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Interview

Bio-Tchané hails IMF plan to set up African regional technical assistance centers

Earlier this year, Abdoulaye Bio-Tchané took over as Director of the IMF's African Department. Before joining the IMF staff, he was Benin's Minister of Finance and Economy. He began his career as an economist in the Central Bank of West African States (BCEAO), where he rose to become Director of the Economic and Monetary Survey Department. He recently returned from a one-week trip with IMF Managing Director Horst Köhler to Burkina Faso, Côte d'Ivoire, Democratic Republic of the Congo, Ghana, and Tanzania. At the end of the trip, on May 3, Köhler announced that the IMF plans to establish five regional centers in Africa to strengthen locally based technical assistance and training.

Bio-Tchané: "There is a new momentum in Africa toward self-help and good governance."

IMF SURVEY: What are your impressions from your first trip as Director of the African Department?

BIO-TCHANÉ: My most marked impression was how passionate the Managing Director is about Africa's development. He is an Afro-optimist! The trip was organized around four themes: strategies to fight poverty, progress in achieving the UN Millennium Development Goals,

(Please turn to the following page)

Brazil navigates choppy waters toward growth and stability

For the past four years, Brazil's economy has been buffeted by external and domestic shocks. Each time, the government responded decisively, adopting strong policy measures in the context of IMF-supported programs to help it weather the storm. Brazil is now well positioned to speed up growth and tackle poverty with continued strong policy performance.

To understand the turbulence of the past four years, one must go back to 1994, when Brazil introduced the stabilization program and currency reform known as the *Real* Plan. The program was centered on an ingenious currency reform and the use of an exchange rate anchor. In addition, the authorities tightened monetary policy, began to take steps to reduce fiscal vulnerabilities, and outlined an ambitious reform agenda.

The *Real* Plan achieved impressive results. Inflation dropped from almost 2,500 percent in 1993 to about

São Paulo stock exchange. After severe turbulence in 2001, Brazil's economy has started to recover.

22 percent in 1995. Economic growth remained strong, and the share of the population living below the poverty line dropped from 19½ percent to about 14½ percent.

However, the plan did not bring about the structural improvement in the fiscal accounts necessary to sustain Brazil's economic policies over

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Africa needs greater ownership of policies

I see the need for IMF staff to engage more actively in discussions on policy issues with the authorities while providing information on the costs and benefits of the alternatives.
—Abdoulaye Bio-Tchané

(Continued from front page) private sector development, and the role of the financial sector. In our workshops, we had participants from all walks of life: cabinet ministers, parliamentarians, bankers, businesspeople, and representatives of women's groups, nongovernmental organizations, and trade unions. They all spoke frankly, and Köhler listened to what they had to say and gave clear messages. I am convinced the poverty reduction strategy paper (PRSP) process has taken hold, with all parties committed to fighting the scourge of poverty. I am also convinced there is a new momentum in Africa toward self-help and good governance, with a new generation of Africans ready to give the best of themselves.

IMF Survey: Do you plan to visit specific countries?
Bio-Tchané: Yes, indeed. This department covers 44 countries. I would like to learn firsthand what's going on in each of them to better serve them all. I am going to the Annual Meetings of the African Development Bank in late May, which is attended by most finance ministers. Then, my first planned trip will be to some countries in west and east Africa.

IMF Survey: You met some of the newly elected African leaders, and they announced major campaigns for good governance, accountability, and a greater role for the private sector. How do you see the IMF's role in reinforcing their work?
Bio-Tchané: The primary responsibility for good governance, accountability, and putting the private sector at the forefront of economic development rests with the country authorities. The IMF will continue to be involved, with policy and technical advice to help them with implementation. These leaders have mentioned that capacity constraints are one of the many hurdles they are facing. That is why the Managing Director decided to open two technical assistance centers in Africa (AFRITACs), which will help countries in east and west Africa build local capacity for economic and financial management.

IMF Survey: You also attended the inaugural meetings of the Investor's Advisory Council in Ghana—a new initiative where private business executives and top government officials are trying to improve the business climate. What are your impressions?
Bio-Tchané: The inaugural session was a huge success. The Council consists of 20 senior executives selected by the Ghanaian authorities from local and international companies drawn from various sectors and regions. It identified a number of problem areas—including inadequate regulatory and legislative frameworks; weaknesses in the energy, financial, telecommunications, and information technology sectors; liberalization that was sometimes too rapid and effected without a thorough study of all the consequences; and the need for sensitivity on the part of the public administration to private sector concerns. Having witnessed the exchanges, I am convinced that a better dialogue between governments and companies will result in concrete steps to attract investment. But again, implementation is crucial.

IMF Survey: How will your experiences in negotiating with the IMF as a minister of finance influence the direction you would like to take the department?
Bio-Tchané: I cannot isolate the impact of that single element in my professional career, but based on that experience I would make four observations. First, I see the need for improved communication between the IMF and country authorities. Second, I see the need for IMF staff to engage more actively in discussions on policy issues with the authorities while providing information on the costs and benefits of the alternatives. Third, the country authorities should prepare for IMF missions more efficiently and supply the requested information in a timely manner. This will make room for an increased focus on policy discussions. Finally, I see a more prominent role for IMF resident representatives, particularly in terms of policy advice, which will help the authorities make informed decisions, and thus contribute to enhancing ownership.

IMF Survey: Benin is seen in many quarters as a success story in its implementation of its IMF-supported programs. What was the source of that success?
Bio-Tchané: Experience with program implementation in member countries teaches us to be careful about labeling a country a success story. Each country has unique characteristics that contribute to strengthening ownership to carry out needed reforms. Even within one country, some factors may play a role in bringing everybody together, or preventing those in charge from securing that support. This is an important issue today in all countries implementing IMF-supported programs, because putting in place reform measures necessarily creates winners and losers in the population.

In Benin's case, one of the most important factors was the authorities' determination to maintain the momentum of reforms. Although it was difficult at times because of the short-term political and social costs of the reforms, the consensus was secured because the majority of policymakers knew that this was the only way to ensure that the country wouldn't return to the difficult times of the early 1980s, when the banking system collapsed, invest-

ment dried up, and the government was no longer able to meet its obligations on wages, domestic suppliers, or external debt. Moreover, the government developed a policy of communication with its people, as well as with the representatives of stakeholders, like trade unions. There was a clear understanding, however, that the government was responsible for the final decision.

IMF SURVEY: In recent years, it seems that many elements have been coming together—from Libreville to Group of 7 initiatives to the New Partnership for Africa's Development (NEPAD)—that should give Africa a window of opportunity to reignite development. Do you see a half-full or a half-empty glass?

BIO-TCHANÉ: I am optimistic by nature; therefore, I see the glass as half full. Even the most vocal "Afro-pessimists" will tell you that Africa has a lot of potential waiting to be realized. Although for most countries development is constrained by many economic and noneconomic factors, I look at the future with a lot of hope. One message that came out of recent meetings of heads of state with the Managing Director and the President of the World Bank is that most African leaders are more determined than ever to find sustainable solutions to their countries' problems. They are also aware of the challenges, and NEPAD is an important initiative in this context.

Africa's economic prospects depend on the implementation of sound macroeconomic policies and reforms that are needed to tackle not only short-term economic and financial difficulties, but also medium- and long-term development challenges. For these efforts to be effective, they have to be supported by Africa's development partners, through technical and financial assistance, as well as through trade measures—including sharply curbing subsidies and increasing access to industrial countries' markets. It is true that most of our countries need to diversify their economies further to fully benefit from greater market access. But, even now, we have seen how the U.S. African Growth and Opportunity Act and other initiatives in Europe can make a difference for countries like Mauritius in terms of higher exports and jobs. Africa's growth prospects will also be influenced by its ability to integrate itself into the world economy in order to benefit from globalization.

