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Discussions on emerging market economies

IMF Managing Director Horst Köhler visits countries of Latin America

Horst Köhler visited Brazil, Argentina, Honduras, and Mexico in his first official travel as the new head of the IMF.

In one of his first actions as Managing Director of the IMF, Horst Köhler visited four countries of Latin America—Brazil, Argentina, Honduras, and Mexico—during the week of May 15–19. Köhler, who had assumed the office of Managing Director on May 1, also met on May 8 in Washington with Miguel Angel Rodriguez, the President of Costa Rica.

In a news brief released on May 11, the IMF announced that the purpose of Köhler's trip to Latin America was to hear perspectives on critical issues facing the global economy. He was particularly interested in the views of emerging market countries on the role of the IMF, which will be an important input in the consideration of reform of the institution. The news brief added that Köhler plans similar trips to Africa and Asia, although dates for this travel had not yet been set.

(Please turn to the following page)

Conference in Lusaka

Seminar participants call for enhanced partnership between Zambia and IMF

Zambian Finance Minister Katele Kalumba, speaking at seminars held with the IMF in Lusaka in April, urged representatives of Zambia's civil society groups to make the country's partnership with the IMF more effective by participating in efforts to identify solutions for the country's economic challenges. Kalumba said there could be no talk of host-country "ownership" of an economic program without such participation and called for both an exchange of ideas and a leveraging of Zambia's relationship with the IMF "for the ultimate benefit of Zambia."

The seminars, the latest in a series the IMF has sponsored in Africa, are intended to expand the IMF's dialogue with legislators and civil society. Similar seminars were held in Cameroon and Nigeria last year. The format of each seminar avoided lengthy presentations, so as to allow ample time for open and informal discussion.

Forging partnerships

In the first seminar in Zambia, on April 26, 40 members of the National Assembly heard keynote remarks from Speaker Amusaa Mwanamwamba, who said he hoped the event would explain to parliamentarians not only the tangible, material benefits but also the social benefits that IMF-supported policies would bring to ordinary Zambians. Kalumba, referring to the IMF as a major partner in Zambia's postindependence economic policies, noted that the legislators had had little contact with the IMF and that they had little opportunity to gain an understanding of its objectives and strategies. He observed that most of Zambia's achievements would have been difficult to attain without the IMF's support, but that there were negative perceptions about the IMF because it had not done enough to explain its role and actions. Kalumba urged the

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(Continued from front page) (The text of the news brief is available on the IMF's website: www.imf.org.)

At a press conference on May 15 at the start of his trip in Rio de Janeiro, Köhler said that "one of the most immediate things that we need to do is to listen more to member countries like Brazil." He added that he and Brazilian President Henrique Cardoso agreed on the principle that the IMF should play a central role in the international financial system. He also said that, while globalization had provided comparative advantages to different economies, the IMF would need to study ways to ensure that emerging market countries obtain a larger share of the growth that results from globalization.

Speaking of moves under way to reform the international financial system, Köhler said, "among the reforms being considered are more comprehensive surveillance of IMF member economies, lending that seeks to provide a bridge back to capital markets for countries suddenly denied private sector funding, streamlining of IMF loan facilities, and provision of debt relief for the world's poorest countries." ■

IMF Managing Director Horst Köhler addresses the IMF staff on May 11.

Recent publications

Books

External Debt and Capital Flight in Sub-Saharan Africa, edited by S. Ibi Ajayi and Mohsin Khan ($26.00)

Occasional Papers ($18.00; academic rate: $15.00)

190: *Capital Controls: Country Experiences with Their Use and Liberalization*, Akira Ariyoshi, Karl Habermeier, Bernard Laurens, Inci Ötker-Robe, Jorge Iván Canales-Kriljenko, and Andrei Kirilenko

Working Papers ($7.00)

00/73: *Caribbean Approaches to Economic Stabilization,* Alvin D.L. Hilaire

00/74: *Social Capital and Civil Society,* Francis Fukuyama

00/75: *A Simple Model of an International Lender of Last Resort,* Charles A. E. Goodhart and Haizhou Huang

00/76: *Assessing Financial System Vulnerabilities,* R. Barry Johnston, Jingquing Chai, and Liliana Schumacher

00/77: *How Accurate Are Private Sector Forecasts? Cross-Country Evidence from Consensus Forecasts of Output Growth*, Prakash Loungani

00/78: *Rural Poverty in Developing Countries: Issues and Policies*, Mahmood Hasan Khan

00/79: *Emergency Liquidity Support Facilities*, Dong He

00/80: *Seasonality and Capacity: An Application to Italy*, Guido de Blasio and Federico Mini

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00/82: *Social Fractionalization, Political Instability, and the Size of Government*, Anthony Annett

IMF Staff Country Reports ($15.00)

00/55: Eritrea: Statistical Appendix

00/56: Republic of Slovenia: Selected Issues

00/58: Burundi: Statistical Annex

00/59: Hungary: Selected Issues and Statistical Appendix

00/60: Poland: Selected Issues

00/61: Poland: Statistical Appendix

00/62: Israel: Selected Issues and Statistical Appendix

00/63: Monetary and Exchange Rate Policies of the Euro Area: The Euro Area Stability Programs

00/64: Bulgaria: Selected Issues and Statistical Appendix

00/65: Luxembourg: Staff Report for the 2000 Article IV Consultation

00/66: São Tomé and Príncipe: Staff Report for the 1999 Article IV Consultation and Request for an Arrangement under the Poverty Reduction and Growth Facility

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Seminar features open Zambian-IMF dialogue

(Continued from front page) parliamentarians, most of whom were ranking members of the National Assembly's specialist committees, to take advantage of the opportunity offered by the meeting "to begin forging a working partnership directly with the IMF." This would enable them to obtain the necessary background to make informed interventions on behalf of the people they lead. Discussions followed on the background to and the way forward in Zambia's relationship with the IMF, the importance of good governance for growth and equity, and the social dimensions of adjustment and reform.

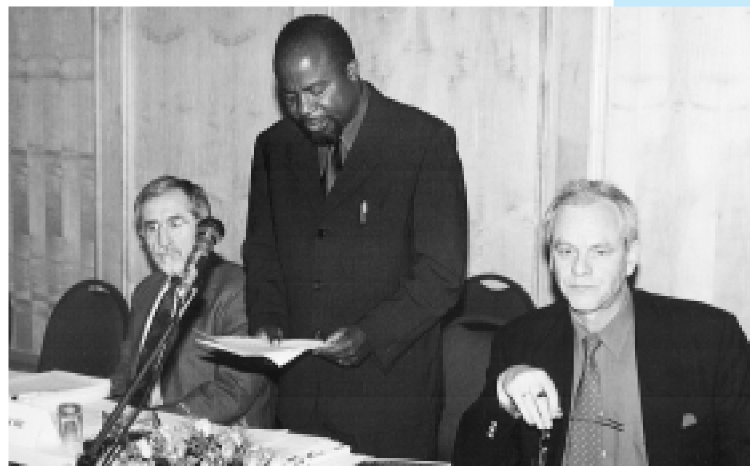
In a resolution adopted at the end of the seminar, the parliamentarians called for the National Assembly's oversight of the executive to be strengthened to ensure that, in particular, resources arising from debt relief were not "misapplied or misdirected." The statement called for IMF-supported programs to incorporate scrutiny of "individual components of expenditure to ensure those aspects that relate to poverty reduction and the standard of living of the people, as well as the most important basic services, are adequately catered for in the budget."

The statement also said that the IMF itself needed to be reformed "to be made responsive to . . . new challenges, especially (those) of developing countries." Graham Hacche, Deputy Director of the IMF's External Relations Department, noted in his remarks to the parliamentarians on good governance that the IMF had made strides in improving its own governance, particularly through increased openness and transparency.

Civil society and the IMF

More than 50 representatives of civil society from Zambia, Zimbabwe, and Malawi attended the second seminar, held on April 27 and 28. Participants included members of nongovernmental organizations, organized labor, the private business sector, religious groups, academia, and the media. Topics discussed included privatization, good governance, debt relief, and poverty reduction. Kalumba told the civil society delegates that Zambia's partnership with the IMF had to be made to work and that only Zambians could define what the partnership would achieve.

