

In this issue

229
**Group of Seven on
IMF role, reforms**

229
**UN Special Session
on HIV/AIDS**

235
**Fischer on Russian
economy**

237
**Aninat on Spain
and globalization**

239
**IMF approves
Turkey review**

240
**Corruption
Perceptions
Index 2001**

241
Inflation targeting

243
**Korea's crisis
response**

and...

230
Selected IMF rates

231
Recent publications

242
New on the web

IMF approves
\$1.5 billion drawing
under Stand-By
credit for Turkey.
See page 239.

Group of Seven report

Finance ministers see crisis prevention as priority, welcome progress made in reform of IMF

In a report—Strengthening the International Financial System and the Multilateral Development Banks—issued following their meeting in Rome on July 7, the finance ministers of the Group of Seven industrial countries called on the IMF to take the lead in helping to reduce the incidence and severity of financial crises. The report, which will go to the Group of Seven/Eight leaders for consideration during their summit in Genoa on July 21–22, focuses partly on private sector involvement, the implementation of internationally agreed standards and codes, and the process of opening access to international capital markets. The report also calls on the multilateral development banks to streamline their activities and focus more on poverty eradication. Extracts from the text of the report

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Finance Ministers of the Group of Seven met in Rome on July 7. Participating were (from left) Paul Martin (Canada), Paul O'Neill (United States), Laurent Fabius (France), J. Gordon Brown (United Kingdom), Giulio Tremonti (Italy), Masajuro Shiokawa (Japan), Didier Reynders (Belgium, representing the euro area finance ministers), and Hans Eichel (Germany).

follow. The full text is available on the G-7 Finance 2001 website (www.g7-2001.org).

The international financial system is central to the functioning of the (Please turn to the following page)

Special session in New York

United Nations meeting ends with commitment to raise spending to battle HIV/AIDS pandemic

On June 25–27, the United Nations (UN) convened a special session of its General Assembly to address a pandemic that, in 2000 alone, increased the number of people living with HIV/AIDS by 5.3 million. The high-profile session concluded with a commitment by UN member governments to increase annual expenditures on HIV/AIDS in low- and middle-income countries to reach a target of between \$7 billion and \$10 billion. The General Assembly also supported the establishment, on an urgent basis, of a global HIV/AIDS and health fund to finance an integrated approach to preventing and treating HIV/AIDS. To raise resources for this effort and to increase public awareness of the dimensions of the problem, the General Assembly also committed itself to vigorous initiatives to rally public and private contributions and to address the pandemic forthrightly.

Scope of problem

Participants noted that the scale and impact of the pandemic are difficult to exaggerate. A total of 36.1 million people currently live with HIV/AIDS—25 million in Africa. Since 1981, 22 million people have died from HIV/AIDS—4 million of them children. Another 13 million children have been orphaned. In (Continued on page 233)

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available

“Private sector involvement in the prevention and resolution of financial crises is an integral part of our efforts to strengthen the international financial architecture.”

—Group of Seven report

(Continued from front page) global economy. It provides a framework that facilitates the exchange of goods, services, and capital, and that sustains sound economic growth. A central objective for us, the finance ministers of the Group of Seven countries, is to foster the continuing development of the conditions necessary for financial and economic stability, which in turn are essential if the benefits of global economic integration are to be sustainable and broadly shared.

The financial crises in emerging market countries over the past decade have underscored both the costs of financial instability and the speed with which problems in one country can spread to others. Finding ways to limit both the occurrence of financial crises and the severity of those that do occur has been central to our work agenda in recent years.

Last year in Fukuoka [see *IMF Survey*, July 17, 2000, page 235], we agreed to continue our efforts to strengthen the international financial architecture by focusing on the reform of the IMF and of the multilateral development banks, on responses to the challenges posed by highly leveraged institutions, offshore financial centers, and cross-border capital movements, and on regional cooperation.

Since last year, substantial progress has been achieved in a number of key areas:

- A major review of IMF lending facilities has been completed to enable a more efficient use of resources and to enhance the catalytic role of official financing. The reform of the IMF's Contingent Credit Line Facility is aimed in particular at strengthening the IMF's role in crisis prevention.

- The IMF has undertaken important initiatives to strengthen financial sector surveillance. We welcome, in particular, the recent establishment of the International Capital Markets Department and the Capital

Markets Consultative Group to develop a constructive dialogue with the private sector.

- The IMF has resolved to put crisis prevention at the heart of its activities and to intensify its efforts in developing vulnerability indicators and an early warning system. We also appreciate the ongoing work to prioritize and focus conditionality and enhance countries' ownership.

- The IMF and the World Bank have considerably intensified their efforts to increase collaboration in the financial sector. In particular, we stress the importance of the joint IMF–World Bank efforts to assess the strength of the financial sector through the Financial Sector Assessment Program (FSAP) and welcome the increased use of FSAPs and Reports on the Observance of Standards and Codes (ROSCs) as essential instruments to identify countries' vulnerabilities.

- The IMF and the Bank have also started collaborating in the poorest countries to fight poverty and make progress toward the international development goals.

- We welcome the progress that has been made at the IMF in making operational a framework for private sector involvement, with a view to reinforcing market discipline and providing orderly adjustment.

- Significant measures to enhance the transparency and accountability of the Bretton Woods institutions have been put in place. In particular, an independent Evaluation Office has been established at the IMF and will help the IMF increase the effectiveness of its work and enhance accountability. We look forward to its future work. We also note the need for further discussion on quotas at the IMF Executive Board.

Against this background, we reaffirm our commitment to step up our efforts to reduce volatility and improve the functioning of the international financial system. In this respect, we will continue to foster international consensus and action on

- strengthening transparency in both the public and the private sector;

- improving prudential regulation and supervision and fighting against abuses of the international financial system; and

- implementing the strategy laid down last year by the International Monetary and Financial Committee for preventing and managing financial crises, including through private sector involvement.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
July 2	3.56	3.56	4.19
July 9	3.56	3.56	4.19

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?2001).