IMF SURVEY: A few years ago, many friends of Africa were saying that it had an image problem—whether it was war, corruption, or disease. Has its image improved any? What can the IMF and others do to help, especially with regard to attracting investment?

BIO-TCHANÉ: One must go beyond labels and problems and focus on solutions. Having said that, we have seen a lot of progress in economic performance in many countries over the past six years or so. Where real commitment to policy reform has existed, the results have been encouraging in terms of macroeconomic stabilization, better financial management, institutional reforms, and enhanced governance. Just look at Benin, Botswana, Burkina Faso, Cameroon, Ethiopia, The Gambia, Mauritius, Tanzania, and Uganda. It is clear today that Africa as a region was able to withstand somewhat the impact of the global economic slowdown in 2000–01 because of the benefits derived from these efforts.

As for attracting private investment, this requires a number of preconditions—including a stable macroeconomic and political environment, efficient and strong financial systems, good infrastructure and communications systems, well-functioning legal and judicial systems, an efficient civil service, and appropriate policies. As it happens, these are some of the elements of IMF-supported programs. Hence, through these programs, as well as through technical assistance and policy advice in the context of our Article IV consultations, the IMF has been helping countries create an investment-friendly environment.

IMF SURVEY: What role do you see the IMF playing in the battle against corruption?

BIO-TCHANÉ: There is ample evidence that a lack of economic governance—such as nontransparent budgetary procedures, corruption, or rent-seeking—hurts investment and, thus, economic efficiency and growth. Similarly, a lack of noneconomic governance—such as a lack of the rule of law, efficient institutions, or accountable systems of governance—hampers countries' economic performance. A lack of governance impinges on variables of relevance to the IMF's mandate, so we do have a role to play. Don't forget that in 1966, the IMF's Interim Committee adopted the declaration of "Partnership for Sustainable Growth," which specified that the promotion of good governance, including fighting corruption, was essential to the prosperity of our member countries.

IMF SURVEY: How can the IMF play a fruitful role in parts of Africa in conflict or just coming out of conflict?

BIO-TCHANÉ: The two cases are not similar. When there is an open conflict, there is not much the IMF can do, given its mandate. But in postconflict cases, the IMF has been able to help countries financially through its emergency postconflict assistance and through technical assistance. In some cases, the postconflict assistance was subsequently replaced by a staff-monitored program and later by our concessional loan facility, the Poverty Reduction and Growth Facility (PRGF), along with access to debt relief under the

The first lesson learned from the review is the consensus that the PRSP process is a good one and that it should continue.
—Abdoulaye Bio-Tchané

> **If the next general review of quotas results in stronger African representation, this would be an encouraging sign for the continent and a further recognition of adjustment efforts carried out by many African countries in recent years.**
> —Abdoulaye Bio-Tchané

Heavily Indebted Poor Countries Initiative. There are other cases where failure to clear arrears to multilateral creditors, including the IMF, prevented postconflict countries from securing needed external assistance. The IMF is ready to help these countries as soon as possible, when the authorities have shown they are serious about implementing needed measures. The current example is the Democratic Republic of the Congo, where the authorities have established an impressive track record through a staff-monitored program that would lead to an arrangement under the PRGF.

IMF SURVEY: In the past two years, there has been a major initiative to help reduce poverty through the PRGF and PRSPs. How useful is the PRSP process?

BIO-TCHANÉ: The PRSP process has been a major undertaking for all involved. The recent review of this process was quite telling in terms of lessons and areas to be strengthened. We have to remember that PRSP countries have limited resources and administrative capacities. When the IMF and the World Bank initiated the PRSP process in 1999, some countries already had poverty reduction strategies that were more or less elaborated. For others, it was totally new territory. So, not surprisingly, the road has been bumpy, which has translated into varying levels of quality in the early interim-PRSPs and PRSPs. Overall, there has been encouraging progress, and to me, the first lesson learned from the review is the consensus that the PRSP process is a good one and that it should continue. Most important, it develops or strengthens ownership, and it gives stakeholders a chance to contribute to the policy debate.

IMF SURVEY: How do you answer critics in Africa who claim the IMF imposes its policies on countries?

BIO-TCHANÉ: I would tell them things are never as simple as they look. Negotiating a program is a complex process for countries and for IMF staff. It is true that the review of IMF conditionality revealed that it was intrusive at times and that streamlining was necessary, particularly in the area of structural reforms. It is also true that a greater involvement of country authorities in policy discussions, including on pros and cons of proposed courses of action, would be desirable. As the PRSP process takes hold, it will help dispel the impression that the IMF imposes policies on countries. It is also important for those critics to realize that financial and economic problems, as well as development challenges, have to be tackled in a comprehensive way, with or without IMF assistance. In addition, the IMF is listening more to a wide range of stakeholders, as part of recent efforts on openness and transparency.

IMF SURVEY: Does Africa have a strong enough voice in the IMF, at both the Executive Board and the staff and management levels?

BIO-TCHANÉ: Distinctions should be made between these three levels. Management gives Africa's concerns, like those of the rest of the IMF's membership, the utmost attention. Moreover, the Managing Director is an excellent spokesperson for Africa. At the staff level, the IMF's 2000 diversity report raised some issues that need to be analyzed. However, I have only recently become head of the African Department; it is a bit premature for me to tell you what I would like to see happen. As for the Executive Board, the issue is related to Africa's quota. The Board held discussions in the context of the Twelfth General Review of Quotas, and many Executive Directors were willing to look into ways to improve Africa's representation. If the next general review of quotas results in stronger African representation, this would be an encouraging sign for the continent and a further recognition of adjustment efforts carried out by many African countries in recent years. ■

Available on the web (www.imf.org)

Press Releases

02/24: IMF Executive Board Endorses IMF's Africa Capacity Building Initiative, May 10

02/25: IMF Approves $64 Million Tranche Under Stand-By Credit and $829 Million Extended Arrangement for the Federal Republic of Yugoslavia (Serbia/Montenegro), May 13

Public Information Notices

02/52: IMF Concludes 2002 Article IV Consultation with Ukraine, May 8

02/53: IMF Concludes 2002 Article IV Consultation with People's Republic of China–Hong Kong Special Administrative Region, May 15

02/54: IMF Concludes 2001 Article IV Consultation with Bangladesh, May 15

Speeches

"Economic Outlook for the Americas," Anne Krueger, IMF First Deputy Managing Director, Council of the Americas, U.S. State Department, Washington, DC, May 7

Transcripts

IMF Economic Forum—Foreign Direct Investment in China: What Do We Need To Know? May 2

Statements at Donor Meetings

Donors' Meeting on East Timor—Staff Statement by Stephen Schwartz, Deputy Division Chief, Asia and Pacific Department, May 14

IMF-supported program fine-tuned to help Brazil

(Continued from front page) the long term. The combination of a fragile fiscal position and the loss of competitiveness associated with the exchange rate peg eventually created a large current account deficit and combined with high interest rates to cause a surge in government domestic and external debt. In addition, a growing share of the domestic debt was linked to the overnight interest rate or to the exchange rate to facilitate its rollover, especially after the Asian and Russian crises raised concerns about the economic prospects for emerging markets in general and for Brazil in particular.

Brazil seeks IMF help

After the Russian default in 1998, market perceptions of Brazil's vulnerabilities led to increased capital outflows and bets against the exchange rate peg. The Brazilian central bank reacted by raising interest rates to more than 30 percent in September 1998 and to more than 40 percent in October, but the country still lost about $25 billion in reserves during those two months. The situation had become critical, and the government started discussions with the IMF, presenting it in October 1998 with a comprehensive adjustment program to address the crisis. The IMF's Executive Board approved financial support within a few weeks.