Zambian Auditor General F.M. Siame said the need for good governance in countries such as Zambia had become urgent. They required good governance to attract development capital in the form of foreign direct investment, loans, and grants. In remarks read on his behalf, Zambia Congress of Trade Unions President Fackson Shamenda said the congress was concerned about the manner and pace at which the Zambian government was implementing structural adjustment policies. "There is little or no consultation with the stakeholders in the entire process of adjustment," he said. Consultation, consensus, and ownership of reforms were key issues in the reform process. Social partners and the wider community had to be involved in the formulation and implementation of social and economic policies.



Zambian Finance Minister Katele Kalumba (center) addresses the seminar. Graham Hacche (left) and Reinold van Til (right) also participated.

Hacche explained that conditions were attached to loans from the IMF partly to safeguard its resources for use by other members in need, but also in part to help the borrowing country. "It is no good to a country if the IMF lends it money that is not put to good use. If that is the case, the country will just be left with debt to the IMF—it will be worse off than it was in the first place," Hacche said.

Zambia needs to continue to emphasize the development of the private sector if it expects to raise sustainable real GDP growth to over 5 percent a year, according to Reinold van Til, Assistant Director in the IMF's African Department. Emphasizing private sector development means the government would need to continue to work on an enabling environment for it, he added. Calvin McDonald, Senior Economist in the IMF's Fiscal Affairs Department, noted that the IMF was strengthening the integration of social policies in its operations by strengthening the link between debt relief granted to low-income countries and poverty reduction. The IMF's new Poverty Reduction and Growth Facility would stress the links between growth and poverty reduction in adjustment programs, he said.

Several participants commented that the seminar for civil society provided a rare opportunity for dialogue with both the IMF and the Zambian authorities, adding that many misconceptions about the work of the IMF had been dispelled and that more such events would be desirable. A common sentiment at the seminar was that the Zambian public misunderstood the role and functions of the IMF. Some participants also said they would seek more intensive consultation with the Zambian authorities on economic policy issues. ■

Simon Willson
IMF External Relations Department

IMF Institute seminar

Dollarization debate needs to be framed in frank examination of options, Calvo counsels

Experience with dollarization is so limited, and empirical data so scant, that any definitive assessment of it at this stage is foolhardy, according to Guillermo Calvo of the University of Maryland. But, addressing an IMF Institute seminar on May 11, he noted that current circumstances do provide the ingredients for an "interesting debate." He counseled taking a fresh look at the assumptions shaping this debate, stressing that his presentation would focus on "how to think about these issues" rather than on conclusive recommendations. He did suggest, however, that analysts and policymakers take a hard look at the real options for exchange rate regimes in emerging economies. What they may find, he said, is that floating regimes may be more illusion than fact and that fixed rates, particularly full dollarization, might emerge as a sensible choice for some countries, especially in Latin America.

Calvo: If the realities of emerging market economies are fully considered, a fixed exchange rate regime might offer an attractive option.

Liability dollarization

A number of questionable assumptions, Calvo warned, are muddying the ongoing debate over dollarization. In the aftermath of major financial crises in the previous decade, fixed exchange rates have fallen out of favor, and dollarization is frequently viewed as a drastic measure, requiring, among other things, the surrender of the central bank's ability to function as a lender of last resort. But dollarization may not be the sharp departure from existing practices that its critics assume. Partial dollarization, for example, already characterizes a number of Latin American economies, he explained. Analysis of this issue commonly focuses on deposit (asset) dollarization, but debt (liability) dollarization is equally important. Individual borrowers with foreign exchange–denominated debts not matched by foreign exchange–denominated assets can be forced into bankruptcy by any depreciation of the exchange rate. The presence of such currency mismatches may argue for full dollarization.

Capital flows and "sudden stops"

If the merits of dollarization are to be weighed frankly, Calvo noted, it is useful to broaden the discussion and examine the realities in which exchange rate regimes operate in emerging economies. According to Calvo, a structural shift occurred in financial globalization around 1989. Official capital flows shrank, as volatile private markets assumed an increasingly important role. In Latin America, Brady bonds, hailed as the solution to the region's debt problem, also had the unforeseen effect of spurring the growth of a bond market, which in turn led to large portfolio inflows. Portfolio funds appeared to peak in the late 1990s. After a severe contraction following the Russian crisis, they seemed unlikely to recover quickly, he added.

Current capital markets are best characterized as "moody," Calvo said. They are heavily dependent on access to good information, but few participants have good information about emerging markets, so everyone else must follow the leaders. These qualities of the market leave it vulnerable to the sharp mood swings that have characterized the 1990s. The sudden stops in flows, which wreaked havoc in emerging markets over the previous decade, are not unprecedented, but did require "enormous adjustments," according to Calvo. These swings, and the corresponding adjustments, are also dishearteningly at odds, he confessed, with the cushioning effect neoclassical economics predicted would result from the development of capital markets in such economies.

The volatility of the past decade has also called into question the ability of central banks in emerging market economies to handle crises of this magnitude. Calvo noted that these central banks lack the resources to carry out the crisis management tasks expected of them. And external assistance has been spotty at best, he said. The Group of Seven's efforts were effective in Mexico and Korea, but proved slow and marginal elsewhere. This hesitance to become involved should not be surprising, Calvo added, since the central banks of the Group of Seven countries have no mandate to stabilize world markets.

In discussing exchange rate options in emerging market countries, full weight needs to be given, Calvo observed, to the environment in which that policy will be implemented. Capital in emerging markets has been moving with an intensity not seen since the late nineteenth and early twentieth centuries. This suggests that a system of fixed exchange rates—like the gold standard system of that era—might again be appropriate.

Fear of floating

Turning to the broad issue of whether a fixed or floating exchange rate regime would be more appropriate

for emerging market countries, Calvo challenged the current fashion that favors floating. The Group of Seven had "demonized" fixed rates, he said, but the reality is that any exchange rate that moves at all is now being labeled a floating exchange rate. In truth, these "floating" regimes are considerably removed from what is classically defined as a floating exchange rate.

Comparing monthly data for a selected group of emerging and advanced economies, he noted that the currencies of emerging market economies were decidedly less likely to fluctuate than those of the major industrial countries. The emerging market countries were also considerably more likely to experience interest rate changes. This evidence suggested, according to Calvo, that policymakers in the so-called floating rate regimes of emerging markets may not intervene directly in the exchange market but may demonstrate a marked willingness to use interest rate policy to stabilize the exchange rate.

Calvo also drew attention to the high international reserves that have characterized the floating exchange rate regimes of many emerging market countries. In the classical view, a floating exchange rate arrangement should obviate the need for countries to carry high reserves. Possibly because of the incomplete nature of these markets and the inevitable credibility issues, emerging markets perceived a need to "float with a life jacket"—that is, to carry high reserves and pay the attendant costs.

More controversially, Calvo suggested that inflation targeting, which was increasingly finding favor in some emerging market economies, could actually be viewed as a form of fixing. Instead of fixing to the price of one unit of foreign exchange or tradable goods, he said, a country that pursues inflation targeting simply fixes to the price level. He added that inflation targeting is not without its pitfalls. Sound banking and financial systems are essential preconditions for inflation targeting; countries with structural problems would perhaps be better off with dollarization, Calvo said. He also cautioned that inflation has been a sleeping monster in recent years. What happens if that monster reawakens? Resurgent inflation, he was convinced, would quickly put pressure on inflation targeting in emerging market economies and force its eventual abandonment.

Calvo addressed the lender of last resort function of central banks in emerging markets. It is the absence of this function that critics have seized upon to question the wisdom of dollarization. But Calvo argued that the lender of last resort capabilities in emerging market countries are largely a "mirage." Without extraordinary levels of reserves at their disposal, emerging markets often find they have extremely limited (and often undesirable) options in a crisis. In this situation, bailing out a banking system requires extensive lines of external credit, but these typically dry up in an emergency. The alternative—printing money—risks fueling inflation.

Emerging market countries that opt for dollarization can partially substitute for the lender of last resort function by setting up external lines of credit. Argentina has come up with an interesting proposal for full dollarization, Calvo added. Under the proposal, the country was seeking to receive from the United States the present discounted value of the seigniorage associated with adoption of the U.S. currency. Calvo did not believe this was likely to happen, however.

To fix or float...

