question, according to Jan Willem Gunning of the Free University of Amsterdam and the Center for the Study of African Economies. The central idea of structural adjustment lending is that aid can buy policy reform. But current evidence suggests that aid is effective only in good policy environments and that the use of aid to bring about policy reform does not work. These findings suggest, Gunning said, that ex ante conditionality in adjustment lending—that is, policy prescriptions set by the donors that the recipient countries must accept as a condition for getting the aid—is ineffective.

If aid effectiveness depends on the quality of the policy environment and donors are powerless to change policies with aid, then, Gunning suggested, the only way to improve efficiency is through ex post conditionality. Donors would treat policy regimes as a given and would allocate aid mainly to countries with a good policy environment. With ex post conditionality, the allocation of aid is tied to success and would enable donors to play an important signaling role in transmitting information on government policies and outcomes to private agents.

Gunning acknowledged that objections to the selectivity approach have been raised. For example, ex post conditionality will leave poor people living under governments with bad policies to fend for themselves. However, aid to such governments is unlikely to benefit the poor anyway, Gunning noted, and could well harm them by financing the continuation of a bad policy regime. A second objection is that countries with good policies do not need aid. But, Gunning stressed, this is simply false. Reputations die "quite slowly," he noted, and domestic savings may remain low for some time in good policy environments, reflecting uncertainty as to whether the new policy regime will be sustained.

Global division of labor

In a keynote address on April 19, Jeffrey Sachs of the Harvard University Center for International Development welcomed what he said was in many respects "a new global consensus on helping the poorest of the poor." Much of the criticism of the IMF and the World Bank was misplaced, he added, saying that they were bearing the brunt of the blame for the fact that many of the rich countries were still, despite the emerging consensus, turning their backs on the poor. As a result, he said, such international efforts at poverty alleviation as the HIPC (Heavily Indebted Poor Countries) Initiative were severely underfunded.

At the same time, Sachs criticized the IMF and the Bank for what he believed was an overly simplistic emphasis on macroeconomic stability and growth, which, he said, was only part of the story. Equally important in his view were expenditures on health and education, technological advances, and structural adjustment coupled with export diversification. He called on the IMF and the Bank to take the lead on debt cancellation by writing off their credits under the Enhanced Structural Adjustment Facility and the International Development Association.

Crisis and recovery

In a review of the Asian crisis, Eisuke Sakakibara, former Vice Minister of Finance for International Affairs in Japan, discussed the alternative "logically clean solutions" to future crises. The solutions are, on the one hand, an international lender of last resort with free capital movements and, on the other, the reinstatement of permanent capital controls. While the IMF alone is currently not a lender of last resort, he said, the IMF and the countries of the Group of Seven could perform such a function if they were willing to lend in sufficient volume. However, he explained, as long as a crisis remains country-specific, or regional, there is not an urgent political need for unaffected countries to pay the significant costs associated with acting as lenders of last resort.

In the absence of a true lender of last resort, Sakakibara continued, countries could opt to insulate their economies in selected areas and still benefit from free flows of goods and services. He observed that both Malaysia and Singapore had taken steps to protect their economies during the Asian crisis while not completely closing their doors to the rest of the world.

Sakakibara then said that the concept of an Asian Monetary Fund, which had encountered opposition when it was originally proposed in 1997, could be helpful if its function were narrowly defined as the provision of necessary liquidity at a time of crisis with a specific formula for private sector participation. It could then complement the work of the IMF, he said.

Willem Gunning

Jeffrey Sachs

Eisuke Sakakibara

The Road to a Free Economy— a retrospective

In his keynote address, "Ten Years After *The Road to a Free Economy*: The Author's Self-Evaluation," on April 20, János Kornai, professor of economics at Harvard University and Collegium Budapest, reassessed proposals he had made in *The Road to a Free Economy*, published in 1990, on how the postsocialist transition should be carried out. He focused on two issues: reform of ownership and macroeconomic stabilization.

At the outset of transition, Kornai said, there was little agreement on how private ownership should be structured in the postsocialist economies or on how to get there. There was a heated debate around two possible strategies, which he referred to as strategy A and strategy B. He said he was one of strategy A's advocates, believing that the development of capitalism had to be an organic, evolutionary process. Strategy A, which Hungary and Poland chose, emphasized the creation of conditions that encouraged the "bottom-up" development of a new private sector through selling state companies to outsiders committed to investing in them and concentrating their ownership. In a process of "natural selection," the fittest companies would survive, he said, and the others would go out of business. Strategy B emphasized accelerated privatization—the rapid liquidation of the state sector—primarily through vouchers giving away shares in state-owned companies or managerial buyouts. Russia pursued an extreme form of strategy B, the Czech Republic, a more moderate form. Strategy A, Kornai said, had been more successful.

He admitted his prescriptions for macroeconomic stabilization were less prescient, however. In his book, he had argued in favor of "radical surgery"—one-stroke stabilization. Although he still believes bold packages are necessary, he said he now realizes that one-stroke action must be followed by years of institutional reform to be sustainable.