A three-year Stand-By Arrangement with the IMF was the centerpiece of a $41 billion official financing package from multilateral and bilateral sources—one of the largest support packages ever put together by the IMF. The program was premised on the notions that confidence would return and that a gradual, controlled depreciation of the *real* could be sustained through ample official financing and a strong policy response that included an increase in the public sector primary balance (from zero in 1998 to 2.6 percent of GDP in 1999, 2.8 percent in 2000, and 3.0 percent in 2001); maintenance of a tight monetary policy; and additional structural reforms to safeguard the soundness and increase the efficiency of the financial and public sectors.

Setbacks and a crumbling peg

The calming effect of this initial program was shortlived, however, as markets soon questioned the commitment of the Brazilian congress and state governments to the program. In December 1998, congress failed to pass a critical component of the fiscal package (pension reform legislation), and in early 1999, the important state of Minas Gerais threatened to suspend servicing its debt to the federal government. Renewed and intense pressure on the currency forced the central bank to allow the *real* to float. This disorderly exit from the peg caused the *real* to overshoot (it lost about 50 percent of its value in a few months), hurt economic activity, and propelled unemployment to a decade-high 8.3 percent in April 1999.

Facing the threat of escalating economic instability, the government and the IMF worked together to adjust Brazil's policy strategy and, in March 1999, put in place a revised and strengthened program. Its main components were an even tighter fiscal stance (targets for the primary surplus were raised by up to a half percentage point of GDP); the introduction of an inflation targeting framework to replace both the exchange rate peg as the nominal anchor for the economy and the central bank net credit target generally used in IMF-supported programs; and a lower floor on net international reserves to accommodate limited interventions by the central bank in the foreign exchange market. In addition, overnight interest rates were temporarily increased to 45 percent.

The fiscal austerity measures and strengthened program yielded positive results, quickly restoring confidence in the spring of 1999 and creating conditions for interest rate reductions through the remainder of the year. Despite much turbulence and a 48 percent depreciation of the *real*, Brazil's economic performance in 1999 as a whole was significantly better than expected. Real GDP grew almost 1 percent (instead of declining sharply as widely predicted by economic analysts and as assumed under the IMF-supported program), consumer price inflation remained in the single digits, and inflows of foreign direct investment reached $29 billion, virtually the same as the year before. Other elements contributed to the program's success as well. First, most of the private sector was hedged at the time of the devaluation, and, second, the domestic banking system had been strengthened by a program—orchestrated by the central bank in 1995—

Inflation plummeted, but deficits and debt increased

	1991–94[1]	1995–98[1]	1999	2000	2001
Public sector primary balance (percent of GDP)	2.9	–0.2	3.2	3.5	3.7
Current account balance (billion U.S. dollars)	0.6	–26.5	–25.4	–24.7	–23.2
Public sector net debt (percent of GDP)	34.6	35.2	53.6	51.8	55.6
Real overnight interest rate (percentage points)	23.1	21.7	15.3	10.7	9.0
Consumer price inflation (percent)	1,269.0	9.7	8.9	6.0	7.7

[1]Yearly average.
Data: IMF, *World Economic Outlook*, April 2002

Austerity measures implemented within a coherent economic policy framework that restores private sector confidence may have, at most, a short-lived contractionary impact on economic activity.

There are signs that economic activity has begun to recover and that inflation this year will be lower than in 2001.

of mergers and closures of private banks in difficulties.

In 2000, economic performance improved markedly, consolidating the success of the new exchange rate and inflation targeting regime supported by strong fiscal discipline. Real GDP growth reached 4½ percent, inflation slowed to the targeted level of 6 percent, foreign direct investment reached a record $32.8 billion, and the unemployment rate declined to 7 percent. The fast recovery of economic activity, capital flows, and other key indicators suggests that austerity measures implemented within a coherent economic policy framework that restores private sector confidence may have, at most, a short-lived contractionary impact on economic activity.

Another round of shocks

Despite the success of the program, two important sources of vulnerability remained: the large external financing need and the structure of the domestic public debt. These vulnerabilities turned into major sources of instability when shocks hit the Brazilian economy at the beginning of 2001. Poor growth prospects for the world economy and rising concerns about Argentina signaled a decline in capital flows to emerging markets as well as potentially weaker Brazilian exports. The situation was aggravated in May, when the news emerged that an imminent domestic electricity shortage could severely disrupt production. Markets became concerned that a large external financing gap would emerge, which put pressure on the *real*.

The Brazilian central bank responded to the instability by initiating another cycle of monetary tightening. Subsequently, as the *real* continued to slide, the central bank announced that it would sell $50 million in the spot market every day until the end of 2001. By preannouncing sales of a constant amount of dollars, the central bank characterized the policy as a way to ensure market liquidity and help close the projected private sector financing gap, because the total amount of these daily sales was equivalent to market estimates of the financing gap at the time of the policy announcement. The central bank also increased the occasional sale of dollar-indexed domestic bonds to help satisfy the increased demand for hedge and avoid a sharper depreciation of the *real*.

With the three-year Stand-By Arrangement scheduled to end in December 2001, the authorities sought its cancellation and requested a new arrangement with the IMF to run through December 2002. Despite some calls for "shock therapy" or other less conventional policy measures, the Brazilian government and IMF staff remained confident in the overall economic strategy of President Fernando Cardoso's administration, agreeing that "more of the same" was the preferred line of action. In September 2001, the IMF's Executive Board approved a new Stand-By Arrangement, which again raised the fiscal targets in the context of a broader strategy to engineer a declining debt-to-GDP ratio in the medium term. The new program made an additional $14.7 billion available to Brazil, and the floor on net international reserves was lowered to give the central bank more scope for intervening in the foreign exchange market, if necessary, to avoid excessive exchange rate volatility and overshooting relative to fundamentals. Later in the year, additional monetary tightening was introduced through more stringent reserve and prudential requirements, which, among other things, reduced the ability of banks to keep open foreign exchange positions.

Markets welcomed the new Stand-By Arrangement but did not immediately return to normalcy. The currency—which had depreciated steadily from the beginning of the year—continued to weaken through October 2001, and the Brazil EMBI spread increased from less than 700 basis points in early February 2001 to almost 1,200 basis points in October 2001.

Weathering another storm

Finally, the government's IMF-supported strategy proved its merits. Beginning in the last quarter of 2001, a sequence of favorable news added the final ingredients for a reversal of expectations in favor of Brazil. Despite the economic slowdown, clear signs emerged that the public sector primary surplus would surpass the more ambitious target set in the September program; the pass-through from the currency depreciation to domestic prices was contained and inflation remained under control; inflows of foreign direct investment beat all expectations; the energy-rationing program averted any significant disruption in production; and the monthly trade balance shifted into sizable surpluses in the last quarter of 2001. The *real* strengthened from about R$2.83 per dollar in late October to R$2.32 per dollar in December, despite a worsening situation in Argentina, suggesting part of the earlier depreciation reflected an overshooting associated with undue market pessimism. More recently, there are signs that economic activity has begun to recover and that inflation this year will be lower than in 2001. In the first quarter of 2002, the Brazil EMBI spread had returned to around 740 basis points (slightly below its end-2000 level), suggesting that Brazil had won another battle on the long road to stability and growth.

Remaining imbalances

Brazil's success in strengthening its fiscal performance, stabilizing the exchange rate, and keeping inflation under control after the mini-crises of 1999

and 2001 does not mean that it can expect clear sailing ahead. Brazil continues to face important constraints to achieving higher and sustainable economic growth while keeping inflation down. The external financing requirement is still relatively high and could increase with the acceleration of economic activity, putting additional pressure on the exchange rate and thereby threatening fiscal sustainability and the inflation targets. Brazil intends to tackle these problems by continuing to implement structural reforms that could allow further and substantial improvements in the external position. It will also continue pressing for greater trade integration in the region and for the removal of trade barriers in industrial markets. In addition, the ongoing financial sector reforms should stimulate domestic savings and help reduce external financing requirements.