Perhaps the key point to remember in the debate over whether a fixed or a floating rate is more appropriate for an emerging market economy, Calvo explained, is that these economies are still "emerging." They are setting policy, he said, in a world in which their own financial markets remain underdeveloped, structural rigidities abound, and corporate sectors have very limited opportunities to hedge. In these emerging market economies, stock markets are relatively recent phenomena and bank lending continues to be the dominant form of financing. Exchange rate movements are costly in this environment, he stressed. Indeed, he argued, if the realities of the emerging market economies are fully factored into the decision on exchange rate regimes, the fixed option might look very attractive. ■

Ramos-Horta pays visit to IMF, meets with Sugisaki

IMF Deputy Managing Director Shigemitsu Sugisaki (left) greets Nobel Laureate José Ramos-Horta of East Timor. Ramos-Horta, who is Vice-President of the National Council of the Timorese Resistance, the umbrella organization of pro-independence movements inside and outside East Timor, was paying a courtesy visit to the IMF.

Indonesian experience

In some crises, bank closures may be more effective than resolution efforts

Intervention in banks by the public authorities is often an integral element of a government's program for resolving a systemic banking crisis. Banks may be closed outright ("closure") or permitted to remain open, but under new rules for conducting business ("open bank resolution"). In some circumstances, closures may be more effective than open bank resolution. In a recent study, *Interventions in Banks During Banking Crises: The Experience of Indonesia*, Charles Enoch, Senior Advisor in the IMF's Statistics Department, examines a number of interventions in Indonesia, most of which included bank closures.

Closures and their aftermath

Between November 1997 and March 1999, there were four major bank closures in Indonesia. This process, Enoch notes, has been controversial, particularly in its early stages, although the more recent closures have been viewed more positively.

November 1997. Indonesia began negotiations with the IMF on a comprehensive adjustment program, as the effects of the currency crisis in Thailand, which began in July 1997, spread to Indonesia. By October 1997, the rupiah had depreciated by almost 40 percent. At the same time, runs had been building up on some private banks, as depositors sought to move their funds out of banks believed to be in trouble into banks that were thought to be more secure. As part of the comprehensive program, the government adopted a bank resolution package. On November 1, it was announced that 16 banks, comprising about 2.5 percent of the assets of the banking sector, would be closed immediately.

The immediate response to the program, Enoch observes, was positive. The exchange rate rebounded slightly, and the runs on the banks declined after a few days. However, within a few weeks, sentiment turned negative. Runs became pervasive across the system as concerns over banks' safety merged into broader concerns about the currency and the stance of economic policy overall. Liquidity support provided by Bank Indonesia, the central bank, and currency depreciation intensified, approaching 60 trillion rupiah at the end of January 1998 and threatening imminent financial meltdown.

Although some commentators have blamed the economic problems that occurred after November 1997 on the closure of the 16 banks, Enoch points out that this closure was only one element of an overall bank resolution and macroeconomic program; it was the failure of the government to implement the program that probably undermined confidence in the banks and in the economic management of the country more generally.

Establishment of restructuring agency. To stop the bank runs, restore monetary control, and address the banking sector's problems, the government announced in late January 1998 a blanket guarantee for all depositors and creditors of domestic banks, as well as the establishment of the Indonesian Bank Restructuring Agency (IBRA). In mid-February, 54 banks were brought under the auspices of the IBRA. However, although the interventions were determined on a transparent and uniform basis and were carried out smoothly, the government, prompted by a concern that the interventions could spark renewed runs, determined that no publicity should accompany the action. This last-minute change severely undermined the operation, Enoch notes.

The establishment of the new restructuring agency was an important step forward, Enoch notes, but because it was established as an agency of the Ministry of Finance, rather than as an autonomous institution, its effectiveness was compromised by the need to obtain political authority, even for its technical operations.

April 1998. The February interventions appeared to have little effect on the behavior of many banks, and liquidity support from Bank Indonesia continued at its earlier levels for several more weeks, Enoch says. By April 1998, it was apparent that forceful intervention was necessary to establish the credibility of the IBRA and the restructuring strategy and to halt the continuing liquidity emissions from Bank Indonesia. At this point, 75 percent of total liquidity support to the banking system (comprising 222 banks) was accounted for by only seven banks, representing 16 percent of the liabilities of the banking system. A newly constituted IBRA team earmarked these banks for "hard" open bank intervention—that is, the suspension of shareholders' rights and the assumption of ownership control by the IBRA—and the replacement of the managers by management teams from designated state banks. In addition, seven small banks were closed.

The operation was carried out smoothly, starting on the weekend of Friday, April 3—this time with ample publicity, and with frequent press briefings by the Finance Minister and the Head and Deputy Head of the IBRA, who explained what was happening and assured all depositors that they were totally protected. All deposits from the closed banks were transferred to the state-owned Bank Negara Indonesia—widely regarded as the strongest bank in the country—and all depositors were able to have immediate access to the deposits by Monday morning.

Like the November 1997 experience, the announcement of bank closures was followed rapidly by the

announcement of agreement on an IMF-supported program. This time, however, the authorities demonstrated their commitment in the following weeks to carrying out the other elements of the program.

August 1998. During the spring and summer of 1998, international accounting firms conducted portfolio reviews of the banks taken over by the IBRA in April 1998. The first results, Enoch notes, were devastating, showing levels of nonperforming loans ranging from 55 percent to more than 90 percent of the banks' portfolios. In June 1998, the audit results were leaked to the press. The immediate consequence was shock that the state of the banks was so bad; but beyond that, the leak prevented any further denial of the seriousness of the crisis and forced the authorities to recognize that further drastic action was urgently needed. In addition to developing an overall plan for the banks it had already taken over but not closed in April and May 1998, the IBRA closed three more banks, representing 5 percent of the liabilities of the banking sector, on August 20, 1998.

March 1999. With the share of the state sector in the banking system increasing substantially and evidence mounting that most of the remaining significant private banks were insolvent, the government announced a plan for restructuring the private banks, in order to retain a residual private banking sector. The plan involved a triage of the banks, primarily according to their capital asset ratios. On March 13, it was announced that 73 banks (representing 5.7 percent of the assets of the banking sector) could continue to function without government support, 38 (5 percent) were to be closed; 7 (2.5 percent) were to be taken over by the IBRA, and 9 (10 percent) were deemed eligible for joint recapitalization. The March 13 interventions, and the subsequent implementation of the measures announced at the same time, were well received by the markets, according to Enoch. The comprehensive nature of the action, involving a resolution decision based on uniform and transparent criteria, added to the credibility of the action and to its favorable reception. The general feeling was that the authorities had finally gotten a full grip on the banking situation. At least partly as a result, Enoch observes, market interest rates began falling rapidly from their crisis levels. With the fall in interest rates, prospects for the economy and for the banking system in particular improved dramatically.

Lessons from the closure process

The massive insolvency of the Indonesian banking system called for a major restructuring of the entire sector, Enoch observes. No single closure strategy could have worked successfully throughout the entire crisis and restructuring period, because the true magnitude of the problem became apparent only over time, calling for a phased implementation of more forceful and more comprehensive measures.

The initial stages of a bank restructuring program are bound to be particularly difficult and messy, Enoch notes. The authorities will always be acting on limited information and are likely to have to operate with an inadequate institutional infrastructure and legal framework. They may also be working in a difficult political environment in which there are strong forces resisting change.

Although every banking crisis will be different, there is a strong case for closing some banks at the outset, especially those that are clearly insolvent and riddled with fraud, according to Enoch. An open bank solution, which may limit the capacity to control further losses and where the bank itself has lost credibility, may not be cost-effective. In bank closures, gross costs are realized up front and are easily identifiable, while in open bank resolutions, the costs are realized over time and increase dramatically if the bank is not properly managed.

In Enoch's view, the experience from November 1997 proved that bank closures must be based on transparent, uniform, simple, and defensible criteria. There should be no exceptions to the specified rule, he states, since the credibility of the entire operation will only be as strong as its weakest link.

In most cases, the authorities will have to identify one or more banks that will be in a position to immediately receive the deposits of the banks being closed. In the absence of a clear alternative, they are likely to select a state bank, as the Indonesian authorities did with Bank Negara Indonesia in April 1998. Although this may be appropriate in some cases (and in Indonesia, there was probably little alternative, Enoch notes), state banks may themselves also suffer from serious weaknesses, and there could be advantages to using a private, or possibly even a foreign, bank for this purpose.

The closure process will reduce the number of banks, boosting the potential for profitability among those remaining. Given that most, or all, of the bank closures will occur in the private sector—and that open bank resolution will likely involve a takeover of private banks by the government—the share of state-owned institutions will rise during a bank restructuring. An important corollary of the restructuring strategy—to which the Indonesian government has committed itself—is a program for the privatization of a large part of the private banking sector.