Kornai said that the question much debated 10 years ago—gradualism versus shock therapy—misstated the problem because it emphasized speed, which, although important, should not be the primary measure of success. To create strong foundations for capitalism, the focus must be on establishing social and political stability, robust political institutions, sustainable growth, a good legal infrastructure, and popular support based on an experience of tangible gains rather than on expectations. He stressed the importance of allowing a broad middle-class base with a stake in capitalism to emerge, and said that the transition from socialism to capitalism was a trial-and-error process and could not be imposed. ■

The papers presented at the Annual Bank Conference on Development Economics are available on the World Bank's website at http://wb.forumone.com/research/abcde.

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Impact of new legislation

Jakarta seminar on decentralization draws lessons from experiences of other countries

In mid-1999, Indonesia passed decentralization legislation that will fundamentally change the structure of the state, which, since the 1950s, has been highly centralized. While there are considerable pressures for decentralized governance in Indonesia, the transition will not be easy and needs to be carefully sequenced. A seminar titled "Indonesia: Decentralization Sequencing Agenda" was held in Jakarta, Indonesia, on March 20–21 to place Indonesia's decentralization effort in the context of international experience. The seminar was sponsored by the IMF's Fiscal Affairs Department, the Center for Social and Economic Research of the University of Indonesia, and the World Bank. Delivering the keynote speech, Bambang Subianto—a member of the president's National Economic Advisory Council and former finance minister—said that the time for implementation was very short and that many provisions of the law would have to be implemented in the 2001 budget. Subianto looked to the seminar to provide a road map for the orderly implementation of the decentralization process.

Lessons from other countries

The seminar drew lessons for Indonesia from the experiences with decentralization of a number of countries, including Brazil, China, Colombia, India, and Italy. It featured presentations by external experts, as well as Indonesian academics and officials. The seminar focused on key issues for Indonesia, ranging from transfer of responsibility for making expenditure decisions and collecting revenues to management of the budget process and design of intergovernmental transfers, including untied general purpose transfers.

The IMF does not have a preconceived notion about the desired level of decentralization in its member countries, according to Ehtisham Ahmad, Advisor in the IMF's Fiscal Affairs Department. Rather, individual countries must decide what is best for them, given their historical and political perspectives. However, he noted, the decentralization process needs to be carefully sequenced to avoid exacerbating macroeconomic imbalances, as illustrated by many countries that have already gone through this experience. A key lesson is that the decentralization of revenues and transfers should not precede the devolution of responsibilities. Moreover, to avoid a political backlash, it is imperative not to endanger the delivery of public services, such as basic health and education, during the transition to decentralization. Revenue and expenditure policies have to be designed carefully to create incentives for local governments to manage public finances effectively and to ensure that an inefficient centralized system is not replaced with an even more inefficient and corrupt local structure of governance.

IMF Executive Board reviews Pakistan's misreporting, remedial steps

In a news brief issued on April 28, the IMF Executive Board announced it had reviewed data revisions and misreporting by Pakistan, along with the authorities' commitment to promptly repurchase [repay] SDR 18.95 million in outstanding debt to the IMF and to voluntarily repurchase another SDR 22 million by May 31, 2000. IMF Deputy Managing Director Eduardo Aninat summarized the discussion. Extracts of his summary follow. The full text of News Brief No. 00/23 is available on the IMF's website (www.imf.org).

"Executive Directors expressed concerns over the misreporting of fiscal data to the IMF between 1997 and 1999. Following their discovery of discrepancies in the fiscal data in late 1999, the authorities informed IMF staff and requested technical assistance to help with the data revision process. In response, a mission from the IMF's Fiscal Affairs Department went to Islamabad in January 2000 to assess the magnitude of the discrepancies and the factors responsible for the discrepancies. As a result of subsequent data revisions, Pakistan's budget deficit for 1997/98 was revised upward by 2 percent of GDP to 7.5 percent of GDP, and the deficit for 1998/99 was raised by 1.4 percent of GDP to 5.9 percent of GDP.

"Observing that the discrepancies in the fiscal data had been discovered by the current authorities themselves and had immediately been brought to the attention of the IMF staff, Directors commended the current authorities for their prompt and full cooperation with the staff in the data revision process.

"In view of the authorities' expression of regret over the misreporting episode, their full cooperation during the data revision process, and their prompt implementation of measures to subsequently strengthen fiscal reporting, Directors felt that the proposed repurchases constituted remedial action that was consistent with practices on misreporting that were in effect at the time the inaccurate fiscal data were provided. Many Directors expressed the hope that, following these actions in response to the data misreporting episode, the authorities could move forward with a bold and wide-ranging reform program designed to achieve a high and sustainable growth path that could be supported by resources from the IMF. In this connection, a mission to Islamabad is envisaged in the near future."