The share of the domestic public debt that is linked to the overnight interest rate or to the exchange rate remains above 75 percent. Brazil's public finances therefore continue to be vulnerable to negative shocks that might affect the exchange rate, require strong monetary tightening, or both. This, in turn, reduces the margin for the possibility of applying countercyclical fiscal policies, with additional implications for economic growth. To tackle these problems, Brazil is determined to maintain a strong primary fiscal position that would allow for a gradual but steady improvement in the composition of the domestic debt through reduced reliance on interest rate– and exchange rate–indexed debt. ■

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Recent publications

IMF Staff Papers ($54 a volume)
Volume 48, special issue
Volume 49, No. 1, 2002

Occasional Papers ($20.00; academic price: $17.50)
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212: *Financial Soundness Indicators: Analytical Aspects and Country Practices*, V. Sundararajan, Charles A. Enoch, Armida San Jose, Paul L. Hilbers, Russell C. Krueger, Marina Moretti, and Graham L. Slack

World Economic and Financial Surveys ($42.00; academic price: $35.00)
World Economic Outlook, April 2002

Books
Financial Risks, Stability, and Globalization, Omotunde E. Johnson ($40.00)
Into the EU: Policy Frameworks in Central Europe, prepared by a staff team led by Robert A. Feldman and C. Maxwell Watson ($26.00) (see page 168)

Working Papers ($10.00)
02/70: *You Say You Want a Revolution: Information Technology and Growth*, Markus Haacker and James H. Morsink
02/71: *The Costs and Benefits of Various Wage Bargaining Structures: An Empirical Exploration*, Alun H. Thomas
02/72: *Is Policy Ownership an Operational Concept?* James M. Boughton and Alexandros T. Mourmouras
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02/85: Kenya: 2001 Article IV Consultation
02/86: Sri Lanka: First and Second Reviews Under the Stand-By Arrangement
02/87: Mauritius: Report on the Observance of Standards and Codes
02/88: Costa Rica: 2001 Article IV Consultation
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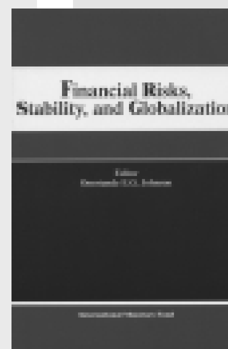

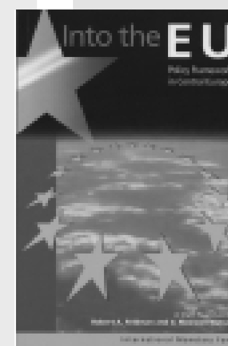

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Interview

Baltic and central European countries face challenges in run-up to EU accession

In the decade following the fall of the Berlin Wall, Baltic and central European countries made huge strides toward meeting one of history's most daunting challenges: the rapid transition from central planning to a market-based economy. But what now? In separate studies, two IMF teams examined the strategies these countries are adopting, particularly relating to macroeconomic and financial sector policies, in the run-up to European Union (EU) accession and, later, monetary union. Jeremy Clift of the IMF's External Relations Department spoke to four of the authors—Robert A. Feldman and C. Maxwell Watson, who looked at five central European states, and Johannes Mueller and Christian Beddies, whose new publication covers the Baltic economies—on the groundwork needed for EU accession.

Authors (left to right) Christian Beddies, Johannes Mueller, Robert A. Feldman, and C. Maxwell Watson debate the policies needed for countries joining the European Union.

CLIFT: You say that the road to EU accession is in many respects mapped out in advance for the applicant countries. In reality, how smooth is the process? What could go wrong?

FELDMAN: The road to EU accession and ultimately the adoption of the euro will place major demands on policymakers as they aim for low inflation, financial and macroeconomic stability, and continuing structural reform in economies increasingly open to capital inflows. It will also require skillful policy management to foster real convergence to EU income levels through growth that is not only strong but also sustainable. Thus, one of the challenges for the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia is to keep fiscal deficits within prudent limits and contain external current account deficits to avoid vulnerabilities. The good news is that an accession framework is in place, and, with the right policies, economic and monetary union and the full benefits of membership in the European Union are within reach.

CLIFT: To set this in a broader context, how large has the transformation over the past 10 years been, and what are the key issues in the next year or so for the Baltic countries?

MUELLER: Estonia, Latvia, and Lithuania have done a tremendous job of moving from centrally planned economies toward full-fledged market economies. They have achieved substantial macroeconomic stabilization, sustained very high growth rates, and controlled inflation, which is now approaching the EU average. In addition, they have implemented a vast array of structural reforms to modernize their economies. Now the Baltics have to face new challenges, many of them on the fiscal side, which is the focus of our paper.

CLIFT: Max, how complicated is it for these applicant countries to adopt the euro, given the large and possibly volatile capital flows that may affect this process, and when might they do so?

WATSON: Adoption of the euro is definitely a second phase, and there are several things to consider. One is the extent to which major structural changes may still be going on in these economies—something that varies from country to country. Another is the speed with which you want to reduce inflation. Everyone would agree that you want inflation in low single digits. How fast do you want to get it down to below 2 percent—which is the euro-area goal—when you have all sorts of other changes in relative prices going on?

A third factor is the maturity of the financial sector. A number of the EU accession countries—certainly some in central Europe—have made remarkable strides in modernizing their banking systems, getting hard budget constraints in place, laying the basis for a sound transmission mechanism for monetary policy, helping to develop the private sector, and filtering capital inflows. Indeed, contrary to views sometimes expressed, the capital inflows and outflows will not be managed simply by adopting the euro: it depends on a range of policies and institutions, including a healthy financial sector—one that is skilled in managing market and credit risks. But most people would accept that—even in the most advanced cases—this process of financial sector maturation is not yet complete.

CLIFT: So the adoption of the euro is some way off?

WATSON: The issue is not so much *when* it will happen as *how*: the precise timing should depend on each country's situation and the progress made in the areas I just mentioned. Candidates must first pass through ERM2—the phase of economic and monetary union that involves a central parity and a wide band—so, yes, adoption would lie some years in the future.

FELDMAN: With yesterday's transition economies becoming today's emerging markets, which in turn are progressing from emerging to converging status, it is important to recognize, and minimize, the risks associated with prospectively large and potentially volatile capital inflows. In this context, the importance of a healthy financial sector cannot be overemphasized.

CLIFT: Given that it's only about a decade since the Baltics gained independence, is there a danger of things moving too fast? Are they coping well?

BEDDIES: So far, the Baltic countries are coping extremely well with the challenges they have been facing. It is important to note that stabilization in the Baltics was achieved through currency boards in Estonia and Lithuania and a fixed exchange rate regime in Latvia. These hard pegs were extremely successful in instilling stability and credibility in the monetary sphere and should continue to serve the Baltics well in their transition toward EU membership. But on the fiscal side, they will have to make some politically difficult choices. The transition phase to EU membership for these countries is much shorter than for previous accession countries. Nevertheless, the Baltics start in a fairly good fiscal position, so they are well placed to meet these challenges.

CLIFT: What are these politically difficult choices that the Baltics face?

BEDDIES: Choices about maintaining or achieving budget balance over the medium term.

MUELLER: Tough choices on the expenditure side of the budget; EU accession requires certain spending based on commitments that are currently being negotiated. But if at the same time the countries are moving toward a balanced budget and thinking about lowering the tax burden, something has to give, and that something is discretionary, nonpriority spending.