Bank closures and other forms of bank intervention, Enoch stresses, are not the only element in a bank restructuring process. Governments need to introduce a comprehensive program, of which closures may be a part. ■

Copies of IMF Policy Discussion Paper No. 00/2, *Interventions in Banks During Banking Crises: The Experience of Indonesia*, by Charles Enoch, are available for $7.00 each from IMF Publication Services. See page 162 for ordering information.

IMF Working Paper

Withholding tax may offer effective means to discourage volatile short-term capital flows

The high costs of volatility have prompted a search for ways to discourage short-term speculative capital movements without harming longer-term investments more in tune with good fundamentals. Taxes offer one possible tool. In the 1930s, John Maynard Keynes, disturbed by the casino-like behavior of the U.S. stock market, proposed a financial transactions tax to increase the cost of speculative activities and redirect energies toward productive objectives. In response to considerable currency and capital flow turbulence in the late 1970s, James Tobin suggested imposing a tax (the Tobin tax) on all transactions involving currency conversion.

Zee: A cross-border capital tax can increase the transaction costs of short-term capital movements without imperiling the attractiveness of longer-term investments.

In an IMF Working Paper titled *Retarding Short-Term Capital Inflows Through Withholding Tax*, Howell H. Zee of the IMF's Fiscal Affairs Department adapts the narrower goals of the Keynes proposal and suggests that countries pursuing sound economic policies and seeking to cope with large and volatile capital flow movements impose a withholding tax on all private capital inflows. Such a tax, Zee argues, would be easy to administer and difficult to evade, and would thus be more effective than the reserve requirements employed by a number of countries to impede short-term capital flows.

Tobin tax

Zee explains that the Tobin proposal, expressly designed to slow hyperactive international capital movements, taxes the amount of currency converted rather than the investment's rate of return. The burden of such a tax varies inversely with the time period of the investment. Even a low nominal rate (1 percent or less) provides a substantial deterrent to short-term transactions but is of little or no consequence for longer-term investments.

Concerns about the Tobin tax arise, however, in terms of the practicalities of its application. The tax is designed to be administered on a universal and uniform basis on all currency conversions. Its critics contend the tax would generate large economic distortions on transactions unrelated to capital flows, require substantial international coordination to put an enforcement mechanism in place, and raise troublesome issues about the distribution of potentially large revenues among countries. Zee suggests these may be valid criticisms of a financial transactions tax that has a global goal. The criticisms are less apt if the transactions tax has the narrower national objective (and thus is more akin to the nature of Keynes's proposal) of moderating the degree of volatility of capital flows into or out of a country.

The principal risk a country faces from liberalizing its capital account is a sudden and significant reversal in capital inflows that has little to do with the country's own policies. Private speculators do not pick up the bill for the destabilizing impact of their decisions—the country does. In economic terms, this constitutes a negative externality for the country and, according to Zee, calls for a classic economic remedy—a tax on the activity that is generating the externality. He also noted that policymakers have increasingly acknowledged the potentially useful role that price-based measures (of which well-designed taxes are a prime example)—rather than quantitative controls on capital movements—can play in addressing volatile capital movements unrelated to economic fundamentals.

A financial transactions tax that is national in nature—what Zee terms a cross-border capital tax—would avoid the concerns about international coordination, enforcement, and revenue sharing that are associated with the Tobin proposal. A cross-border capital tax would not differentiate between capital flows that generate externalities and those that do not, but the tax burden on flows that do not generate externalities would be insignificant, as they typically have a much longer time horizon.

Cross-border capital tax

Zee proposes a cross-border capital tax that would subject all private financial inflows to a withholding tax at the point, and time, of their entry into the country. The amount withheld on such inflows that is unrelated to capital movements (primarily trade and income flows) would be credited against domestic tax liabilities, and excess credits would in principle be refundable. Most of the burden of the tax would fall on the short-term foreign borrowings of residents; export receipts and income from foreign sources would largely escape the tax.

A cross-border capital tax, Zee suggests, could be readily designed to require all financial institutions that handle funds transferred from abroad to serve as withholding agents; all taxes withheld on export receipts are refunded to exporters under the refund mechanism of a value-added tax; all taxes withheld on interest, dividends, royalties, repatriated profits, and other income flows are credited against domestic income tax liabilities; and the rate of the cross-border capital tax could be adjusted to the degree of disincentive needed.

The proposed tax could be implemented easily. It relies on a withholding mechanism that can be found

in one form or another in almost all tax systems. By piggybacking on effective existing infrastructures, the new tax avoids the administrative headaches associated with designing and operating new systems and keeps start-up and administrative costs to a minimum.

Clearly, Zee admits, there will be minor administrative complications, notably in determining export credits and refunds in countries without value-added taxes and in handling paperwork for those who receive funds from abroad but are not otherwise required to file income tax returns. But this added burden would likely be counterbalanced by benefits beyond the obvious one of discouraging volatile short-term capital flows. A cross-border capital tax could at least partially address the increasingly vexing question of how to tax foreign-source capital income (for example, interest and dividends). With globally integrated financial markets, capital income from abroad is easy to earn but difficult to detect unless taxpayers voluntarily report it. A cross-border capital tax would serve, Zee says, as a final withholding tax, or a minimum income tax, on unreported income.

There is no hard-and-fast rule for determining the optimal rate of a cross-border capital tax, Zee adds. A rate as low as 1 percent imposes a heavy penalty on short-term investments and, if capital flows are high, yields significant revenue. Authorities might be tempted to view this tax as a revenue source, but he strongly cautions against it. Indeed, Zee suggests that some or all of the revenue should be shared among the withholding institutions. This would reimburse them for administrative costs and remove the temptation to use the tax for other objectives.

The withholding proposal offers an interesting contrast to the use of reserve requirements on short-term capital flows (such as Chile employed), Zee says. The two systems take fundamentally different approaches. Chile's reserve requirements, which implicitly serve as a tax (in terms of the interest lost on reserves), necessitate the identification of types of capital flows liable for the reserve requirement. In practical terms, this targeted coverage has been fraught with problems, as borrowers and officials looked to find, or close, loopholes in the system.

A withholding tax largely sidesteps enforcement issues, because it covers all financial inflows and places the burden of proof on those who file for credits and refunds. It is inherently harder to evade (the fungibility of capital flows is immaterial when the tax is applied to all inflows), and easier and less costly to administer (since it relies on existing tax infrastructures).

Ultimately, Zee concludes, a cross-border capital tax offers an effective means of increasing the transaction costs of short-term capital movements without imperiling the attractiveness of longer-term investments. It will not shield a country from the consequences of unsustainable policies. A cross-border capital tax, he insists, would correct for market failures, not propagate policy failures. ■

Members' use of IMF credit
(million SDRs)

	During April 2000	January–April 2000	January–April 1999
General Resources Account	**158.30**	**1,324.82**	**5,024.23**
Stand-By Arrangements	106.00	1,012.52	4,013.32
SRF	0.00	0.00	3,636.09
EFF	52.30	312.30	567.79
CCFF	0.00	0.00	443.12
PRGF[1]	**20.00**	**106.81**	**330.51**
Total	**178.30**	**1,431.63**	**5,354.74**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CCFF = Compensatory and Contingency Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.
[1]Formerly ESAF—the Enhanced Structural Adjustment Facility.
Data: IMF Treasurer's Department

Copies of IMF Working Paper No. 00/40, *Retarding Short-Term Capital Flows Through Withholding Tax,* by Howell H. Zee, are available for $7.00 each from IMF Publication Services. See page 162 for ordering information.