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

Data: IMF Treasurer's Department

Private sector involvement

Private sector involvement in the prevention and resolution of financial crises is an integral part of our efforts to strengthen the international financial architecture. While the IMF has an essential role to play,

official resources are limited in relation to private financial flows. The engagement of private investors is thus essential for the resolution of payments imbalances in crises and for the restoration of medium-term sustainability. To strengthen market discipline and promote a stable flow of finance to emerging markets, the official sector needs to avoid creating expectations that private creditors and investors will be protected from losses.

At the same time, we reaffirm that our aim in crisis management is not to encourage default, but rather to promote agreement between debtors and creditors on cooperative, voluntary steps to help the debtor overcome its payments difficulties.

We welcome the progress that has been made recently to involve the private sector in the resolution of financial crises and underscore the need for further progress. We agree on the need for further efforts to implement a range of measures, in particular:

- We stress the importance of information sharing and enhancing the dialogue between countries and their private creditors, both during normal periods and when addressing emerging pressures in the external account. We encourage countries to establish mechanisms to support a dialogue with creditors and call on the IMF to support this process.

- We also agree on the importance of collective action clauses to facilitate orderly crisis resolution.

We welcome the agreement by the IMF to take forward further work on the framework for private sector involvement with a view to achieving greater clarity, taking into account the need for operational flexibility. In particular, further efforts are needed to

- Review the requirements and procedures used to determine access to IMF financing, including clarifying and strengthening them as necessary in order to reinforce the exceptional character of large official rescue packages. Exceptional financing, through any IMF

Recent publications

Working Papers (\$10.00)

- 00/175: *Trade and Domestic Financial Market Reform Under Political Uncertainty—Implications for Investment, Savings, and the Real Exchange Rate*, Rina Bhattacharya
- 00/176: *Smuggling, Currency Substitution, and Unofficial Dollarization: A Crime-Theoretic Approach*, Alex Mourmouras and Steven H. Russell
- 01/58: *Monetary Implications of Cross-Border Derivatives for Emerging Economies*, Armando Morales
- 01/59: *Whose Inflation? A Characterization of the CPI Plutocratic Bias*, Eduardo Ley
- 01/60: *Price Volatility and Financial Instability*, DeLisle Worrell and Hyginus Leon
- 01/62: *Financial System Standards and Financial Stability—The Case of Basel Core Principles*, V. Sundararajan, David Marston, and Ritu Basu
- 01/64: *Determinants of Private Capital Flows in the 1970s and 1990s—Is There Evidence of Contagion?* Leonardo F. Hernández, Pamela Mellado, and Rodrigo O. Valdes
- 01/72: *Treatment of Mobile Phone Licenses in the National Accounts*, Robert Dippelsman and Nils Maehle
- 01/74: *Fiscal Deficits and Inflation—A New Look at the Emerging Market Evidence*, Luis Catao and Marco Terrones
- 01/75: *Domestic Petroleum Price Smoothing in Developing and Transition Countries*, Giulio Federico, James Daniel, and Benedict Bingham
- 01/76: *The International Lender of Last Resort—How Large Is Large Enough?* Olivier Jeanne and Charles Wyplosz

- 01/77: *Wealth Effects and the New Economy*, Hali Edison and Torsten Sløk
- 01/78: *New Economy Stock Valuations and Investment in the 1990s*, Hali Edison and Torsten Sløk
- 01/79: *Benefits of Compliance with Securities Listing Standards—Evidence from the Depository Receipt Market*, Abdourahmane Sarr

IMF Staff Country Reports (\$15.00)

- 01/91: Bolivia: Statistical Annex
- 01/92: Bolivia: 2001 Article IV Consultation and Request for Third Annual Arrangement Under the Poverty Reduction and Growth Facility
- 01/94: Kingdom of the Netherlands 2001 Article IV Consultation
- 01/95: Kingdom of the Netherlands, Selected Issues—Cyclically Advanced Euro-Area Economies: Consequences and Policy Options
- 01/96: Kingdom of the Netherlands, Selected Issues—The Labor Income Tax Credit in an International Perspective
- 01/97: Republic of Estonia: 2001 Article IV Consultation
- 01/98: Republic of Estonia: Statistical Appendix
- 01/99: Republic of Estonia: Report on Observance of Standards and Codes—Fiscal Transparency Module

Others

IMF Research Bulletin, Vol. 2, No. 2 (free)

Publications are available from IMF Publication Services, Box X2001, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; e-mail: publications@imf.org.

For information on the IMF on the Internet—including the full texts of the English edition of the *IMF Survey*, the *IMF Survey's* annual *Supplement on the IMF, Finance & Development*, an updated *IMF Publications Catalog*, and daily SDR exchange rates of 45 currencies—please visit the IMF's website (www.imf.org). The full texts of all Working Papers and Policy Discussion Papers are also available on the IMF's website.



“Significant progress has been made in producing assessments of countries’ observance of international codes and standards.”

—Group of Seven report

facility, requires extensive justification. For instance, there should be evidence that the country has experienced a sudden, disruptive loss of confidence; that an early correction of difficulties is expected; and that there is a risk of contagion that could pose a wider threat to the stability of the international financial system. It should also take into account efforts by the debtor country to secure participation by private investors.

- Enhance the analytical basis for the IMF’s assessment of a country’s financial position. Programs should include a thorough analysis of the country’s medium-term debt and balance of payments profile, and prospects for regaining market access. To this end, the IMF should also provide detailed information and program assumptions about sources of private financing and reinforce the monitoring and assessment, as appropriate, of private flows during program implementation.

- Review the experience with the IMF’s policy for lending into arrears.