CLIFT: So you foresee considerable fiscal tensions?

FELDMAN: One thing that emerges from our study is that fiscal policy has a lot to contend with. It is at the fulcrum of policy frameworks. It has to deal with various economic stresses, including those that can arise, for example, from current account deficits or the difficulties in macroeconomic management in the face of large and potentially volatile capital inflows. It is also faced with various competing spending pressures that tend to add to the fiscal deficit at a time when countries are rightly seeking to consolidate their public finances over the medium term. But uncertainties in the economic outlook should prompt, not discourage, a medium-term approach to policy.

WATSON: The policy frameworks present a fundamental dilemma for policymakers. Policies need to be firm enough to both guide and harness expectations, but flexible enough to cope with uncertainty in the real economy and about prices, capital flows, and the current account of the balance of payments. How does one achieve this? Policy frameworks must be credible and transparent so that uncertainties can be handled. And such frameworks must be cast in a medium-term mold, as Bob said.

FELDMAN: Medium-term fiscal frameworks also help identify, early on, the tensions that can arise and allow the authorities to determine how best to phase in needed structural reforms. This includes upfront expenditure reforms that are so important if lower-priority, discretionary spending items are to adjust to achieve targets for the fiscal balance while safeguarding high-priority expenditures that support growth. In this context, medium-term expenditure limits are also an attractive tool for establishing credibility and political support.

MUELLER: Our paper has also focused on the need to have medium-term frameworks in place to help set spending priorities. We mention the importance of public sector reform—to help improve the efficiency and effectiveness of public sector spending—and pension and civil service reform. While the central European study favors expenditure rules, our paper promotes a balanced budget rule that could offer some policy guidance for the Baltic countries. But it doesn't really matter which rule they follow, as long as the role helps shape expectations, is transparent and credible, and can be monitored.

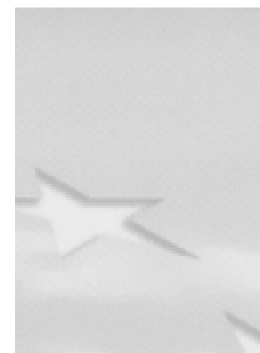
CLIFT: You indicate that the Baltic countries need to increase military spending. How will that be achieved?

BEDDIES: We were talking about the commitments the authorities have already made. They have strong hopes of joining NATO [the North Atlantic Treaty Organization] and are committed to meeting its requirements, which would mean spending roughly 2 percent of GDP on military expenditures by the time they accede to the treaty.

MUELLER: And the Baltics have almost achieved these targets. Estonia and Lithuania are already at 2 percent of GDP, and Latvia is at 1.8 percent of GDP.

BEDDIES: Latvia will achieve it next year.

WATSON: Should these countries be trying urgently to meet the Maastricht fiscal criterion or to conform with the EU Stability and Growth Pact? In other words, should they aim now for fiscal positions that are lim-



Feldman: "Fiscal policy has a lot to contend with."

Beddies: "So far, the Baltic countries are coping extremely well with the challenges they have been facing."

ited to a deficit of 3 percent of GDP or set their sights on positions that are close to balance or in surplus?

Both of our publications suggest the initial emphasis should be on fundamentals. And what the fundamentals suggest for the small and very open Baltic economies is a balanced budget rule, provided that it fits broadly with the external current account framework. In the central European economies, our answer is to develop a rule rooted in the fundamentals of each of these economies. There is a big difference, for example, between Poland and Estonia. Again, we say: don't meet Maastricht too early, simply for Maastricht's sake—look at the fiscal position in terms of domestic priorities, including sustaining growth.

Watson: "With the right policy setting, it is a win-win situation."

This suggests that the larger countries in central Europe should not focus on a balanced budget rule but pay attention chiefly to the external current account deficit and not let it get too big. Empirically, this advice likely drives one toward fiscal positions that are fairly close to balance—in fact, Maastricht compatible, but for domestic and fundamental reasons, not doctrinal. A fairly prudent fiscal policy clearly supports sustainable growth. There is no conflict between sound fiscal positions and real convergence.

Mueller: We fully agree. For the Baltics, there are some key reasons why they should adhere to their self-declared balanced budget objective. First, given the exchange rate pegs, fiscal policy is the sole macroeconomic policy instrument to limit the risks emanating from persistent external current account deficits. Second, the public sector's call on national saving must be reduced to maintain low interest rates and avoid crowding out the private sector. And, third, the authorities must avoid a situation in which they have to undertake a procyclical fiscal adjustment to meet the Maastricht and Stability and Growth Pact criteria.

Mueller: "For the Baltics, there are some key reasons why they should adhere to their self-declared balanced budget objective."

Clift: What does the accession of all these applicants mean for the current European Union?

Watson: On the EU side, there is a question of further improving the efficiency and design of some institutions as you expand the membership. That is an institutional challenge, but we all know that it has a political dimension. It is not easy, but I'm sure it will be accomplished.

Another concern is an inflow of labor from central and eastern Europe, or pressure on wages to become more differentiated. The message for policymakers in existing EU member states is to press on with the structural reforms you need to make anyway. These will tend to enhance the functioning of their labor markets and draw more people into employment, including through further liberalization and wage differentiation, where needed. As those things go right within the European Union, they will intrinsically allay some of the concerns about enlargement. Therefore, there is no conflict between the domestic EU priorities in structural policies and the requirements of accession. Far from it. This should be a virtuous circle. With the right policy setting, it is a win-win situation. But from the political economic perspective, we know structural reform is not easy.

Feldman: Indeed. The past 10 years have been historic in terms of the breakdown of central planning, the move to market economies, and now the efforts to join the European Union. The candidate countries benefit, but so, too, do the existing members. As Max said, it is really a win-win situation. As a result, we look for a larger economic and monetary union that will bring benefits to everybody involved. ■

Copies of IMF Occasional Paper No. 213, *The Baltic Countries: Medium-Term Fiscal Issues Related to EU and NATO Accession*, by Johannes Mueller, Christian Beddies, Robert Burgess, Vitali Kramarenko, and Joannes Mongardini, are priced at $20.00 ($17.50 for academics and students).

Into the EU: Policy Frameworks in Central Europe, by a staff team led by Robert A. Feldman and C. Maxwell Watson, with Peter Doyle, Costas Christou, Christina Daseking, Dora Iakova, Guorong Jiang, Louis Kuijs, Rachel van Elkan, and Nancy Wagner, is available for $26.00 from IMF Publication Services. See page 167 for ordering information.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
May 1	2.28	2.28	2.92
May 6	2.30	2.30	2.94
May 13	2.30	2.30	2.94
May 20	2.33	2.33	2.98

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2002).

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

Data: IMF Treasurer's Department

Interview

Transition countries should not worry too much about real exchange rate appreciations

A number of countries making the transition from centrally planned to market economies have experienced strong real exchange rate appreciations. What is causing these movements, and what steps should policymakers take in response? And with these appreciations typically entailing higher inflation, will the countries seeking to join the European Economic and Monetary Union (EMU) be able to meet the Maastricht inflation criterion? A recent paper by Mark De Broeck of the IMF's European I Department and Torsten Sløk of the Research Department finds that, in a number of countries, these appreciations are mostly driven by productivity gains. When real exchange rate appreciations are part of the process of income convergence toward the advanced economies, there is no need, they argue, for a policy response.

IMF Survey: What prompted you to study exchange rate movements in transition countries?

Sløk: The main motivation for the paper was to look at the special situation of transition countries—the central and eastern European countries, and Russia and the other countries of the former Soviet Union—after their move to market-based economies. The rigidities that existed in these economies under the old centrally planned system were removed very quickly and that led to dramatic changes in productivity and relative prices.