FINANCE & DEVELOPMENT
PUBLISHED BY THE INTERNATIONAL MONETARY FUND

The June issue of *Finance & Development, which will be available shortly, includes several articles focusing on the fight against corruption. In many countries, corruption is a major factor weakening the body politic and jeopardizing prospects for economic growth. Among the articles in this issue are:*

Subverting Corruption
Robert Klitgaard
Making Anticorruption Agencies More Effective
Jeremy Pope and Frank Vogl
Governance Matters: From Measurement to Action
Daniel Kaufmann, Aart Kray, and Pablo Zoido-Lobatón
Stakeholders, Governance, and the Russian Enterprise Dilemma
Raj Desai and Itzhak Goldberg
Where Are Emerging Markets Headed?
Mohamed A. El-Erian
Trade Liberalization in the Caribbean
Janet Stotsky, Esther Suss, and Stephen Tokarick
European Labor Markets and EMU: Challenges Ahead
Rüdiger Soltwedel, Dirk Dohse, and Christiane Krieger-Boden
The New World of Banking
Tomás J.T. Baliño and Angel Ubide

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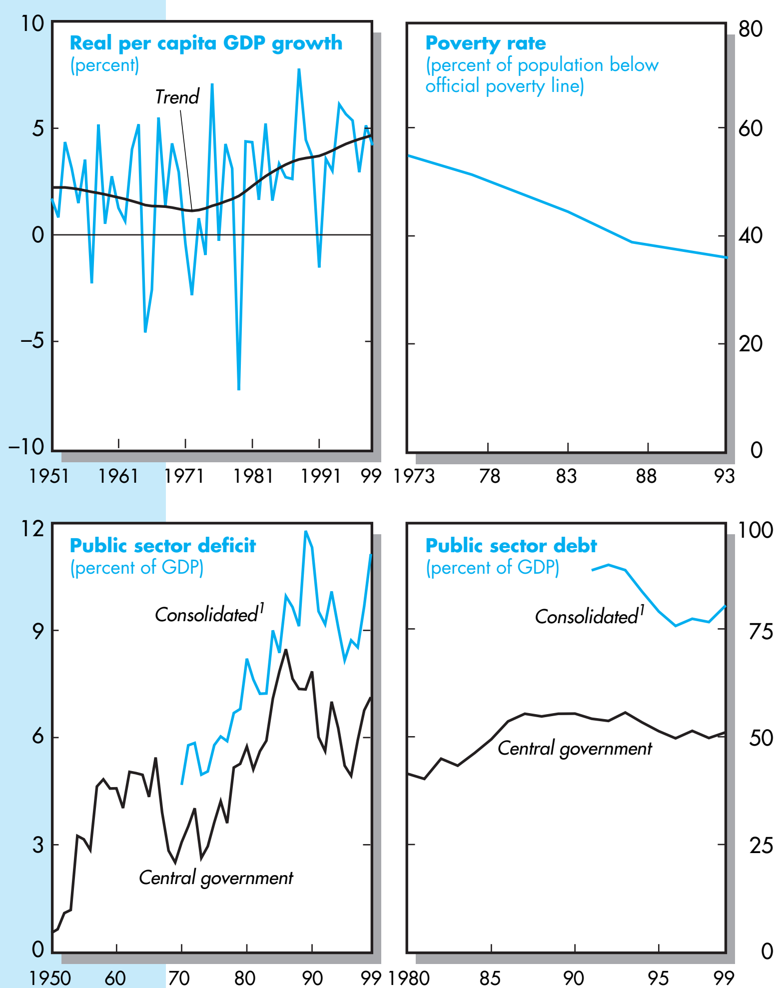
Indian reforms spark gains, but more are needed to sustain higher growth and reduce poverty

India has been among the fastest growing economies in the world over the past two decades. It has achieved trend improvements in growth, literacy, mortality, and poverty rates (see chart, top panels, this page). In recent years, India's deft handling of monetary policy has helped it successfully weather the Asian crisis while maintaining low inflation and a comfortable external position. Yet despite these gains, poverty rates remain high, with more than one-third of the population still living below the official poverty line. This uneven progress raises questions about the impact of recent economic and structural reforms and about what more can be done to reduce poverty.

India: economic indicators



Note: Data shown are for fiscal years, which begin in April.
[1]Consolidated public sector comprises the central and state governments, central public enterprises, and the accounts of the Oil Coordinating Committee.

Data: IMF, *World Economic Outlook*, April 2000, Box 4.2

Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez and Michael Spilotro for the IMF, pages 161–162, 164–165, and 168; Kemal Jufri for AFP, pages 166 and 167.

Period of low growth

In the three decades following independence in 1947, per capita GDP in India rose only 1½ percent a year (see table, page 171). Throughout this period, the country's economy was characterized by a high degree of government planning and regulation and pervasive industrial controls. Increasingly, restrictions on private credit, the role for the public enterprise sector, and subsidy programs also expanded. Strict controls on foreign direct investment, an elaborate import licensing system, and—from the 1970s—high tariff rates further stifled the economy's growth potential.

In the 1980s, liberalization of import and industrial controls and improved agricultural performance helped accelerate real per capita GDP growth to an average rate of 3¾ percent. But this expansion also reflected other developments, notably increased fiscal stimulus and a debt-financed consumption and investment boom that became unsustainable toward the end of the decade.

Crisis and reform

A balance of payments crisis ensued in 1991, reflecting a deteriorating fiscal position, rising external debt (especially short-term debt), a surge in world oil prices, and a sharp decline in remittances from Indian workers in the Middle East. As capital flight accelerated and official reserves rapidly declined, the Indian government entered into a Stand-By Arrangement with the IMF and embarked on a program of fiscal and structural reforms.

Corrective policy measures successfully restored macroeconomic stability. The central government deficit declined to 4¾ percent of GDP in 1996/97 from 8 percent before the crisis through tax reforms, cuts in subsidies, and reduced defense and other expenditures (see chart, lower panels, this page). The lower deficit, in turn, reduced the financing that had to be provided by the central bank, and wholesale price inflation declined to nearly 6 percent by 1996/97 from a precrisis level of almost 14 percent.

In addition, India introduced important structural reforms. It liberalized industrial licensing and investment approval procedures and reduced the number of industries reserved for the public sector. External sector reforms reduced the import-weighted tariff rate to 25 percent by 1996/97 from 87 percent in 1990/91, eased import licensing requirements, relaxed controls on foreign direct and portfolio investment, and provided

greater exchange rate flexibility. In the financial sector, the authorities implemented measures to liberalize interest rates, strengthen prudential norms and supervision, encourage greater competition in the banking system, and improve the operation of capital markets.

In response to the government's policy package, the recovery from the 1991 crisis was rapid. Private investment rates rose sharply, and real per capita GDP growth increased to more than 6 percent by 1995/96. Productivity improved significantly as well—as evidenced by increased total factor productivity growth at both the aggregate and firm levels and by declining incremental capital output ratios, particularly in the services sector (see table, this page).

Unfinished business

More recently, however, per capita growth has slowed, averaging closer to 4 percent between 1997/98 and 1999/00, compared with 4¾ percent between 1992/93 and 1996/97. To some extent, this reflected a cyclical catchup following the 1991 balance of payments crisis, as well as the adverse impact of the Asian crisis and agricultural supply shocks. But economic performance also appears to have been adversely affected by a reversal of fiscal adjustment, infrastructure bottlenecks, and delays in implementing structural reforms. Increased civil service wages and subsidies, as well as rising debt service, pushed up the fiscal deficit and resulted in higher real interest rates. These higher rates, combined with banks' efforts to improve their balance sheets, slowed credit growth. Infrastructure constraints also continued to bind, as the earlier fiscal consolidation had relied too heavily on reduced public investment. Consequently, the contribution of private investment to growth fell by one-half from earlier in the decade, and measured productivity growth, particularly in the industrial sector, deteriorated (see table, this page).

Moreover, the poverty rate remains very high, suggesting a possible slowing in the impressive rate of decline that had extended from the mid-1970s through the 1980s. This outcome partly reflects the relatively poor performance, in the 1990s, of the agricultural sector—a key sector, since some 70 percent of the labor force still relies on the land for its livelihood. While adverse supply shocks played a role, the lack of agricultural reform also contributed to low investment rates and low productivity. In addition, the scope for mobility of low-skilled labor out of the agricultural sector has likely been limited by the absence of robust and sustained growth in the industrial sector and by the relatively larger contribution of the higher-skilled service sector to GDP growth.

What new measures would sustain high growth rates in all sectors and achieve more substantial poverty alleviation? Faster growth would require durable fiscal consolidation to raise national saving and crowd in private investment spending; further liberalization of foreign trade and investment flows; and additional reforms in labor markets and in the agricul-

India: expenditure and sectoral components of growth

(Average annual percent, unless otherwise noted)[1]

	1951–79	1980–90	1992–96	1997–99[2]
Real per capita GDP growth[3]	1.5	3.8	4.7	4.1
Real GDP growth[3]	3.7	5.9	6.7	5.8
Contribution to growth, by expenditure				
Private consumption	2.4	3.8	3.9	2.5
Public consumption	0.4	0.8	0.5	1.4
Gross fixed investment	0.8	1.5	1.9	1.2
Private investment	...	0.8	1.8	0.9
Public investment	...	0.6	0.1	0.3
Net exports[4]	...	0.1	0.1	0.6
Contribution to growth, by sector				
Public	1.1	1.7	2.8	5.2
Private	2.2	4.2	3.8	0.7
Contribution to growth, by sector				
Agriculture	1.1	1.6	1.4	0.5
Industry	1.0	1.7	2.0	1.5
Services	1.4	2.5	3.2	3.8
ICORs, by sector[5]				
Overall	...	4.2	4.1	4.8
Agriculture	...	2.0	1.5	2.6
Industry	...	5.7	6.8	10.7
Services	...	4.0	2.9	2.1

[1]Averages computed over fiscal years beginning in April.
[2]1999 figures on GDP and sectoral production are CSO Advance Estimates; annual population growth assumed constant at 1.7 percent; average contribution of expenditure categories and private and public production computed over 1997–98.
[3]Measured at market prices; base year is 1980 for data until 1993, and 1993 thereafter.
[4]Includes statistical discrepancy.
[5]The incremental capital output ratio (ICOR) is the ratio of the investment rate to the GDP growth rate; a falling ICOR over time therefore indicates improved capital productivity.