Assigning functions, coordinating budgets

A variety of issues were raised at the seminar. First, participants stressed that, if decentralization in Indonesia is to be effective, it is important to assign different functions to the appropriate level of local government—provinces, districts, or associations of districts. The legislation requires that most expenditure functions be devolved in a "big bang" to districts during 2001. While participants felt that it would be relatively easy to assign the revenue shares and transfers to local government entities, they were uncertain as to whether the central and subnational governments could decide within the time available on the functions that would devolve to the districts in 2001 and whether the districts would be capable of assuming these functions. Nor was it clear whether districts should be responsible for such functions as teaching hospitals, the national transportation grid, or air traffic control.

Because the national budget cycle will shift to January from April beginning in 2001, only four months remain for decentralization proposals to be incorporated in the budget to be submitted to parliament. The participants also stressed that the success of the decentralization program will hinge on the establishment of systems to coordinate the management and reporting of the subnational budgets. The role of the ministry of finance in this area is crucial but requires further clarification.

Other key issues that Indonesia must address when it decentralizes its government, in the view of seminar participants, are how the existing central, or deconcentrated, staff will be allocated to local units; who will ensure that relevant assets, such as buildings and other infrastructure, are delivered; who will be responsible for regulation; and how policymaking will be coordinated across regions. It is also critical—and required by the legislation—that when responsibility for certain functions shifts to a different level of government, the necessary financing follow these functions. This will help prevent macroeconomic difficulties (such as increased general government deficits) as well as ensure that the salaries of former central employees—including teachers, doctors, and contractors—for which local governments will assume responsibility are paid as of January 1, 2001.

Revenues and expenditures

A team representing the Center for Social and Economic Research of the University of Indonesia pointed out that existing revenue assignments need to be considered further. Currently, the team noted, local governments do not have control over tax rates and, hence, cannot raise more revenues to finance additional expenditures at the margin. Such control is critical for local accountability. Revenues from the land and property tax, for example, are shared, but the center determines the tax rate and the central tax administration collects the tax. It was agreed that the local units of government should be able to set the rates for this tax, even if the central tax administration remains responsible for land valuation, payments collection, and audits.

Participants felt that the regions should not be allowed unlimited borrowing possibilities, which could also lead to macroeconomic difficulties. Emil Salim, chairman of the president's National Economic Advisory Council, suggested that Indonesia had much to learn from the experiences of Latin American countries with unconstrained local borrowing. A number of measures for managing expenditures were proposed, and participants noted that the IMF's Fiscal Affairs Department is providing technical assistance in this area.

Seminar participants discussed other potential revenue sources that could be shared between the central tax administration and local and provincial levels of government. One possibility would be for the central government to allocate to the local governments a certain number of percentage points (known as "piggybacking") from the personal income tax or, at the provincial level only, the corporate income tax. According to the participants, the proposals for sharing government revenues derived from the production of onshore oil and gas with the provinces and districts in which these resources originate were fraught with uncertainty. The complexity inherent in determining the revenue shares, given existing production-sharing arrangements, could lead to disputes as to the amounts to be shared. One proposed solution would be to assign a clearly defined royalty, levy excises on production to offset environmental damage, and implement the suggested piggy-backed income tax share. The revenue sharing would also exacerbate interregional disparities. In any case, the seminar participants noted, the issue of regional disparity must be addressed in the context of the general system for transfer among subnational governments.

Conclusion

Participants focused on more sequenced alternatives to the "big bang" approach to decentralization. Given the enormity of the task at hand, the Indonesian authorities could adopt two possible strategies. For 2001, they could decide to decentralize quickly to the provincial level in the first instance. Alternatively, the focus on districts could be maintained, but districts would assume responsibilities that they are capable of administering on a case-by-case basis. In both cases, the legislated principle that financing should follow function needs to be maintained so as not to endanger Indonesia's economic stabilization. ■

Ehtisham Ahmad
IMF Fiscal Affairs Department

VATs are appropriate for wide range of economies, but certain preconditions are vital for success

The Fiscal Affairs Department recently presented the IMF's Executive Board with a detailed examination of the value-added tax (VAT). This study is currently with national authorities for comments. Two of its principal authors, Liam Ebrill and Michael Keen, discuss the findings with the IMF Survey.

IMF Survey: What is a VAT?

Keen: A VAT is a tax levied on all sales of commodities—goods and services—at every stage of production. The crucial element is that it credits taxes paid on inputs against taxes charged on outputs. By contrast, a simple turnover tax is levied on each transaction. This tax cascades through the chain of production and provides enormous incentives to, among other things, avoid the tax by vertical integration. Crediting allows the tax process to have a much more neutral impact on economic activity.

IMF Survey: What has driven the broad and relatively rapid acceptance of the VAT?

Ebrill: A combination of rising revenue needs—which implied a need for higher tax rates in general—and the degree to which earlier taxes, such as the turnover taxes, led to misallocations of resources. Also, most VATs operate as a tax on consumption, which is appealing from an economic perspective. But the rise in the VAT has truly been extraordinary (see map, page 156).

IMF Survey: Why did the Fiscal Affairs Department decide to do a major study at this juncture?

Ebrill: The department has been providing technical assistance on tax matters for many years, and the VAT is a major part of this. We wanted to be certain we were providing the right advice, and we wanted to know if there were areas where we should change our advice or at least make it more consistent.