A major area of interest to us was what this all meant in terms of real exchange rate movements. Why is that relevant? Because, if you have an idea of why real exchange rates move, it is easier to assess how policy should respond, if at all. We find that for most transition countries one of the key reasons why the real exchange rate is appreciating is strong productivity gains. These productivity-driven real exchange rate appreciations are a positive sign that income levels in these economies have begun to converge toward the living standards in high-income market economies.

De Broeck: Especially early in the transition period, real and nominal exchange rate movements in these countries were more pronounced than in other countries. Such large, sharp movements help identify the factors that caused them. It is also interesting that these movements had the same underlying tendencies irrespective of the exchange rate regime the transition countries used.

IMF Survey: Why have transition countries experienced such strong real exchange rate appreciations?

Sløk: The key hypothesis is that these strong appreciations reflect underlying structural shifts. When a transition country introduces a market-based pricing system and opens up, allowing more exports and imports, it allocates resources better and increases the competitiveness of its tradable goods sector (for example, in manufacturing). This improves productivity, which in turn allows wages in this tradable goods sector to increase. Because wages are often linked across sectors, productivity and wage increases in the tradables sector also generate wage increases in the nontradables sector (such as the service sector or government). When wages go up in all sectors, the overall price level in the economy will start to go up, and this results in an appreciation of the real exchange rate.

What does an appreciation mean for a country? It could signal deteriorating external competitiveness. An appreciation driven by productivity gains, however, does not harm competitiveness and is part of the convergence process that will raise income levels in the transition countries.

Sløk: "One of the key reasons why the real exchange rate is appreciating is strong productivity gains."

De Broeck: It is important to realize that these countries started the transition process at a level of productivity significantly below that of market economies. Once the initial phase of the transition process was over, macroeconomic stabilization achieved, and distortions eliminated, most of these countries saw substantial productivity gains.

Also, when market-determined exchange rates replaced administratively set rates, this was typically done at a level somewhat below the equilibrium level. So, in the initial years of the transition, some of the real exchange rate appreciations resulted from the correction of the initial undervaluation. Our paper tried to distinguish between the underlying equilibrium appreciation that was primarily due to productivity gains and the initial appreciation associated with the introduction of market-based exchange rates at below-equilibrium levels.

De Broeck: "As long as this catching-up process continues, there will be further real exchange rate appreciations."

Sløk: Before the move to a market-based economy, most firms in these countries simply produced a certain number of goods because they were instructed to do so. Suddenly, firms were allowed to produce more or less, lower or increase prices, and reorganize the way they produced and sold goods. These types of changes led to strong productivity gains. Also, because transition countries started from such a distorted system, it is easier to identify a strong impact of productivity gains on

their real exchange rates than in countries where so many other factors drive the exchange rate.

IMF SURVEY: Are there further appreciations in store?

DE BROECK: We think so. While real exchange rates in most of the transition countries have moved toward their equilibrium paths, there is scope for further appreciation along these paths. Transition countries have lower income levels than advanced economies. As incomes catch up as a result of faster productivity growth, prices in the transition countries will increase, causing the real exchange rate to appreciate. But by how much? Our study indicates that if the income gap is narrowed by 1 percent, then the price level, and, hence, the real exchange rate will increase about 0.4 percent.

The transition process is going to be stretched out. Even the most advanced transition countries still have income levels that are only 60 to 70 percent of the EU average. For example, Slovenia—the most advanced transition country—could take about 10 to 15 years before it fully catches up with EU countries. Less advanced EU accession countries could take about 30 to 40 years. As long as this catching-up process continues, there will be further real exchange rate appreciations. This catching-up process is not, however, specific to the transition economies. It is a general feature of the income convergence of lower-income countries to high-income countries. But we think the transition countries, given the significant scope for further productivity increases, will catch up a bit faster than nontransition countries of a comparable level of development.

SLØK: However, this does not mean that all real exchange rate appreciation in the transition countries is positive news. Appreciation can come from many factors other than this catching-up component.

IMF SURVEY: What are the major challenges posed by these appreciations? Is a policy response required?

DE BROECK: As long as the appreciation in the real exchange rate is due to an equilibrium phenomenon driven by productivity gains in the tradables sector, then it should not really be a challenge or concern. However, if the appreciation is driven by other factors, such as excess domestic demand, countries should be concerned because that would erode their competitiveness. It is therefore important for policymakers to identify the underlying sources of real exchange rate appreciation. That is the main challenge.

Determining the underlying trends, however, requires judgment. Based on our analysis, I don't think we can give concrete guidelines to policymakers on how to respond when they see the real exchange rate appreciate. The results we mentioned earlier—1 percent extra growth in the transition countries leading to a 0.4 percent real appreciation—is in the context of an underlying, longer-term relationship.

SLØK: The equilibrium level of the real exchange rate in transition countries remains difficult to estimate. A lot of factors need to be taken into account when considering to what extent these real exchange rate appreciations threaten competitiveness and require a policy response.

DE BROECK: For instance, many transition countries still have a number of administered prices. When designing a scheme to gradually bring these prices to cost-recovery levels or liberalize them, policymakers should take into account how these adjustments will affect inflation and competitiveness.

IMF SURVEY: Do these appreciations pose any issues for the EU accession countries?

DE BROECK: These real exchange rate appreciations pose a special challenge for the EU accession countries that also want to join EMU because these appreciations are expected to continue during the period of preparation for, and the initial years of, EMU membership. There are some constraints when a country wants to join EMU in terms of how high inflation can be. So there will be some issues.

First, when the EU accession countries are preparing for EMU membership, the real exchange rate appreciations will have implications for their choice of exchange rate arrangement. Second, once these countries join EMU, inflation in some of them may still be higher than in the original EMU members, reflecting continued faster productivity growth. It will be a matter for the European Central Bank to decide to what extent this source of additional inflation will be taken into account when assessing inflation developments in the enlarged monetary union. It will still take a few years before the EU accession countries can become EMU members. By that time, the underlying real

As long as the appreciation in the real exchange rate is due to an equilibrium phenomenon driven by productivity gains in the tradables sector, then it should not really be a challenge or concern.
—Mark De Broeck

Members' use of IMF credit
(million SDRs)

	During April 2002	January–April 2002	January–April 2001
General Resources Account	**1,038.53**	**8,947.75**	**3,640.70**
Stand-By	1,038.53	8,672.51	3,581.90
SRF	0.00	0.00	2,349.57
EFF	0.00	275.24	58.80
CFF	0.00	0.00	0.00
PRGF	**206.90**	**323.03**	**244.16**
Total	**1,245.43**	**9,270.78**	**3,884.86**

SRF = Supplemental Reserve Facility
EFF = Extended Fund Facility
CFF = Compensatory Financing Facility
PRGF = Poverty Reduction and Growth Facility
Figures may not add to totals shown owing to rounding.

Data: IMF Treasurer's Department

appreciation of the exchange rate in these countries may have become small enough that it can be accommodated without any major problems.

SLØK: We find that the magnitude of the productivity-driven appreciation is stronger in the EU accession countries than in other transition countries. This is partly due to the EU enlargement process, which provides an external "anchor," helping the accession countries adjust and reform their economies. In contrast, in Russia and other former Soviet Union countries, which are not the first natural set of members for the EU, the lack of such an anchor has unfortunately resulted in less progress with structural reforms. ■

Copies of IMF Working Paper 01/56, *Interpreting Real Exchange Rate Movements in Transition Countries*, by Mark De Broeck and Torsten Sløk, are available for $10.00 each from IMF Publication Services. See page 167 for ordering information.