- Strengthen the relationship and increase coordination between the IMF and the Paris Club in the process of assessing the level and scope of participation of private creditors in debt-restructuring cases, especially concerning comparability of treatment.

- Ensure that all programs are subject to transparent ex post monitoring and evaluation, with a view to assessing the involvement of the private sector against the assumptions made in the program.

Standards and codes

We reaffirm our commitment to promote the implementation and surveillance of internationally agreed codes and standards, in particular the 12 key standards identified by the Financial Stability Forum. Their implementation is in the economic interest of all countries, and ownership is an important element in this process. We welcome the contributions of the many different actors, including the IMF, the World Bank, and the Financial Stability Forum, in making it possible for countries to implement codes and standards and in assessing their compliance. These efforts should be continued, and coordination among the relevant institutions (international financial institutions and standard-setting bodies) strengthened to ensure that all inputs are effectively integrated.

We underscore the importance of continuing to identify market and official incentives to encourage compliance with international codes and standards, as well as the need to continue raising market awareness of the significance of codes and standards and their relevance to private sector pricing and allocation decisions. In this respect, we welcome the ongoing work of the Financial Stability Forum working group on incentives and call on the IMF to continue analyzing

the benefits associated with implementing codes and standards.

Technical assistance and support are crucial to ensure that no country is left behind in the global effort to raise standards. We welcome the important contribution of the IMF, the World Bank, and national authorities toward addressing resource constraints to implementing standards by providing advice and assistance. The international financial institutions should catalogue and assess these technical assistance resources and demands to ensure that support is channeled effectively. We agree to make every effort, working together with the international financial institutions, the Financial Stability Forum, and the international regulatory and supervisory bodies, to consider ways to supplement the amount of human, technical, and financial resources available to assist countries to implement codes and standards. In this respect, we welcome the commitments that have been made so far.

Significant progress has been made in producing assessments of countries’ observance of international codes and standards. IMF-led ROSCs and the joint IMF–World Bank FSAPs should continue to be the principal and permanent tools for providing independent, authoritative, and consistent assessments of individual countries’ compliance with codes and standards.

We look forward to further participation in these initiatives by a range of industrial and developing countries, including Group of Seven countries. In this respect, we welcome the commitments made by the finance ministers and central bank governors of the Group of 20 to undertake the completion of the ROSCs and the FSAPs and to promote wider public articulation of commitments to adopt key standards and action plans for compliance.

Authoritative information on the observance of codes and standards should be fully integrated into enhanced IMF surveillance under Article IV, increasing its effectiveness as a tool for crisis prevention. This is a critical step, and the IMF should work expeditiously to implement it. The work being taken forward in the IMF on the modalities for using codes and standards information to guide and inform surveillance is an important step in this direction and we encourage its early completion.

Work to assess compliance with, and to implement, codes and standards needs to take full account of each country’s unique development and reform priorities and institutional characteristics. We agree that countries and the IMF should continue to work, together with standard-setters as appropriate, to set priorities and establish action plans for compliance, within the framework of individual economic reform programs. ■

Commitment made to tackle HIV/AIDS

(Continued from front page) the worst affected country—Botswana—35 percent of the adults aged 15–49 live with HIV/AIDS; the country’s life expectancy at birth has now declined to 36 years, according to UN sources.

U.S. Secretary of State Colin Powell noted that “no war on the face of the world is as destructive as the AIDS pandemic. Only through sustained international cooperation can we address the spread of AIDS.” World Bank President James Wolfensohn indicated that one reason why the HIV/AIDS pandemic is so menacing is that it “is no longer just a health problem, but a global development problem, threatening to reverse many of the gains made over the last half century.”

And no part of the globe is immune. Noting the toll that the pandemic is taking in Africa, Festus Mogae, President of Botswana, observed that “the unchecked spread of the pandemic poses a serious threat to the goal of reducing global poverty by half by the year 2015.” K. Burke Dillon, Executive Vice-President at the Inter-American Development Bank, pointed to the ominous spread of HIV/AIDS in the Western Hemisphere. “Prevalence levels in the Caribbean,” she

stressed, “are the highest outside of sub-Saharan Africa, and in Central America the epidemic is growing rapidly.” Pitak Intrawityanunt, Deputy Prime Minister of Thailand, said “Thailand was the first Asian country to break the silence and come out of denial.” He stressed that the crisis needs regional and global cooperation as well as national action.

Indeed, the scope of the discussions—which touched on health, human rights, social impact, macroeconomic implications, and international security—served to underscore the degree to which the HIV/AIDS issue had been elevated to a major component of international politics. Using the occasion of his appointment to a second five-year term as UN Secretary-General to highlight the urgency and enormity of the task at hand, Kofi Annan said he was making the battle against HIV/AIDS a “personal priority.”

Declaration of Commitment

On June 27, the General Assembly concluded its session with a “battle plan” for a global fight against HIV/AIDS. Drawing on a political mandate from the UN’s Millennium Declaration, the HIV/AIDS declaration calls for

Declaration of Commitment on HIV/AIDS

Following is a summary of the recommendations of the UN’s Declaration of Commitment. The full text is available on the UN’s website (www.un.org/ga/aids/coverage/FinalDeclarationHIVAIDS.html).

The declaration emphasizes the importance of strong leadership at all levels, noting complementary roles for government, civil society, and the private sector. The declaration also stresses

Prevention must be the mainstay of the response:

- By 2003, establish time-bound national targets to achieve the internationally agreed global prevention goal to reduce by 2005 HIV prevalence among people aged 15 to 24 in the most affected countries by 25 percent and by 25 percent globally by 2010.
- By 2005, reduce the proportion of infants infected with HIV by 20 percent, and by 50 percent by 2010.

Care, support, and treatment are fundamental:

- By 2003, ensure that national strategies are developed in close collaboration with the international community to strengthen health care systems and address factors affecting the provision of HIV-related drugs, including antiretroviral drugs.