Keen: Also, the VAT is hugely underresearched. To address our technical assistance concerns, we had to look at the VAT in a broader context and ask how it had fared and whether it had improved efficiency.

IMF Survey: What were the goals of the study?

Keen: A key question was whether any elements of our advice have not worked. The study surveyed VAT experts on individual countries, and this allowed us to compare IMF advice and actual practice. Where there had been systematic differences between the two, we asked ourselves: Is our advice incorrect or are we not selling it effectively? The study yielded useful information in a number of areas.

Ebrill: We certainly found the devil was in the details. The exercise was much richer in insights on details of the tax than we had anticipated.

IMF Survey: Has the VAT been inappropriate for certain types of countries? And are there conditions that must be in place before a country implements a VAT?

Ebrill: When the VAT first came into being in Europe, it was presumed to be a tax for sophisticated countries with sophisticated taxpayers. Now, the VAT is being implemented in a wide range of economies. We found that if the crediting mechanism is emphasized and if individual country circumstances are taken into account, the VAT can be applied just about anywhere. The only remaining questions have to do with the smallest open island economies.

The preconditions were one of the most important lessons of this exercise—and one we perhaps did not anticipate. Some tax administration reforms should be in place before a country embarks on a VAT, and these reforms are more difficult and more time-consuming to implement than we expected. Our results strongly suggest that self-assessment and a tradition of paying taxes are necessary preconditions for the effective implementation of a VAT.

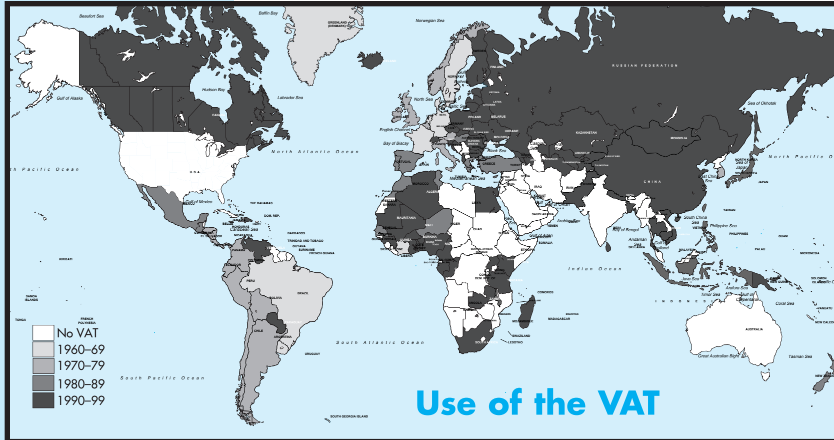
Keen: We also came to appreciate that in some countries a VAT comes about naturally. The VAT seems a dramatic step, but in many cases a country with a broad-based tax notices problems with cascading and introduces crediting arrangements. In effect, the VAT serves as a tidying-up exercise. Of course, a VAT is a deepening of the tax process, but in a structural sense, conditions often dictate when a VAT emerges.

Liam Ebrill (left) and Michael Keen.

IMF Survey: What were the study's findings with regard to tax policy issues?

Ebrill: On some issues, the study provided definitive results; on others, the findings clarified our understand-

ing of an issue but did not necessarily provide a clear-cut answer. In the debate over whether multiple rates or a single rate is preferable for a VAT, we found a genuine trade-off between tax administration considerations, which favor single rates, and tax policy considerations, which suggest taking account of differences in demand for various commodities. Most experts are still inclined toward a single rate, but certainly there are aspects of the issue that cannot be resolved definitively.



KEEN: In contrast, we did make genuine progress on where to set the threshold for a VAT. The study found that we quite consistently recommended thresholds higher than those actually adopted. We asked ourselves what considerations drove those decisions and what constituted an optimal threshold for a VAT. With the benefit of simple modeling, we figured out the marginal costs and benefits of moving the threshold around.

A higher threshold saves on costs for both the tax authorities and the taxpayer. But a higher threshold also exacts a cost in terms of revenue and can induce distortions between companies above and below the threshold. Theory tends to back up the IMF's preference for a high threshold, but why, then, haven't we persuaded countries about this? We had perhaps tended to ignore the importance of imposing a simple tax on people below the VAT threshold, because the resulting revenue was not much. But such a tax may help politically to sustain a high threshold and thus be advantageous. This helped us bring policy and administrative perspectives together and think through a coherent strategy.

EBRILL: In the treatment of agriculture, we found our advice was not necessarily consistent across countries, and certainly the implementation of that advice was not. We realized we could come up with a much more coherent argument as to why agriculture should be treated like any other sector. Agriculture is a very difficult area to tax, but some of the devices used to exempt agriculture are causing even more problems.

KEEN: The study also provided useful information on exemptions, which waive the tax charged on outputs but do not credit for amounts paid on inputs. In terms of tax neutrality, the VAT can be a thing of great beauty—at least to a certain strange kind of person. Even multiple rates preserve the elegance of a VAT by retaining the critical element of crediting. But exemptions truly muck it up. Once the cascading starts, the tax system loses any kind of transparency.