Data: IMF, *World Economic Outlook* April 2000

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
May 1	4.29	4.29	4.88
May 2	4.29	4.29	4.97
May 8	4.41	4.41	5.11
May 15	4.49	4.49	5.20

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

tural, industrial, and financial sectors to promote greater efficiency and export competitiveness. These reforms will need to remove domestic pricing distortions, improve bankruptcy procedures, and ease restrictions on firm and farm size and regulations that make it difficult to shed labor (and therefore impede job creation). Fiscal priorities would also need to redirect resources into human and physical capital investments.

The experience of the 1990s has demonstrated the potential benefits of reform, and there is broad agreement in India that further reforms are needed. Several factors argue for translating this consensus into swift action. First, the establishment of a bold agenda would be facilitated by the relatively favorable current economic situation and the significant majority enjoyed by the ruling coalition. Second, with the consolidated public sector deficit rising again and the public sector debt stock close to 80 percent of GDP, fiscal sustainability is a serious concern. Third, India is committed to trade liberalization measures under the World Trade Organization, including removing all quantitative restrictions by 2001. For India to achieve the maximum benefits from a more liberal trade system, the structural impediments affecting domestic producers must be addressed in the interim.

Encouragingly, India's new government has taken a number of initiatives that suggest a strengthened commitment to structural reform, including liberalization of the insurance sector, automatic clearance for foreign direct investment in many sectors, and a landmark agreement on state sales tax rationalization. At the same time, however, the budget passed by parliament in May 2000 targets only modest deficit reduction in the coming fiscal year, and a clearly defined agenda for reform has yet to be established. Critical and difficult challenges thus remain to be addressed. ■

Patricia Reynolds
IMF Asia and Pacific Department

The full text of the box that was the source of this article, as well as an additional table, appears as Box 4.2 in the *World Economic Outlook*, April 2000. Printed copies of the *World Economic Outlook* will be available by end-May. Please contact IMF Publication Services for ordering details.

OECD report

Official development assistance rises, although few countries meet UN target

After declining for more than five years, official development assistance (ODA) by members of the Organization for Economic Cooperation and Development's (OECD's) Development Assistance Committee (DAC) rose by $3.6 billion, or 9.6 percent in real terms in 1998. According to the OECD's DAC Journal: *Development Cooperation 1999 Report* (see box for list of DAC members), this shift was due to decisions by several countries to stabilize or rebuild aid programs, as well as to short-term measures adopted to deal with the Asian financial crisis.

The 1992–93 recession cut tax revenues and increased welfare payments, prompting DAC members to reduce their public expenditures and slash aid budgets. Consequently, from 1992 to 1997, aid to the developing world from DAC member countries fell by 21 percent in real terms—the largest decline since the committee was established in 1961, the report states. The 1998 increase brought DAC members' ODA to $52 billion (see chart). Despite the rise, however, the report warns that the ratio of ODA to GNP in DAC members has fallen to about 0.25 percent, well below the 0.33 percent average the group maintained during the 1970s and 1980s. In dollar terms, this means that there is $20 billion less a year than there would have been if previous levels had been maintained.

In 1998, 15 of the 21 DAC member countries reported an increase in net ODA disbursements in real terms, the report says. Denmark, the Netherlands, Norway, and Sweden were, however, the only countries to meet the UN's ODA target of 0.7 percent of GNP. The main elements of ODA from the Group of Seven countries are

- a rise of $1.3 billion from Japan, reflecting loans disbursed to countries affected by the Asian crisis;
- an increase of $1.9 billion from the United States, reflecting larger deposits of promissory notes with multilateral development banks and increases in food and emergency aid, especially to Africa;
- $2.3 billion in aid from Italy, reflecting increased flows to multilateral agencies and higher net loan disbursements;

Development Assistance Committee

The members of the Development Assistance Committee are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, the United States, and the Commission of the European Communities.

• an 8.6 percent increase in real terms in aid from the United Kingdom, underscoring its commitment to increase aid by 25 percent by 2001; and

• falls in real terms in aid from Canada (11 percent), France (8.7 percent), and Germany (4.2 percent).

Aid from other DAC member countries increased by 3.5 percent, the report states, accounting for 26 percent of members' total ODA. On average, non–Group of Seven members are more than twice as generous as the Group of Seven countries, relative to their national income. Group of Seven countries donated an average of 0.2 percent of their GNP to ODA, while non–Group of Seven countries donated 0.45 percent.

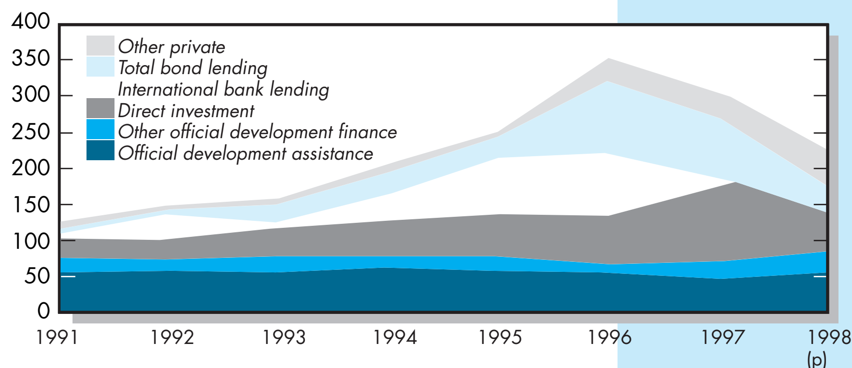
ODA outlook

In 1999, the war in Kosovo produced hundreds of thousands of refugees; rebuilding cannot take place without a great deal of external help, the report explains. Much also needs to be done in Bosnia and to stabilize parts of Africa, the Middle East, and Asia.

Among the Group of Seven, the United Kingdom has committed to increasing its aid spending faster than its GNP, and Italy aims to increase ODA over the near term to bring its ODA/GNP ratio up to the DAC average, the report says. The Prime Minister of Canada has said that he hopes Canada's aid will at least begin to rise in real terms. Among the non–Group of Seven countries, aid prospects are brighter. Denmark, the Netherlands, Norway, and Sweden are adhering to ODA targets, the report says, while Luxembourg aims to reach 0.7 percent of GNP by 2000 and 1.0 percent within five years. Finland, Ireland, Belgium, Spain, New Zealand, and Switzerland all have plans to maintain aid spending.

Total net resource flows to developing countries

(current billion dollars)



Data: OECD, *Development Cooperation, 1999 Report*

But, according to the report, conditions in the four largest donors—Japan, the United States, France, and Germany—may prevent total ODA from rising:

• While signs point to a recovery in Western Europe, France is focusing on cutting taxes, and Germany, on reducing public spending to stimulate their economies.

• Japan has a huge fiscal deficit aimed at boosting domestic demand and may not maintain aid levels it reached during the Asian crisis.

Available on the web (www.imf.org)

News Briefs

00/26: Release of PricewaterhouseCoopers Report on the National Bank of Ukraine, May 4

00/27: IMF Completes Final Review of Thai Program, May 8

00/28: IMF Managing Director Horst Köhler to Visit Argentina, Brazil, Honduras, and Mexico, May 11

Public Information Notices (PINs)

00/34: Luxembourg, May 16

00/35: São Tomé and Príncipe, May 16

Press Briefings

Transcript of a press briefing by Thomas Dawson, Director, IMF External Relations Department, May 4

Poverty Reduction Strategy Papers

São Tomé and Príncipe for 2000–02 (interim), May 2

Concluding Remarks for Article IV Consultations

Czech Republic, May 9

Other

Social Policy Issues in IMF-Supported Programs: Follow-Up on the 1995 World Summit for Social Development, May 5

Progress Report on the Bank-Fund Financial Sector Liaison Committee, May 8

Notes

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.