Respect for the rights of people living with HIV/AIDS drives an effective response:

- By 2003, strengthen legislation to ensure the full enjoyment of all human rights and fundamental freedoms by people living with HIV/AIDS and members of vulnerable groups; in particular, to ensure access to education, inheritance, employment, social and health services, and legal protection.

- Empowering women is essential for reducing vulnerability; children orphaned and affected by HIV/AIDS need special assistance.

Addressing HIV/AIDS is an investment in sustainable development:

- By 2003, evaluate the economic and social impact of the HIV/AIDS epidemic and address the impact on household income.
- Adapt economic and social development policies, including social safety nets, to address the impact of HIV/AIDS on economic growth, labor productivity, and deficit-creating pressures on public resources.

New, additional, and sustained resources are essential:

- By 2005, through a series of incremental steps, reach an overall target of annual expenditure on the epidemic of \$7 billion–10 billion from domestic and international resources.
- Urge the developed countries that have not done so to strive to meet the target of 0.7 percent of their gross national product for overall official development assistance.
- Integrate HIV/AIDS actions in development assistance programs and poverty eradication strategies.
- Without further delay, implement the enhanced Heavily Indebted Poor Countries (HIPC) Initiative and agree to cancel all bilateral official debts of HIPC countries as soon as possible, especially those most affected by HIV/AIDS.
- By 2002, launch a worldwide fundraising campaign aimed at the general public to contribute to the global HIV/AIDS and health fund.

“No war on the face of the world is as destructive as the AIDS pandemic.”

—U.S. Secretary of State Colin Powell

political leadership and accountability and sets specific targets, most of which are to be achieved by 2003–05.

UN Secretary-General Annan pledged to have the proposed global fund for HIV/AIDS, malaria, and tuberculosis operational by year-end; details on its scope and structure are forthcoming. Annan also proposed a fivefold increase in total annual spending on the fight against HIV/AIDS, which is now under \$2 billion. UNAIDS predicts that as much as one-third to one-half of the total resources could come from public and private domestic sources, with the remainder drawn from additional international resources.

The latest official figures, however, indicate that current pledges to the global fund from public and private sources amount to around \$1 billion. Wolfensohn indicated that the World Bank would be willing to do what it can to rally political support and help manage the fund. Asked if \$10 billion would be sufficient to underwrite the fight against AIDS, he replied that “people have to be convinced that fighting AIDS is not a matter of charity but of self-interest.” Given a global GDP of \$30 trillion, there are sufficient resources, he added, “if it were made a priority.”

Linkages

On the socioeconomic impact of HIV/AIDS and the need to strengthen national capacities to curb and deal with the pandemic, participants agreed that HIV/AIDS and poverty were closely intertwined. Poverty reduction must, therefore, be an integral part of the campaign against the pandemic. And debt relief and increased flows of official development assistance were essential.

A number of participants cited strong links between the HIV/AIDS pandemic and overall macroeconomic performance. Discussants noted that the increased health care and social security costs associated with the disease, together with declining enterprise profitability and lost worker incomes, are likely to increase budget deficits, lower savings and investment, and induce macroeconomic instability. The resulting slowdown in economic growth likely increases poverty. Poverty, in turn, feeds a vicious cycle as household expenditure on health and nutrition declines.

The United Nations Development Program (UNDP) presented evidence that, in the 1990s, AIDS reduced Africa’s per capita annual growth by 0.8 percent and that, in coming years, the worst affected countries would see 1–2 percentage points shaved off their per capita growth rates. The World Bank estimates that in some of the hardest hit countries, per capita income may drop by 8 percent by 2010, while consumption may fall even further. More research is

needed, participants agreed, on the specific macroeconomic implications of HIV/AIDS.

The International Labor Organization (ILO) used the occasion of the special session to launch a code of practice with respect to HIV/AIDS in the workplace. The code aims to provide workers, employers, and governments with new global guidelines for addressing the HIV/AIDS pandemic based on international labor standards. ILO Director-General Juan Somavía argued that the pandemic has enormous economic ramifications, because it affects the most economically active members of society. Earnings are reduced and productivity lost, while treatment imposes huge costs. An estimated 23 million or more workers aged 15–49 carry the HIV virus.

Human rights issues were a recurrent theme in the three-day special session. Participants acknowledged the link between an effective and sustainable response to the crisis and respect for all human rights—notably those that guarantee nondiscrimination, gender equality, and the meaningful participation in society of affected and vulnerable groups. UN High Commissioner for Human Rights Mary Robinson asked, “Is there any greater human rights problem in the world today than the fact that 36 million people suffer from HIV/AIDS?”

In a related program, the Joint Global Business Council on HIV/AIDS, which was set up to expand business involvement in the fight against the pandemic, highlighted the willingness of leading global corporations, such as Coca-Cola, Unilever, Viacom, and AOL Time Warner, to shoulder more of the burden. Many participants in the special session also argued that drug companies cannot ignore the poor. Campaigners for cheaper antiretroviral medicines warmly welcomed the U.S. decision, on the opening day of the session, to withdraw a patent complaint against Brazil in the World Trade Organization. Brazil is widely recognized as running one of the most successful AIDS treatment programs in the developing world.

Cultural sensitivities and NGOs

With AIDS still a taboo subject in some cultures, a number of member countries raised concerns about explicit language in the declaration. A controversy flared over the wording of the document, but this did not alter the consensus view that the pandemic needed to be attacked head-on. Dr. Peter Piot, Director of UNAIDS, noted that “the declaration is a strong blueprint for critical achievement.” The declaration, he observed, clearly respects the rights of women and adolescent girls to protect themselves from the risk of HIV infection, sees no polarization between prevention and treatment, and emphasizes the need for both adequate resources and the involvement of nongovernmental organizations (NGOs) in the battle.