IMF SURVEY: On the tax administration side, the study suggests crucial issues.

EBRILL: The study focuses on areas of difficulty—notably, auditing, self-assessment, and refunds. Auditing requires a rational and effective use of scarce resources. The study found that the audit function has often been underemphasized in the implementation phase. Initially, taxpayers assume everyone is watching them, so this does not cause a problem. The problems come later, if taxpayers realize they are not being watched.

The study also looked closely at self-assessment. With self-assessment, taxpayers figure out their own tax bill rather than have the authorities do this for each citizen and assess accordingly. We found that introducing a VAT in countries that aren't comfortable with self-assessment causes problems. The authorities then sometimes compound this problem by imposing more, not fewer, requirements on taxpayers. Clearly, countries uncomfortable with self-assessment should consider developing that capacity before pushing ahead with a VAT.

IMF SURVEY: How does a country develop self-assessment capabilities?

KEEN: You build on what you already have, and education and taxpayer training help. You also keep the tax system simple. In countries with final withholding arrangements, initially most individual taxpayers would not have to file returns, and the number having to make arrangements for their tax liabilities would be minimized. It would be an incremental process. As people learn how to work with the system, it can become more sophisticated.

EBRILL: Refunds are clearly also a significant problem with the VAT in many countries. Exports should be zero rated, and the exporter should be entitled to whatever VAT is already embodied in the good. In practice, however, this is not working very well. Countries with fiscal problems are reluctant to part with the cash they have collected, and where there are concerns about fraud, the authorities may not be confident about their ability to identify genuine claims. Whatever the reason, many countries are not paying refunds. But the moment you do not pay refunds, you undermine the very principle of a VAT. Quantitatively, this can be a very large problem—in many developing countries, half of gross VAT receipts could be refundable.

KEEN: Some countries restrict refunds to exporters or to capital goods. This reduces the apparent size of the

problem but still jeopardizes the crediting mechanism. We have tried—though not entirely successfully—to develop a simple indicator for what the proper level of refunds in a country should be.

IMF Survey: Were there other issues?

EBRILL: Going into the study, we asked ourselves whether a VAT was appropriate for small island economies. It is not clear, at least in simple small economies that import a lot of their consumption, that there is a huge gain from moving toward a VAT. A tariff may achieve the same result. But we found it was not so much a matter of the economy's size as it was a question of how much of the economy's consumption comes from imports, how much domestic production there is, and how complicated that domestic production is.

There are many small island economies where the VAT appears to work very well. Barbados, for example, has an increasingly sophisticated economy and a growing service sector, and it found that a VAT allowed it to broaden its tax base. The evidence suggests a VAT is more useful in more circumstances than some have argued.

IMF Survey: What are the priorities for future IMF technical assistance and research?

EBRILL: Our study pulls together a lot of useful insights in a cogent fashion and allows us to ensure that our technical assistance program is as coherent and fruitful as possible. We have sent this study to the IMF's Executive Directors and are hopeful we will receive comments from their national authorities. At some future stage, we are also considering regional conferences to meet with officials and identify precisely where the points of tension with the VAT are.

KEEN: Two issues warrant more attention in the future: how VATs function in federal systems of government and the growing impact of E-commerce on VATs.

The VAT has functioned very well as countries have become more closely integrated in economic terms, because it so neatly removes indirect taxation from exports. It's one reason why it has been so successful in the European Union. The irony is that the VAT has proved problematic when integration proceeds beyond a certain point. That's because it becomes much more difficult to enforce zero rating on exports in the absence of border controls—it is simply harder to check that goods have actually been exported. One challenge now is how to run a VAT within increasingly integrated economic units that see themselves as a single country. This is why within Europe, for example, progress on the VAT has virtually come to a halt.

This issue comes up in other countries as well. It's no coincidence that two of the biggest countries without a VAT are the United States and India, which are both federal countries. The issue has come up in our technical assistance work in the CIS [Commonwealth of Independent States], Bosnia, and India (which recently announced its plans to adopt state-level VATs). We have been doing conceptual work on this and see it as an important area for the future.

On the impact of E-commerce, the question is whether the Internet changes anything fundamental or simply intensifies existing problems. To a large extent, we see it intensifying existing problems—particularly the treatment of services. Under a VAT, it has always been difficult to treat services, because it is hard to intercept services as they cross borders. E-commerce, however, may make it harder to control some additional transactions. Once we digitize goods, for example, they become hard to intercept at the border. ■

The study on the value-added tax is with national authorities for comments. The study, with comments incorporated, will provide the basis of a forthcoming book by the authors.