The magnitude of the productivity-driven appreciation is stronger in the EU accession countries than in other transition countries.
—Torsten Sløk

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

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina[1]	March 10, 2000	March 9, 2003	16,936.80	7,180.49
Brazil[1]	September 14, 2001	December 13, 2002	12,144.40	8,468.82
Bulgaria	February 27, 2002	February 26, 2004	240.00	208.00
Croatia	March 19, 2001	May 18, 2002	200.00	200.00
Guatemala	April 1, 2002	March 31, 2003	84.00	84.00
Latvia	April 20, 2001	December 19, 2002	33.00	33.00
Lithuania	August 30, 2001	March 29, 2003	86.52	86.52
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Romania	October 31, 2001	April 29, 2003	300.00	248.00
Serbia/Montenegro	June 11, 2001	May 31, 2002	200.00	50.00
Sri Lanka	April 20, 2001	August 19, 2002	200.00	48.32
Turkey[1]	February 4, 2002	December 31, 2004	12,821.20	4,627.20
Uruguay	April 1, 2002	March 31, 2004	594.10	471.50
Total			**44,095.02**	**21,960.85**
EFF				
Colombia	December 20, 1999	December 19, 2002	1,957.00	1,957.00
Indonesia	February 4, 2000	December 31, 2003	3,638.00	2,201.96
Jordan	April 15, 1999	May 31, 2002	127.88	60.89
Ukraine	September 4, 1998	September 3, 2002	1,919.95	726.95
Total			**7,642.83**	**4,946.80**
PRGF				
Armenia	May 23, 2001	May 22, 2004	69.00	59.00
Azerbaijan	July 6, 2001	July 5, 2004	80.45	64.35
Benin	July 17, 2000	July 16, 2003	27.00	12.12
Bolivia	September 18, 1998	June 7, 2002	100.96	37.10
Burkina Faso	September 10, 1999	December 9, 2002	39.12	5.58
Cambodia	October 22, 1999	February 28, 2003	58.50	16.72
Cameroon	December 21, 2000	December 20, 2003	111.42	63.66
Cape Verde	April 10, 2002	April 9, 2005	8.64	7.41
Chad	January 7, 2000	January 6, 2003	47.60	15.80
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Djibouti	October 18, 1999	October 17, 2002	19.08	10.00
Ethiopia	March 22, 2001	March 21, 2004	100.28	41.72
Georgia	January 12, 2001	January 11, 2004	108.00	81.00
Ghana	May 3, 1999	November 30, 2002	228.80	52.58
Guinea	May 2, 2001	May 1, 2004	64.26	51.41
Guinea-Bissau	December 15, 2000	December 14, 2003	14.20	9.12
Honduras	March 26, 1999	December 31, 2002	156.75	48.45
Kenya	August 4, 2000	August 3, 2003	190.00	156.40
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	61.68
Lao People's Dem. Rep.	April 25, 2001	April 24, 2004	31.70	22.64
Lesotho	March 9, 2001	March 8, 2004	24.50	14.00
Madagascar	March 1, 2001	February 29, 2004	79.43	56.74
Malawi	December 21, 2000	December 20, 2003	45.11	38.67
Mali	August 6, 1999	August 5, 2003	51.32	19.65
Mauritania	July 21, 1999	July 20, 2002	42.49	12.14
Moldova	December 21, 2000	December 20, 2003	110.88	92.40
Mongolia	September 28, 2001	September 27, 2004	28.49	24.42
Mozambique	June 28, 1999	June 27, 2002	87.20	25.20
Niger	December 22, 2000	December 21, 2003	59.20	33.82
Pakistan	December 6, 2001	December 5, 2004	1,033.70	861.40
São Tomé & Príncipe	April 28, 2000	April 27, 2003	6.66	4.76
Sierra Leone	September 26, 2001	September 25, 2004	130.84	74.67
Tanzania	April 4, 2000	April 3, 2003	135.00	35.00
Vietnam	April 13, 2001	April 12, 2004	290.00	207.20
Zambia	March 25, 1999	March 28, 2003	254.45	149.63
Total			**4,201.11**	**2,700.58**
Grand total			**55,938.96**	**29,608.23**

[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.

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

IMF Economic Forum

For China, foreign direct investment translates into higher productivity growth

There is no arguing that China's dramatic economic transformation has been remarkable and that opening up the economy to both foreign direct investment (FDI) and trade has made an important contribution. But what role, exactly, has FDI played in this success story? And what role will it play as the country joins the World Trade Organization (WTO) and further opens up its economy? Tapping the perspectives of academia, think tanks, and IMF staff, an IMF Economic Forum on May 2 offered provocative analyses of what drove FDI and took an upbeat view of its role in coming years.

Foreign entrepreneurs are playing the role of venture capitalists, providing seed capital to businesses that are discriminated against by the banks.
—Yasheng Huang

As Wanda Tseng, IMF Deputy Director of the Asia and Pacific Department, noted in her opening remarks, two decades of economic reforms and resilience in the face of regional crises have paid off handsomely for China in terms of "spectacular growth, substantial inroads in reducing poverty, and the development of a very vibrant nonstate sector." Clearly, a key element in this transformation was an early decision to progressively open the country to the outside world through trade and foreign investment. This Economic Forum, Tseng explained, is taking a closer look at what drove those flows, what impact they have had on China's economic performance, and what the future implications for FDI are from further liberalization and the convertibility of the renminbi.

First, the big picture

But before FDI's role—past or future—was discussed, Markus Rodlauer, Assistant Director for the IMF's China Division, outlined the larger picture, examining developments in China's balance of payments and exploring how external flows related to the domestic economy in terms of the savings-investment balance. In recent years, he said, China's current account surplus has averaged about $25 billion (about 2.5 percent of GDP) and FDI net inflows, about $40 billion (roughly 4 percent of GDP).

As Rodlauer and other panelists noted, however, China did not "need" FDI in that it had huge amounts of domestic savings (averaging 40 percent of GDP—a level sharply higher even than other Asian economies) and an "equally astounding aggregate level of domestic investment" (35–40 percent of GDP). What is to be made of this puzzle—huge inflows of FDI amid very strong domestic savings and investment? Rodlauer argued that FDI's substantive contribution was not so much in filling any balance of payments gap but rather in dramatically improving the productivity of investment and boosting growth.

Drivers of FDI

Why, indeed, did China want FDI? Harvard Business Professor Yasheng Huang, summarizing the thesis of his forthcoming book, *Selling China*, had a story to tell. Jettison some of your stereotypes about FDI in China, he said, because a lot of conventional explanations are at least partially wrong. FDI may have improved the productivity of China's investment, but it did so within an institutional context that kept efficient private domestic entrepreneurs from making these same contributions.

On the face of it, Huang noted, FDI's role looks large and direct. China's exports surged over the course of the past decade, and the role of foreign-invested enterprises (joint and wholly owned ventures) expanded dramatically, accounting for 15 percent of exports in 1990 and 48 percent in 2000. But look more closely, he added, and you also find a "switching effect." More than two-thirds of this boost in exports is accounted for by well-financed foreign firms (often from Hong Kong SAR, Taiwan Province of China, and Macao SAR) supplanting credit-strapped private domestic firms.

A truer picture of FDI's role, Huang also suggested, can be gained from subtracting the investments of the dominant state-owned enterprise sector and comparing FDI with nonstate firm investment. In that context, the annual average share of FDI is the equivalent of 28 percent of nonstate domestic capital formation—remarkably close to highly FDI-dependent Singapore (30 percent) and Malaysia (24 percent). All three countries, he argued, systematically suppressed local entrepreneurs (albeit for different reasons) and substituted foreign know-how. In China, he said, the motivation was ideological—until the late 1990s, the government was leery of the power of private firms.