NGOs participated actively in the special session and rallied peacefully in the streets before the event. Despite calls for more explicit language with respect to

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United Nations Secretary-General Kofi Annan (center); Harri Holkeri (right), president of the fifty-fifth session of the U.N. General Assembly, and Peter Piot (left), Executive Director of UNAIDS, hold a portion of the AIDS quilt to kick off the UN special session on AIDS on June 25 in New York.

vulnerable groups and human rights, AIDS service organizations were generally supportive of the Declaration of Commitment. The “Drop the Debt” campaign called for outright cancellation of multilateral as well as bilateral debt, arguing that debt cancellation is needed to fight the pandemic, particularly in sub-Saharan Africa. Others were concerned that the voices of the poor had not been heard because of the minimal involvement by African civil society.

In closing, the President of the General Assembly, Harri Holkeri, sounded an urgent note. The world is now faced with alarming statistics, he said. “We have reached a

turning point—either we will reach out to those that need help the most, or we will be held responsible for not acting when we had the chance.” It augurs well for the future that high-level political forums beyond the UN, such as the upcoming summits of the Group of Seven/Eight in Genoa, the Organization of African Unity in Lusaka, and a special summit meeting of the Association of South-East Asian Nations on HIV/AIDS in November, will continue to give prominence to the battle against the HIV/AIDS pandemic. ■

Axel Palmason
IMF United Nations Office

Address in Moscow

Fischer welcomes progress of Russian economy, calls for fresh efforts to tackle structural reform

Following are edited excerpts from “*The Russian Economy: Prospects and Retrospect*,” an address by IMF First Deputy Managing Director Stanley Fischer at the Higher School of Economics in Moscow on June 19. The full text of the speech is available on the IMF’s website (www.imf.org).

It is a great pleasure to appear before this audience on what I expect to be my last visit to Russia as a member of the IMF. Fortunately, the economic situation now is much less dramatic than it was on some of my earlier trips. The sense of growing normalcy that I have had on my last two visits to Russia—particularly this time—is in many ways the main achievement of Russian economic policy during the past decade and especially during the past three years.

Current situation

In 1997, a GDP growth rate of 0.5 percent seemed like a great achievement. In 1999 and 2000, however, Russia grew at 5.4 percent and 8.3 percent, respectively. The official forecast for this year is around 4 percent, and it could come in a little lower than that. But these growth rates are much more consistent with what should have been happening in Russia in earlier years.

Russia’s stronger growth performance is due in large part to two factors: the real devaluation of the exchange rate, and higher energy prices. But we should not underestimate either the importance of the strategic decisions taken following the devaluation and the debt default in 1998, or the progress that has been made in structural reforms. The Primakov government, which came to power in 1998 proclaiming that it would take another route, soon realized that the Russian people had no desire for high inflation and no desire to abandon the effort to develop a market economy. Together, the finance ministry and the central bank kept a lid on inflation, and eventually policy returned more decisively to the reform path that had been chosen a decade ago.

The economy is operating in an extraordinary fashion now. The current account surpluses of 18 percent of GDP last year and 12 percent expected for this year are not the sort of phenomenon that most industrial economies have to deal with. They pose a real dilemma for macroeconomic policy, because the reserve inflows they imply tend to cause a real appreciation and loss of competitiveness. This can come about through inflation or an appreciation of the nominal exchange rate, but one way or another, it is hard to avoid.

What can be done? Obviously, given the gains generated by the postcrisis devaluation, no one wants a significant real appreciation in the short run. So the choices are to tighten fiscal policy, to sterilize reserve inflows, or a combination of the two. In the short run, finance ministries prefer central banks to deal with these problems by sterilizing, and central banks prefer finance ministries to deal with these problems by running bigger budget surpluses. But your budget surplus, current account surplus, and reserve inflows are all so large that both sides will have to contribute.

Further, we should bear in mind that once relations between the central bank and the finance ministry are regularized—with the central bank recapitalized and a sound legal basis established for returning central bank profits to the government—any losses that the central bank makes on sterilization will ultimately fall on the treasury. Any losses that the central bank makes in the meantime will also fall on the treasury, since those losses will affect the amount the treasury will have to provide to recapitalize the central bank. In the end, the cost of sterilization has to come out of the government’s pocket.

But that does not mean that we should be indifferent between the use of sterilization and fiscal adjust-

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IMF First Deputy Managing Director Stanley Fischer (left) met with Russian President Vladimir Putin in the Kremlin on June 18.

“The proposed and potential measures constitute an impressive reform agenda that is going to take many years.”

—Stanley Fischer

ment. In current circumstances, you need both. Recent data suggest inflation will exceed this year’s 14 percent target, possibly significantly so. But we are only five months into the year, and where inflation ends up depends a lot on the policies pursued during the remainder of the year—in particular, how much of the pressure from reserve inflows is taken on the exchange rate and how much on inflation.

So long as Russia has a strong current account, the dilemma that is being faced now will continue. What is more, the dilemma is likely to become even more acute when confidence in investing in the Russian economy resumes and brings about a reversal of capital flight. To the extent that this translates into an increase in Russia’s low investment rate, it will contribute to the long-run growth of the economy without necessarily putting pressure on the real exchange rate. But to the extent that it is used to purchase existing assets, it will put further upward pressure on the exchange rate. Structural reform has a vital part to play in ensuring that the real exchange rate appreciates through improvements in productivity, via higher investment and more efficient business organization.

Structural reform

I’d like now to move on to discuss structural reforms, because the macroeconomic situation is in a fundamental sense under control.