Available on the web (www.imf.org)

Press Releases

00/33: IMF Approves $9.0 Million PRGF Credit for São Tomé and Príncipe, April 28

00/34: IMF and World Bank Support Debt Relief for Uganda, May 2

News Briefs

00/23: IMF Executive Board Reviews Pakistan Misreporting, Remedial Steps, April 28 [see page 153]

00/24: IMF Completes Turkey Review and Approves $293 Million Credit, April 28

00/25: IMF Statement on Uganda Reaching Enhanced HIPC Completion Point, May 2

Public Information Notices (PINs)

00/33: Israel, April 24

Letters of Intent and Memorandums of Economic and Financial Policies (date posted)

Ecuador, April 24

São Tomé and Príncipe, April 28

Turkey, May 1

Other

Reports on the Observance of Standards and Codes: An Update, April 19

IMF's Civic Program, April 24

Notes:

PINs are IMF Executive Board assessments of members' economic prospects and policies. They are 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.

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.

Improved growth performance

After escaping effects of Asian crisis, Philippines must avoid return to past boom-bust cycles

Over the past two decades, the Philippines has come out of a long period of slow growth and economic imbalances to become a dynamic emerging market economy. Skillful crisis management largely allowed it to escape the recent turbulence in Asia, further enhancing its image as a strong and vigorous economy.

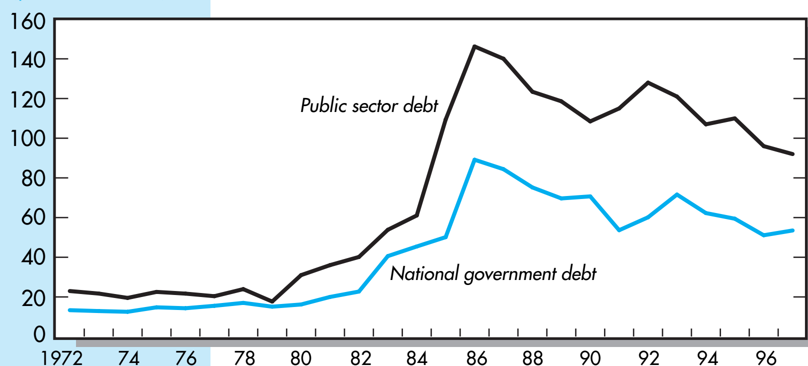
Reforms under way since the late 1980s (and supported in the 1990s by an Extended Fund Facility and a Stand-By Arrangement from the IMF) continue to bear fruit, but events over the past two years also highlight what remains to be done. The task now is not only to restore growth and investor confidence but also to sustain momentum. The Philippines must prevent a return to the boom-and-bust cycles of the past and ensure the country benefits fully from integration into the global marketplace. Accomplishing this will mean tackling the still-pervasive legacy of the past—notably, low savings, widespread poverty, accommodation of rent-seeking activities, and structural weaknesses in the public sector. This article, based on IMF Occasional Paper No. 187, *Philippines: Toward Sustainable and Rapid Growth*, looks at the achievements and the challenges ahead for the Philippine economy.

GDP growth
(percent change)

	Philippines	Malaysia	Indonesia	Thailand
1969–74	4.0	7.6	5.6	4.6
1975–80	3.9	6.6	5.9	5.5
1981–86	–1.3	1.5	3.4	3.4
1987–92	2.6	7.1	4.4	6.5
1993–99	3.0	4.0	1.4	1.8

Data: IMF, Occasional Paper No. 187

Philippines: public and national government debt
(percent of GNP)



Data: IMF, Occasional Paper No.187

Economic growth

Weaker growth rates have long set the Philippine economy apart from many of its Asian neighbors, but its recent performance offers grounds for optimism. The benefits of reform are being felt through higher growth, particularly since 1993, and the country exhibited a new resilience during the Asian crisis (see table, this page). At the height of the crisis, Philippine real GDP declined by only 1/2 of 1 percent in 1998, compared with declines of 6–14 percent in the countries most heavily affected by the crisis. Productivity growth appears to have picked up, and there has been some movement away from the Philippines' past reliance on a capital-intensive, import-competing system of production. Empirical work by IMF staff, presented in the Occasional Paper, suggests that the improved performance has its roots in the economy's increasing openness, stable investment rates, and expanded foreign direct investment.

Sustained growth will be contingent on continuing outward-oriented and market-driven policies. To raise saving and investment rates and improve productivity, it will be essential to return to fiscal consolidation and streamline the public sector; maintain prudent monetary policies; create a level playing field through continued trade liberalization and the strengthening of governance; improve prudential, supervisory, and debt resolution frameworks in the financial and corporate sector; and implement policies to reduce poverty and improve equity.

Public finance

In the early 1990s, the Philippines' fiscal accounts improved significantly. The improvement reflected not only a strong consolidation in the national government budget and a substantial reduction in the deficit of the government-owned and -controlled corporations, but also the improved position of other public sector entities. As a result, public debt has fallen significantly from the highs in the mid-1980s (see chart, this page). Since 1997, however, fiscal balances have moved back into higher deficits, as fiscal policy turned expansionary to support domestic demand. Although a widening of the fiscal deficit in line with the slowing economy was appropriate, a larger fiscal stimulus could have been provided—and expenditure cuts in 1998, avoided—if the tax collection effort had yielded stronger results.