Poverty Reduction Strategy Papers (PRSPs). It is intended that countries with programs supported by the Poverty Reduction and Growth Facility will in time be based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a poverty reduction strategy paper.

Concluding Remarks for Article IV Consultations. At the conclusion of annual Article IV discussions with the authorities, and prior to the preparation of the staff's report to the Executive Board, the IMF mission often provides the authorities with a statement of its preliminary findings.

Starting May 12, the IMF began releasing on its external website (www.imf.org) a weekly schedule of the public engagements of IMF Managing Director Horst Köhler, First Deputy Managing Director Stanley Fischer, and Deputy Managing Directors Eduardo Aninat and Shigemitsu Sugisaki.

The schedule will be posted each Friday at about 4:00 p.m. Washington, D.C., time.

• While the United States has a healthy fiscal surplus, its congress remains skeptical about aid, so its ODA is likely to be about the same as the total amount of the four other DAC members who give the most and whose combined populations exceed California's. ■

The *Development Cooperation 1999 Report* is available for $49.00 from the OECD Bookshop, 2 rue Andre Pascal, 75775 Paris Cedex, France; phone: 33 1 45 24 81 83; fax: 33 1 45 24 19 50; e-mail: sales@oecd.org; or at the OECD online bookshop (www.oecd.org/bookshop).

Stand-By, EFF, and PRGF Arrangements as of April 30

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By			**45,606.43**	**17,409.46**
Argentina	March 10, 2000	March 9, 2003	5,398.61	5,398.61
Bosnia and Herzegovina	May 29, 1998	March 31, 2001	94.42	30.15
Brazil[1]	December 2, 1998	December 1, 2001	10,419.84	2,550.69
Ecuador	April 19, 2000	April 18, 2001	226.73	141.73
Estonia	March 1, 2000	August 31, 2001	29.34	29.34
Korea[1]	December 4, 1997	December 3, 2000	15,500.00	1,087.50
Latvia	December 10, 1999	April 9, 2001	33.00	33.00
Lithuania	March 8, 2000	June 7, 2001	61.80	61.80
Mexico	July 7, 1999	November 30, 2000	3,103.00	1,163.50
Papua New Guinea	March 29, 2000	May 28, 2001	85.54	75.54
Philippines	April 1, 1998	June 30, 2000	1,020.79	475.13
Romania	August 5, 1999	May 31, 2000	400.00	347.00
Russia	July 28, 1999	December 27, 2000	3,300.00	2,828.57
Thailand	August 20, 1997	June 19, 2000	2,900.00	400.00
Turkey	December 22, 1999	December 21, 2002	2,892.00	2,670.28
Zimbabwe	August 2, 1999	October 1, 2000	141.36	116.62
EFF			**9,798.37**	**8,157.56**
Bulgaria	September 25, 1998	September 24, 2001	627.62	261.52
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2002	3,638.00	3,378.00
Jordan	April 15, 1999	April 14, 2002	127.88	106.56
Kazakhstan	December 13, 1999	December 12, 2002	329.10	329.10
Moldova	May 20, 1996	May 19, 2000	135.00	47.50
Pakistan	October 20, 1997	October 19, 2000	454.92	341.18
Panama	December 10, 1997	December 9, 2000	120.00	80.00
Peru	June 24, 1999	May 31, 2002	383.00	383.00
Ukraine	September 4, 1998	September 3, 2001	1,919.95	1,207.80
Yemen	October 29, 1997	March 1, 2001	105.90	65.90
PRGF			**3,516.41**	**2,017.93**
Albania	May 13, 1998	May 12, 2001	45.04	14.11
Benin	August 28, 1996	August 26, 2000	27.18	10.87
Bolivia	September 18, 1998	September 17, 2001	100.96	56.10
Burkina Faso	September 10, 1999	September 9, 2002	39.12	33.53
Cambodia	October 22, 1999	October 21, 2002	58.50	50.14
Cameroon	August 20, 1997	August 19, 2000	162.12	36.03
Central African Republic	July 20, 1998	July 19, 2001	49.44	32.96
Chad	January 7, 2000	January 7, 2003	36.40	31.20
Côte d'Ivoire	March 17, 1998	March 16, 2001	285.84	161.98
Djibouti	October 18, 1999	October 17, 2002	19.08	16.36
The Gambia	June 29, 1998	June 28, 2001	20.61	13.74
Ghana	May 3, 1999	May 2, 2002	155.00	110.70
Guinea	January 13, 1997	December 20, 2000	70.80	15.73
Guyana	July 15, 1998	July 14, 2001	53.76	35.84
Honduras	March 26, 1999	March 25, 2002	156.75	80.75
Kyrgyz Republic	June 26, 1998	June 25, 2001	73.38	38.23
Madagascar	November 27, 1996	July 27, 2000	81.36	40.68
Mali	August 6, 1999	August 5, 2002	46.65	39.90
Mauritania	July 21, 1999	July 20, 2002	42.49	36.42
Mongolia	July 30, 1997	July 29, 2000	33.39	15.95
Mozambique	June 28, 1999	June 27, 2002	87.20	42.00
Nicaragua	March 18, 1998	March 17, 2001	148.96	53.82
Pakistan	October 20, 1997	October 19, 2000	682.38	417.01
Rwanda	June 24, 1998	June 23, 2001	71.40	38.08
São Tomé & Príncipe	April 28, 2000	April 28, 2003	6.66	6.66
Senegal	April 20, 1998	April 19, 2001	107.01	57.07
Tajikistan	June 24, 1998	June 23, 2001	100.30	40.02
Tanzania	March 31, 2000	March 30, 2003	135.00	115.00
Uganda	November 10, 1997	November 9, 2000	100.43	17.85
Yemen	October 29, 1997	October 28, 2000	264.75	114.75
Zambia	March 25, 1999	March 24, 2002	254.45	244.45
Total			**58,921.21**	**27,584.95**

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Treasurer's Department

Extended Fund Facility Arrangements are designed to rectify balance of payments difficulties that stem from structural problems.

Military expenditures stabilize during 1999; variations persist in different regions

Worldwide military spending fell steadily in the 1990s as a share of world output. The latest IMF *World Economic Outlook* data for 131 countries show that these expenditures stabilized at approximately 2.1 percent of GDP in 1999 (see table, page 176). Other data sources confirm this trend. According to the International Institute for Strategic Studies (IISS), worldwide military spending leveled off at 2.5 percent of GDP in 1998. Stockholm International Peace Research Institute (SIPRI) data show a slight reduction in worldwide military spending to 2.1 percent of GDP in the same year. An important reason for differences in the estimates of worldwide military spending among different data sources is variations in data coverage.

Military spending patterns

As reported in previous reviews in the *IMF Survey* (June 7, 1999, page 186, and May 11, 1998, page 149), important variations remain in military spending patterns across regions (see chart, this page). *World Economic Outlook* data show that military spending increased in 1999 as a share of both GDP and total government outlays in the industrial countries, Africa, and the Baltic countries, Russia, and the other countries of the former Soviet Union. The increase in military spending in Africa is confirmed by both SIPRI and IISS. According to IISS, military spending increased as a share of GDP in Asia and in the Middle East in 1998. Military spending remains the lowest among all regions in the Western Hemisphere, at 1.2 percent of the region's GDP and 5.4 percent of total government spending.