Tax system. In recent months, there have been real achievements on the structural side. The political effort has focused on strengthening the central government, but that has also meant consolidating fiscal federalism, which is economically important. Thinking back to some of the laws that were passed and not passed in July 1998, a key goal was to strengthen the fiscal position of the federal government: getting revenues that should have belonged to the center back to the center, and trying to better organize regional and local government revenues. That issue has not been finally resolved, but it is being tackled as part of the fiscal improvement that has resulted from enhancements in the structure of fiscal federalism.

You now have at least four out of five chapters of Part Two of the Tax Code passed, including setting the income tax rate at a flat 13 percent. Revenues from the income tax have increased during this process—perhaps as a result of higher tax compliance, or perhaps because of very rapid income growth. And you are about to complete the reform of the corporate tax system. These are considerable achievements.

Land reform. Russia is making progress on urban land reform. Unfortunately, legislators became extremely excited during the Duma debate, indicating the extremely strong feelings on this issue. When and if agricultural land reform will be undertaken is unclear. But that, too, is important.

Financial sector. There is one other critical set of reforms. Reform of the financial system does not appear to be very high on the agenda, but the banking system is dominated by the state banks. And although large companies are able to get credit, small and medium-sized firms—typically the motor of growth—are not well served by the Russian financial system. Creating a modern capital market and strengthening the banking system and banking supervision should be high priorities. I have heard several times the argument that financial sector reform cannot be very urgent because the economy is growing so well anyway. Evidently, companies can finance themselves internally, and banks are being recapitalized by the economic recovery. But focusing on existing firms misses the point: Russia has a latent entrepreneurial class that could create numerous new enterprises if there were an efficient way to finance them.

Progress to date. Several other important measures are in the legislative pipeline: reform of taxation of natural resources, the Labor Code, the deregulation package supported by Minister German Gref, pension reform, and legal reforms. This is a very full agenda, and there is considerable uncertainty about what will be passed this year. But it is impressive that the government is committed to this ambitious agenda. For those who recall the 1996 Extended Fund Facility program, the only source of regret is that these good things did not happen some years ago.

Of course, one has to have reservations. After all, nobody feels comfortable supporting wholeheartedly what any government is doing. One has to be concerned about the cost of some of the concessions, particularly on the tax code, that have been made to get reforms through. And some reforms have only just been submitted. And, of course, passing laws is not the same as implementing them. It remains to put all this into practice—and that is no small challenge.

I read with great interest and pleasure President Putin’s address to the Federal Assembly on April 3. This is a remarkable document that lays out the full reform agenda, also mentioning a new privatization law, the removal of currency controls, improvements in the health and education systems, financing for science, and an oil stabilization fund.

Taken as a whole, the proposed and potential measures constitute an impressive reform agenda that is going to take many years. Finally Russia is tackling many of the key structural reforms that it has long known are necessary. This time seems to be different. I hope the inevitable political opposition can be overcome and the process continued. But we should not underestimate the vested interests that still have to be confronted.

IMF and Russia

What has been the IMF’s role in Russia? In the first instance, we should not exaggerate—what has been

achieved is due mainly to the efforts of Russians. But the IMF did help Russia tame inflation in 1995–96, and did help in the implementation of critical structural reforms. The IMF's technical assistance and program conditionality helped create a modern central bank in Russia, and we played a large role in helping create a modern treasury with control over spending in all parts of the government. We also helped in many other institutional reforms, including those of the tax system and to some extent in the banking system.

But the IMF's most fundamental contribution has been to stand consistently for a particular approach to economic policy—in favor of macroeconomic stability, market-oriented structural reforms, and integration into the global economy. We were not the only ones to stand for those principles—the reformers in Russia stood for exactly the same things. But we were able to support them, and we were able over a sustained period to bring the same set of views consistently before the Russian people and before the Russian policymakers. I hope and believe we contributed to the consensus on economic policy that now exists in Russia. Today, one does not see people in Russia wanting to go back to the past; one does not see them looking for a third way; and that, I believe, is in large part what we contributed to.

What about the future? Possibly, Russia will one day need the IMF's financial support again. Measures are now being taken to tackle Russia's prospective debt-servicing problem in 2003, but if external conditions

worsen severely, then external help may be needed. And if Russia does need a program again, it is a member of the IMF, and it is entitled to have a program if it meets the required conditions. Italy, France, and the United Kingdom had programs 25 years ago, and it would not be extraordinary for Russia to have a program at this stage of its development.

But it may well not be needed. Then, Russia's role in the IMF will be like that of other nonborrowing countries. Russia will be subject to the surveillance of the IMF. Regular Article IV missions will come and they will report to the IMF Board on what is happening. We hope that those Article IV reports would be published, so that the rest of the world could share the IMF's evaluation of the Russian economy.

No doubt, we would continue to provide technical assistance as well where it is requested. Over the course of time, we can see Russia increasingly taking its role as a major country in the international system, helping lead the IMF and helping develop the international system. Russia and the IMF would also cooperate to solve problems that we have in common—for example, the difficulties of the Central Asian republics. They need the help of the international community, provided through the IMF, but their problems cannot be solved without Russia's assistance.

Whether there is a program or not, there will still be good relations between Russia and the IMF, a constructive relationship in which the IMF contributes to Russia, and Russia increasingly contributes to the IMF. ■

Aninat address

Globalization and careful planning have fueled Spain's rapid economic development

Following are edited excerpts from “Reflections on Globalization, Spain, and the IMF,” an address given by IMF Deputy Managing Director Eduardo Aninat at the general meeting of ELKARGI, the Credits and Guarantees Association for Basque Provinces, in San Sebastian, Spain, on June 29, attended by 1,000 small and medium-sized entrepreneurs. The full text is available on the IMF's website (www.imf.org).

Benefits and risks of globalization

Globalization could be defined as the increasing integration of activities—especially economic activities—among nations around the world. The world as a whole has benefited greatly from this openness. The strong consensus among policymakers and economists today is that outward-oriented strategies are essential for achieving the sustained economic growth needed to raise living standards.