Major tax reforms in recent years have improved the tax structure, but revenue efforts need further strengthening. Rationalizing incentives that currently erode the tax base would create a less distortionary and more efficient tax system, and further reform of the tax administration system would boost revenues and ensure transparent and uniform treatment of taxpayers.

While some progress has been made in scaling down unproductive expenditures, additional steps to improve the quality of expenditure are needed—

notably, a rationalization of the structure and size of the civil service and a reform of the inefficient system of intergovernmental finances. Such measures would free up resources for more growth-oriented spending on infrastructure and human development. Reforms in the wider public sector are also urgently needed, particularly in the power sector, where the finances of the National Power Corporation are unsustainable. Draft legislation enabling power sector reforms is expected to be approved by mid-2000.

Fiscal sustainability has improved considerably in recent years, but the fiscal situation remains vulnerable to shocks. Strong economic growth and continued fiscal reforms would keep public sector debt on a sustainable path over the medium term.

Monetary and exchange rate policy

By the end of the 1990s, the Philippines' monetary policy institutions had evolved into a well-functioning system. Over the past 15 years, the country has reformed its monetary framework and policy instruments and created the Bangko Sentral ng Pilipinas (BSP). Since replacing the old (and insolvent) Central Bank of the Philippines in 1993, the BSP has become an independent monetary authority with full administrative autonomy and a clear legal mandate to pursue price stability. It has kept a sharp focus on macroeconomic stability, responding flexibly to new challenges.

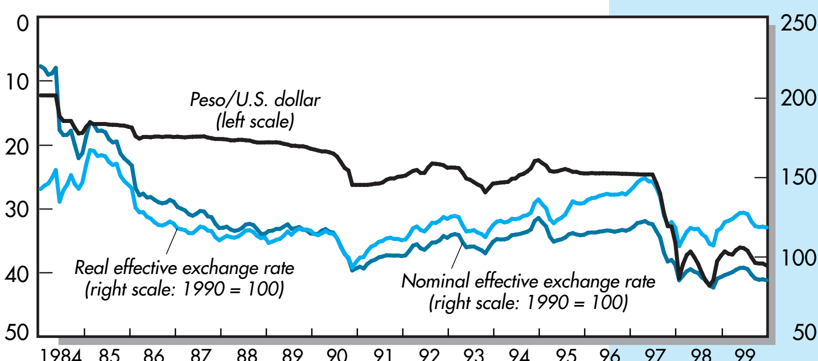
Since 1984, the Philippines has formally based its monetary policy on a floating exchange rate and monetary targets. While this provides an appropriate overall framework for monetary policy, the BSP at times has appeared to follow multiple objectives—for example, adopting a de facto peg of the exchange rate in late 1995 while retaining base money targets. Even so, the BSP has been largely successful in recent years: it was able to reduce inflation in the face of the policy challenges posed by capital inflows and instability in money demand in the mid-1990s and successfully managed monetary policy during the Asian crisis—combining exchange rate flexibility with a relatively tight interest rate policy. While not aggressively defending a particular level of the peso, the BSP used interest rates to lean against the wind of exchange market pressure and intervened only to build up reserves and maintain orderly market conditions. After the crisis abated and stabilization was well under way, the central bank shifted its stance to support economic recovery and reduced interest rates to below precrisis levels.

In the period ahead, the main challenge for the BSP will be to maintain price stability—a statutory goal reflected in its recent decision to move toward inflation targeting in the coming year. Such a framework will allow the BSP to implement monetary policy in a consistent and transparent framework well understood by the public.

External sector

The Philippines' external sector came under heavy pressure during the Asian crisis, but it proved less vulnerable than in the most heavily affected countries in the region. Lessons learned from earlier crises, particularly in external debt management and banking policies, obviously helped contain the buildup of imbalances in the mid-1990s. Nevertheless, large capital inflows in this period nearly overwhelmed the policy framework and led to an overvaluation of the peso (see chart, this page), a growing current account deficit, and rapidly rising short-term debt. When the tide turned in 1997 as capital flows reversed direction, the authorities reacted quickly by floating the peso, raising

Philippines: exchange rates



Note: An upward movement indicates an appreciation of the peso.
Data: IMF, Occasional Paper No.187

interest rates, and accelerating structural reforms. These policies stabilized the external position without the severe disruption experienced in some other countries affected by the crisis. By 1999, the current account had shifted into a sizable surplus, boosted by strong export performance throughout the crisis period and sluggish imports. During this period, the country built up its international reserves to record levels.

Continued and significant trade liberalization has induced favorable structural changes since the 1980s. The average tariff rate fell to 10 percent in 1999. And Philippine exports have increased strongly, reflecting their rapidly growing global market share in electronics and electronic components (see chart, page 160). Although such growth has come partly at the expense of some of the more traditional exports (such as garments and minerals), the country has demonstrated its capacity to compete successfully in one of the most dynamic export markets in the world.