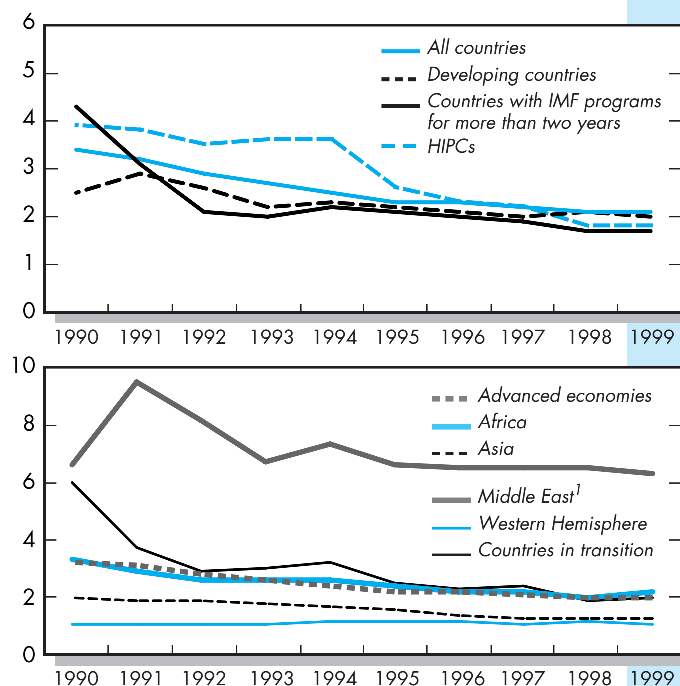
In IMF-supported programs and policy dialogue with member countries, considerable emphasis is placed on how to reduce unproductive spending (for example, "white elephant" projects, generalized subsidies, transfers to loss-making public enterprises, among others). In a sample of 64 countries that have had IMF-supported programs for more than two years, military outlays stabilized at 1.7 percent of GDP in 1998–99, following a steady decline from over 2.0 percent of GDP in 1995. Defense outlays remain higher in countries with Poverty Reduction and Growth Facility (PRGF) arrangements than in other IMF-program countries, particularly as a share of total government spending. In these countries, military spending is also higher than the world average as a share of GDP. In heavily indebted poor countries, despite a lower-than-average share of spending in GDP, military outlays account for the highest share in total government spending among all regions, except the newly industrialized Asian economies and the Middle East.

Armed conflicts

The increase in military spending in some regions may be attributed to the eruption of armed conflicts. Comprehensive definitions of such conflicts are difficult and not without limitations. For instance, SIPRI defines a major armed conflict "as a prolonged combat between the military forces of two or more governments, or of one government and at least one organized armed group, and incurring the battle-related deaths of at least 1,000 people during the entire conflict. A conflict location is the territory of a state." Taking SIPRI's definition, for the world as a whole, the number of conflicts fell to 26 in 1998, against 31 in 1990. Since 1996, the number of armed conflicts has stabilized or fallen in all regions with the exception of Africa, where it more than doubled. In 1998, Africa had the highest number of armed conflicts (11), followed by Asia (8) and the Middle East (4).

Military expenditures

(percent of GDP)



Note: Weighted by country GDP.
[1]Includes Cyprus, Malta, and Turkey.

Data: IMF, *World Economic Outlook*

Arms imports have increased worldwide

Increases in arms imports also explain the rise in military spending in some regions. Data for 136 countries reported by the U.S. Arms Control and Disarmament Agency show that worldwide arms imports accounted for approximately 0.2 percent of GDP in 1997, against

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0.1 percent in 1996. Information on arms imports, and defense procurement in general, should be interpreted with caution. Defense contracts are often drawn up in secrecy, and the payment for arms imports may not always be recorded as defense outlays or subject to standard budget oversight.

Notwithstanding these problems, there are important variations in arms imports patterns across regions. In the newly industrialized Asian countries, imports of arms and military equipment almost tripled to 1.3 percent of GDP between 1996 and 1997. In the Middle East, arms imports reached 2.9 percent of GDP in 1997, an increase of 0.3 percentage point relative to 1996, and remain the highest among all regions. Spending on arms imports is the lowest in the Western Hemisphere, at 0.1 percent of GDP. The share of arms imports in GDP is in line with the world average in the sample of IMF program countries, but is almost twice the world average in PRGF countries. ■

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Military expenditures

	1990	1995	1996	1997	1998	1999	1990	1995	1996	1997	1998	1999	Change 1998–99	Number of countries
	(percent of GDP)[1]						(percent of total expenditure)						(billion dollars)	
World Economic Outlook [2]														
All countries	3.4	2.3	2.3	2.2	2.1	2.1	14.2	10.7	10.6	10.3	9.6	10.0	30.5	131
Advanced economies	3.3	2.4	2.4	2.2	2.1	2.2	14.3	10.6	10.7	10.4	9.6	10.3	37.1	25
Industrial countries	3.3	2.3	2.3	2.2	2.0	2.1	14.1	10.4	10.4	10.1	9.4	10.1	34.4	22
Newly industrialized Asian economies[3]	4.3	3.3	3.6	3.5	3.6	3.4	25.1	18.9	19.0	17.7	17.0	15.7	2.7	3
Developing countries	2.5	2.2	2.1	2.0	2.1	2.0	12.0	11.3	10.7	10.1	9.7	9.2	–1.5	86
Africa	3.4	2.5	2.3	2.3	2.1	2.3	12.4	9.0	8.6	8.5	7.8	8.2	0.6	43
Asia	2.1	1.7	1.5	1.4	1.4	1.4	10.6	11.3	10.3	9.2	8.7	7.9	1.5	11
Middle East	6.6	6.6	6.5	6.5	6.5	6.3	21.2	21.8	20.2	20.3	19.7	19.0	0.3	12
Western Hemisphere	1.2	1.3	1.3	1.2	1.3	1.2	7.1	6.7	6.5	6.1	6.0	5.4	–3.9	20
Countries in transition	6.0	2.6	2.4	2.5	2.0	2.1	15.9	10.1	9.4	10.1	8.2	8.4	–5.0	20
Central Europe	2.3	2.3	1.9	1.9	2.1	2.0	11.4	7.0	6.3	6.3	7.2	6.1	–3.6	7
Baltics, Russia, and other Former Soviet Union	6.9	2.8	2.6	2.8	1.8	2.1	16.4	13.8	12.1	13.4	9.6	11.2	–1.4	13
Countries with IMF programs for more than two years	4.3	2.1	2.0	1.9	1.7	1.7	14.3	9.7	9.3	8.7	7.6	7.5	–5.7	64
PRGF countries	5.2	3.8	3.5	3.3	3.1	3.1	10.0	14.8	13.9	13.7	12.8	13.1	–0.3	35
HIPCs	3.9	2.6	2.3	2.2	1.8	1.8	15.9	15.4	14.0	13.6	11.8	11.7	0.6	33
ACDA														
All countries	3.6	2.6	2.6	2.7	...	...	...	...	...	...	...	...	...	107
Africa	3.6	3.0	3.0	3.0	...	...	...	...	...	...	...	...	...	32
Asia	6.0	4.9	4.8	5.2	...	...	...	...	...	...	...	...	...	12
Middle East	11.6	7.0	6.8	6.8	...	...	...	...	...	...	...	...	...	12
Western Hemisphere	1.6	1.6	1.7	1.7	...	...	...	...	...	...	...	...	...	19
HIPCs	4.3	4.2	4.0	4.2	...	...	...	...	...	...	...	...	...	25
SIPRI[4]														
All countries	3.3	2.4	2.4	2.3	2.1	...	...	...	...	...	...	...	...	96
Africa	3.5	2.5	2.3	2.1	2.3	...	...	...	...	...	...	...	...	26
Asia	2.6	2.1	2.0	2.1	2.1	...	...	...	...	...	...	...	...	10
Middle East	7.8	5.9	5.6	6.3	6.3	...	...	...	...	...	...	...	...	14
Western Hemisphere	1.1	1.3	1.1	1.4	1.3	...	...	...	...	...	...	...	...	14
HIPCs	4.7	3.0	2.4	2.2	3.3	...	...	...	...	...	...	...	...	18
IISS														
All countries	3.1	2.6	2.5	2.5	2.5	...	...	...	...	...	...	...	...	89
Africa	2.8	2.9	2.8	2.9	3.1	...	...	...	...	...	...	...	...	16
Asia	3.1	3.5	3.4	3.3	3.5	...	...	...	...	...	...	...	...	14
Middle East	10.0	7.6	7.5	7.4	8.0	...	...	...	...	...	...	...	...	11
Western Hemisphere	0.7	1.5	1.8	2.2	2.2	...	...	...	...	...	...	...	...	17
HIPCs	5.1	2.8	2.6	2.4	2.1	...	...	...	...	...	...	...	...	14

Note: HIPCs = heavily indebted poor countries; ACDA = (U.S.) Arms Control and Disarmament Agency; SIPRI = Stockholm International Peace Research Institute; and IISS = International Institute for Strategic Studies

[1]Weighted by country GDP.
[2]For 1990, the sample size is 127; for 1999, it is 128.
[3]Includes Korea, Singapore, and Taiwan Province of China.
[4]For 1997, the sample contains 89 countries, and for 1998, 70 countries.

Data: IMF, *World Economic Outlook*; ACDA, *World Military Expenditures and Arms Transfers*; SIPRI, *SIPRI Yearbook, Armaments, Disarmament and International Security*; and IISS, *The Military Balance*