But this is not to question in any sense that there are very real risks associated with globalization: the risk of

overstretching the abilities of societies and political structures to adapt; the risk that excessively volatile capital markets will trigger financial crises that can much more easily ricochet from one country to another; that the benefits of globalization will be concentrated among the few, not the many; that diseases, like AIDS, will spread globally at frightening speeds; that crime will become internationalized, as we are already seeing with controlled substances, leading in turn to problems such as money laundering; and, finally, that expectations will not be met. Thus, our principal challenge, as put so well by Nobel Laureate economist Amartya Sen in a recent lecture, is “how to make good use of the remarkable benefits of economic intercourse and technological progress in a way that pays adequate attention to the interests of the deprived and the underdog.”

Case of Spain

During the 1990s, many Latin American countries took far-reaching steps to better integrate and quickly began

“Why did Spain arrive with a splash? No doubt globalization and a desire to integrate with the rest of the world—after a long period of protectionism and political isolation—were driving factors.”
—Eduardo Aninat

enjoying the fruits. But Spain is the star performer in the Spanish-speaking world when it comes to making a dramatic leap into the economic “big leagues”!

- Spain is catching up with its European peers. Its per capita GDP has jumped from about 75 percent of the European Union (EU) average in the mid-1970s to nearly 87 percent, with most of the increase taking place in just the last five years. The economy has been growing at an average 4 percent annual rate over the last four years and should grow at around 3 percent this year.

- Trade plays a far more important role in Spain’s economy, with exports (of goods and services) plus imports shooting up from 27 percent of GDP in 1970 to 62 percent in 2000. This increase is most impressive!

- We also see major changes on the services front. Spanish banks are increasingly playing a prominent role in Latin America, with these banks now controlling nearly 20 percent of Latin America’s banking sector. In addition, major Spanish firms like Repsol-YPF (energy) and Telefónica (communications) are investing heavily in Latin America.

- Spain’s foreign direct investment (FDI) has shot up in the last decade from less than 1 percent of GDP to nearly 10 percent, and FDI in Spain has risen from just under 3 percent of GDP to nearly 7 percent. Spain has gone from being a net importer of investment on the order of 2 percent of GDP annually to being a net exporter on the order of 3 percent. Indeed, Spain is now the sixth largest investor in the world. It is also the twelfth largest donor of official development aid and the eighth largest contributor to the United Nations.

Why did Spain arrive with a splash? No doubt globalization and a desire to integrate with the rest of the world—after a long period of protectionism and political and economic isolation—were driving factors. Of course, this didn’t happen overnight but rather reflected a carefully calculated act of faith spread over many decades that has paid off. What are the landmarks?

- *Trade liberalization.* Beginning with the 1959 stabilization plan and the return of European tourists after the upheavals of civil and world wars, the process of liberalization was gradual and moved in stages, as Spain set its sights on integrating with the rest of Europe and partook in the global trade rounds.

- *Integration into the European Union.* This resulted in a very intense period of trade reform, with administered trade regimes abandoned and tariff structures brought into line with EU requirements.

- *Changes in the legal system.* These were substantial in the early 1990s as Spain brought its laws into line with European Community standards and updated and reformed its laws to make them as complete, functional, and modern as those of its peers.

- *Changes in monetary policy and status of the central bank.* From 1973 to 1983, the government fol-

lowed a monetary policy that was characteristic of a relatively closed economy, concentrating on the control of broad monetary aggregates. Between 1984 and 1989—when growing financial innovation made ensuring the stability of the financial system an increasingly important goal—monetary policy gradually began to focus more on interest rates and exchange rates. In 1994, parliament recognized the principle of central bank independence, switching the focus of monetary policy to price stability, but keeping Spain within the framework of the European Monetary System. In 1995, Spain successfully implemented an inflation-targeting regime. Finally, in 1999, Spain became a founding member of the euro.

This careful planning has paid off, with Spain significantly outperforming its euro-area colleagues in most respects. Even a casual glance at the data makes clear that Spain stands close to the head of the class. Over the last four years, real output has grown at an annual rate of 4 percent, and over the last six years, it has grown faster than for the euro area as a whole *for each and every single year*. Over the same period, real exports have grown by an average of 10 percent annually, about one-third better than for the euro area as a whole. Indeed, it was the strong growth of real exports in the mid-1990s that led off the current economic expansion.

Spain also deserves high marks for putting its fiscal house in order. Over the last five years, the budget deficit has declined from 6.6 percent of GDP to just 0.3 percent of GDP—a major achievement by any standard—with the government hoping to achieve fiscal balance this year. In addition, the ratio of debt to GDP, which in the mid-1990s stood at 68 percent of GDP, has now declined by 8 percentage points, and further declines are in the offing.

To be sure, significant challenges still remain. On the job front, although employment has shot up in recent years (averaging 3½ percent annually since 1995, an astounding three times the euro-area average), the unemployment rate stands at a very high 13.4 percent, with significant human and social costs. But keep in mind that as recently as 1996, the rate of unemployment averaged more than 22 percent. Spain was able to turn this around thanks to wage moderation on the part of workers, better labor relations, and substantial labor market reforms that reduced dismissal costs and social security contributions for certain classes of workers. Further reforms are now needed to continue to reduce dismissal costs, enhance labor mobility, and decentralize the collective bargaining process. And Spain must continue to tackle regional disparities.

Spain should also move quickly to dampen inflationary pressures, as its persistent inflation differential relative to the monetary union average could lead to an

erosion of exporters' competitive position in the medium term.