Huang cited further evidence of this suppression in the regional and sectoral distribution of FDI. Unlike the regionally and sectorally concentrated FDI found elsewhere, China's FDI has flowed to many provinces and many industries. There is some evidence, he said, that domestic capital mobility may actually have declined over the reform period and that provinces that could meet their investment needs from local sources had to turn to FDI for capital.

Typically, a growing market with good fundamentals attracts domestic as well as foreign investment.

Wanda Tseng

Nicholas Lardy

Yasheng Huang

Harm Zebregs

Markus Rodlauer

But in China, the FDI component of investment grew much more strongly than domestic investment until 1996–97, when government policies began to treat domestic entrepreneurs much better, which in turn spurred greater domestic investment.

Also look carefully, Huang said, at the large presence of FDI in the export sector. In labor-intensive industries such as garments and footwear, FDI accounted for about 61 percent of the exports. In comparable industries in Indonesia and Taiwan Province of China, the foreign involvement was dramatically lower (33 percent and 5.7 percent, respectively). In Taiwan Province of China, the export success story was the product of local entrepreneurs. In China? "Essentially," he explained, "foreign entrepreneurs are playing the role of venture capitalists, providing seed capital to businesses that are discriminated against by the banks."

China's FDI has a similarly unusual role in privatization. Huang found numerous instances of state-owned enterprises contributing their brand names, customer bases, and operating assets to finance an equity claim on a newly created joint venture. In the process, however, the state-owned joint-venture partner became a shareholding company with no operating assets. The FDI story, he emphasized, is really a de facto privatization story—one in which the government has not allowed domestic private companies to acquire the same state-owned enterprise assets that foreigners can.

But there was also a case to be made for the more traditional drivers of FDI. Summarizing his recent IMF Policy Discussion Paper (02/3), Harm Zebregs, an economist in the IMF's China Division, suggested that market size, abundant cheap labor, and adequate infrastructure did play a role in attracting investment to China. So, too, did reduced barriers and preferential policies that took the form of tax concessions and special privileges and that allowed open economic zones to play a crucial role in the gradual liberalization of the economy. Other elements, such as cultural, bureaucratic, and legal environments, helped attract FDI from the Chinese diaspora, and the lack of familiarity with these same elements prompted European and U.S. investors to seek local counterparts.

Nicholas Lardy, a Senior Fellow at the Brookings Institution, found merit in both arguments. Distortions in China's financial system were a very important reason why China relied on the external sector, he said, but traditional determinants were also influential. Lardy added two further drivers of FDI that he felt had been insufficiently acknowledged: China's processing program, which allows foreign firms to import, duty free, capital goods and components and assemblies that will be used for export processing ("an enormous driver of China's trade growth") and the convertibility of the current account, in 1996, which has allowed foreign-invested firms to repatriate declared dividends from joint ventures.

FDI's impact and lessons

What did FDI do for China, and indeed for the firms investing in China? Zebregs found FDI had a relatively small effect on growth through higher capital accumulation but a more significant effect through higher productivity growth—an impact estimated at 2–2.5 percent of GDP growth in the 1990s. Foreign-invested enterprises, he added, had labor productivity twice as high as state-owned enterprises; created job opportunities (and currently account for 3 percent of urban employment); and played a key role in China's impressive trade growth.

Lardy dismissed the fairly widespread myth that processing activity and the foreign firms operating in enclaves had little impact on the domestic economy. He preferred the productivity argument. Look at what's happening in the processing sector, he said. While the rate of value added was relatively low in the early 1990s, "value added as a percentage of output in the processing sector roughly doubled." This means, he added, that as more and more foreign firms operate, they create demand. A lot of domestic firms are producing more parts and components.

Lardy also tackled the increasingly common myth that foreign investors aren't turning a profit. Examine systematic data rather than anecdotes, he suggested, and you find profitability in the second half of the 1990s at about 14 percent—that same profit margin investors are finding in Brazil and Turkey.

Does China's success, then, hold lessons for other countries? Zebregs suggested the most important lesson is that China's success is not unique. Its recipe was a

China's success is not unique. Its recipe was a standard one: large domestic markets, low wage costs, and improved infrastructure, complemented by open FDI policies and the establishment of open economic zones.
—Harm Zebregs

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standard one: large domestic markets, low wage costs, and improved infrastructure, complemented by open FDI policies and the establishment of open economic zones. Less common, but no less important, was China's decision to pursue a gradual, persistent reform strategy that built on the success of market-based reforms in a few locations to develop, over time, broader interest in, and support for, wider reforms.

Of course, that's not to say that the strategy didn't have its pitfalls. Zebregs pointed, in particular, to an increasingly complex and biased tax incentive system (something the authorities are now attempting to rectify with unified tax rates for foreign-invested and domestic firms) and growing income disparities between coastal and inland provinces (a problem abetted by FDI concentrations and now hoped to be redressed through a redirection of FDI to western and central provinces).

What now?

Though much has changed in China, much more change seems to loom on the horizon. One pressing question is what effect China's WTO commitments will have on the volume and composition of FDI inflows. Lardy cited several WTO commitments that will make investment in manufacturing more attractive, and he saw China and foreign investors poised to take advantage of the phaseout of textile and apparel quotas. Overall, though, Lardy was convinced that the truly significant changes would occur in areas previously closed to FDI, notably telecommunications, financial services, and distribution. On balance, he looked for moderate growth in overall FDI, with a significant shift, over time, in its composition.

Trade-related changes, however, are not the only reforms in prospect, and Rodlauer closed the panel discussion by examining the likely implications of further liberalizing the capital account (including FDI) and pursuing the convertibility of the renminbi.

On the capital account, Rodlauer reminded the audience that, despite steps to liberalize the trade and FDI regimes, China still employs extensive capital controls to retain scope for independent monetary policy and maintain a stable exchange rate, as well as to limit vulnerability to capital flow reversals and protect certain domestic industries. FDI, while fairly open, is nonetheless tightly regulated on an individual basis. Portfolio equity and loans are also strictly controlled, with entirely separate systems for foreigners and residents.

Eventual opening up of the capital account and full convertibility are likely to be unavoidable, Rodlauer said, and China itself has stated this as an explicit and long-term goal. The authorities are aware of the well-known benefits of opening the capital account and similarly aware of the equally well-known risks. It is in

A billboard of Shanghai's Pudong—one of the open economic zones that has been a key driver of foreign direct investment in China.

view of these risks—overheating, sudden reversals, and contagion—that the authorities have opted for a very deliberate and gradual path to capital account liberalization. They have specifically mentioned, Rodlauer said, their desire to reform their enterprise and banking sectors first and have tight budget constraints in place. And they are particularly concerned about the sort of excessive borrowing that has characterized other transition countries and the very large volatility that could occur in their still fairly narrow capital markets.

How then to proceed? The keys, as country experience makes clear, are strong macroeconomic policies and a strong financial system. On the macroeconomic side, Rodlauer observed, China's balance of payments position is very strong, but work remains to be done on sustainable public finances and on the exchange rate and monetary policy side (where at some point China will have to move gradually from its current exchange rate regime to greater flexibility). In the financial sector, state-owned banks and enterprises will need to be rehabilitated, he said, and a strong prudential system put in place.

This is a large work program, Rodlauer conceded, and opening up and liberalizing is always a complex and interconnected process. Uncertainties are a given, he observed, but you have to start somewhere, monitor very carefully, and be very flexible. China has gotten the sequencing "quite right" thus far—opening with FDI, moving to portfolio equity flows, and leaving short-term debt-creating flows until the end. Now that the authorities have adopted convertibility as a long-term goal, he concluded, the next step is very carefully phasing it in and supporting it with appropriate reforms and macroeconomic policies. ■

The full text of the May 2 Economic Forum on FDI in China is available on the IMF's website (www.imf.org).