Despite this improvement in the external position, a challenging policy agenda for the medium term is to reduce the country's vulnerability to shocks. Macroeconomic policies will need to combine prudent demand management with exchange rate flexibility to support sustained rapid growth and prevent the buildup of excessive leverage and debt. To sustain gains in market share, the Philippines will need to assist its export sector through increased infrastructure investments, enhanced

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access of small and medium-sized enterprises to finance, and improved services, including in the area of public administration. Moreover, to encourage further integration with global markets, trade liberalization will need to continue in line with the country's commitment to reduce the general uniform tariff to 5 percent.

Financial and corporate reforms

As economic performance improved in the 1990s, the banking sector also became more efficient and more resilient in coping with shocks. Financial sector reforms prior to the 1997 crisis encouraged greater competition, strengthened supervisory and regulatory systems, and streamlined the tools of monetary policy. These reforms substantially improved the system's financial intermediation and payment flows and helped shield the Philippine banking system from the worst effects of the Asian crisis in 1997–98. Nonetheless, the ratio of nonperforming loans to total loans rose from 4 percent precrisis to a peak of 14½ percent in early 1999. In response, the authorities initiated further reforms to bolster the banks' capacity to face adverse shocks, enhance supervisory capabilities, and reinforce the institutional framework to deal with troubled banks.

To further strengthen the system, reinforce supervisory capabilities, and bring supervisory standards up to best international practices, continued reforms will need to reduce distortions in financial intermediation (such as eliminating mandatory credit allocation programs), enhance prudential and supervisory frameworks, streamline the process of bank exit and resolution of problem banks, and restore the only large bank in difficulty—the Philippine National—to a sustainable financial position (together with its full privatization, for which an action plan has recently been adopted).

Philippine companies, which had manageable levels of total indebtedness and exposure to foreign debt at the beginning of the crisis, weathered the tumult fairly well. But reforms to bring corporate governance into line with best international practice could help build market confidence and encourage stable, long-term investment. Other reforms could usefully address the protection of creditor and minority shareholder rights, debt resolution and insolvency, enforcement of accounting standards and disclosure rules, and adherence to standards for borrowing and lending (particularly with respect to insider loans).

Equity and growth

As the Philippines' growth performance has improved, the incidence of poverty has declined—from 44 percent in 1985 to 32 percent in 1999. But poverty remains high, particularly in the rural areas, and income distribution is very unequal. Poverty indicators appear to reflect policies in agricultural, fiscal, and external areas that are biased against the rural sector. In the agricultural sector, heavy regulation and uncertainty concerning the implementation of land ownership reform have hampered much-needed investment. In the fiscal area, the share of education expenditures has risen, but concerns remain about quality and distribution. In addition, spending on health and nutrition remains low by regional standards and is biased toward personal health care rather than preventive care. In the external sector, exchange and trade policies historically would contribute to inequity by protecting manufacturing at the expense of agriculture. In addition, protection and other incentives encouraged the manufacturing sector to substitute capital for labor.

While high growth has previously helped to reduce poverty, attaining the government's targets for poverty alleviation (poverty incidence of 25–28 percent by 2004) will likely require, in addition to high growth, targeted interventions in the rural areas as well as higher-quality and better targeted fiscal expenditures directed to social objectives and further reductions in protection.

Overall, the Philippines has made great strides in the past 15 years, achieving strong and comprehensive reform and minimizing the disruption from the Asian crisis. At the same time, however, the crisis exposed structural weaknesses on which further progress will have to be made in order to achieve sustained rapid growth and significant poverty reduction. ■

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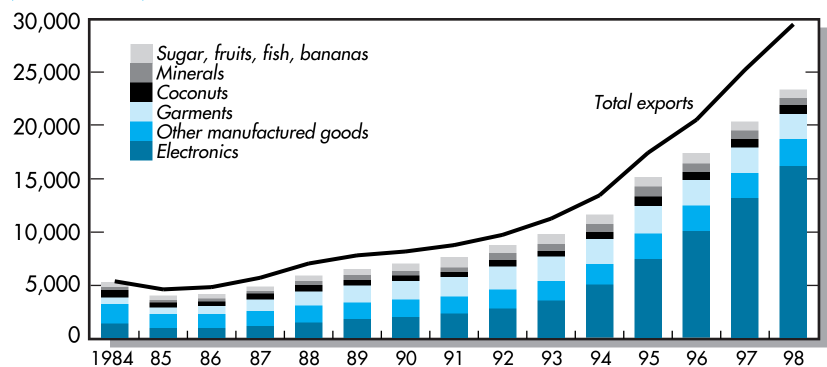
Philippines: selected export components
(million dollars)



Data: IMF, Occasional Paper No.187

Copies of IMF Occasional Paper No. 187, *Philippines: Toward Sustainable and Rapid Growth*, by Markus Rodlauer, Prakash Loungani, Vivek Arora, C. Christofides, Enrique G. de la Piedra, Piyabha Kongsamut, Kristina Kostial, Victoria Summers, and Athanasios Vamvakidis, are available for $18.00 (academic rate: $15.00) each from IMF Publications Services. See page 152 for ordering details.