Global challenges

As Spain now charts its way forward, it must do so with a world economy undergoing a critical period of adjustment. The engine of global growth over the past 10 years—the U.S. economy—is sputtering, with no other region taking its place. The IMF is forecasting world growth of around 3 percent this year, significantly lower than was generally foreseen last year. On the plus side, the timely U.S. interest rate cuts and tax relief should help facilitate a pickup in the second half of this year, gaining momentum in 2002. Moreover, global inflationary pressures remain manageable, allowing room for maneuver in monetary policies. But on the negative side, oil prices still remain high, substantial current account imbalances remain among the major industrial countries, Japan's situation appears increasingly difficult, and stock markets remain volatile.

Against this background, can the euro area manage growth around its underlying potential of 2.5 percent this year? The recent slowdown of industrial production, particularly in Germany, combined with rising headline inflation, gives rise to concern. While the recent increase in headline inflation may limit the scope

for aggressive monetary easing by the European Central Bank, a further weakening of activity, or signs that underlying inflation is abating, would allow scope for additional rate cuts. The main policy priority, however, remains that far more is needed in terms of ambitious reforms to get rid of structural rigidities, especially in labor markets, pension systems, and product markets. Moreover, Europe should be aiming at boosting potential growth to well over 3 percent—an increase that would significantly lower unemployment, strengthen the euro, and help strengthen the global economy.

How can the international community help spread the benefits of globalization? Industrial countries should practice what they preach and open up their own economies, especially in areas where developing countries have a clear and demonstrated comparative advantage. Meanwhile, the IMF supports calls for the poorest countries to have duty- and quota-free access to industrial country markets.

Industrial countries should also deliver on their long-promised increase in official development aid to the targeted level of 0.7 percent of GDP. And they should follow through on their pledges for debt relief to the poorest countries—here, we welcome the decisions by a number of Group of Seven countries to forgive 100 percent of bilateral debts. ■

IMF approves \$1.5 billion drawing under Stand-By credit for Turkey

On July 12, the IMF's Executive Board approved the eighth review of Turkey's economic program supported by the three-year Stand-By Arrangement. The Board's decision will enable Turkey to draw SDR 1.2 billion (about \$1.5 billion) immediately from the IMF. Following is the edited text of IMF News Brief 01/57. The full text is available on the IMF's website (www.imf.org).

The Stand-By credit was approved in December 1999 for SDR 2.9 billion (about \$4 billion) [see *IMF Survey*, January 10, 2000]. In December 2000, SDR 5.8 billion (about \$7 billion) in additional financial resources were made available under the Supplemental Reserve Facility [see *IMF Survey*, December 11, 2000]. On May 15, 2001, the IMF approved the increase of the Stand-By credit by SDR 6.4 billion (about \$8 billion), bringing the total available resources from the IMF to SDR 15 billion (about \$19 billion) [see *IMF Survey*, May 21, 2001]. So far, Turkey has drawn a total of SDR 6.9 billion (about \$9 billion) from the IMF.

Following the Executive Board discussion on Turkey, IMF Managing Director Horst Köhler, said: "The IMF commends the Turkish authorities' strong and comprehensive efforts to implement their strengthened program and approves completion of the eighth review. Much has been achieved to restructure the economy and improve Turkey's economic fundamentals. However, ambiguities regarding the implementation of certain measures have delayed the

full benefits of the program. Looking forward, the IMF urges the strongest possible execution of, and unified political leadership behind, the program. This, together with the IMF's full support, is the best avenue for putting Turkey back on the road to low inflation and sustained growth.

"Progress with financial sector reform has been impressive. Decisive steps have been taken to restructure the state banks and intervened private banks, which will contribute to greater stability in money markets and to enhanced governance. The authorities are determined to continue their efforts to ensure that private banks are adequately capitalized, and to respond to any problems in the financial sector with prompt and decisive action.

"Sustained structural reform is key to the improvement of economic prospects and to reducing the role of the state in the economy. Recent measures to enhance governance and fiscal transparency are most welcome, and their continued implementation will lend further credibility to the reform effort.

"Greater transparency in the conduct of monetary policy under the program will help market participants in assessing monetary conditions and guide inflationary expectations. Continued achievement of the program's monetary targets will remain important in the period ahead, while the authorities prepare for the adoption of formal inflation targeting as early as is feasible. The impact of the public sector wage settlement and of the wheat price decision will have to be closely monitored, and incomes policy strengthened. Overall, full program implementation should help bring interest rates down from their present high levels and ensure the success of the program."



Transparency International findings illustrate “vicious circle” of poverty and corruption

“The new index illustrates once more the vicious circle of poverty and corruption.”

—Peter Eigen

“There is no end in sight to the misuse of power by those in public office—and corruption levels are perceived to be as high as ever in both the developed and developing worlds,” said Peter Eigen, Chair of Transparency International, speaking at a Paris press conference in June to launch the nonprofit organization’s *Corruption Perceptions Index 2001*. “There is a worldwide corruption crisis,” he continued, “and that is the clear message from the *Corruption Perceptions Index 2001*, which reflects the degree to which corruption is perceived to exist among public officials and politicians. Scores of less than 5 out of a clean score of 10 are registered by countries on every continent, including members of the Organization of American States and the European Union.”

This year’s index ranks 91 countries. Some of the richest countries in the world—Finland, Denmark, New Zealand, Iceland, Singapore, and Sweden—scored 9 or higher out of 10 in the new index, indicating very low levels of perceived corruption. But 55 countries—many of which are among the world’s poorest—scored less than 5, suggesting high levels of perceived corruption in government and public administration.

Wide-ranging survey

The index, first launched in 1995, is a poll of polls—this year drawing on 14 surveys from 7 independent institutions. The surveys reflect the perceptions of businesspeople, academics, and country analysts. According to the Transparency International website, surveys are used because hard empirical data on corruption levels across countries do not exist. The surveys are recent (undertaken over the past three years), and a minimum of three surveys must be available before a country can be included in the index. This prudent approach, Eigen said, means that probably a number of countries with high corruption levels are not included. And because only three or four data sources are available for some countries and wide variations exist between individual survey results, he cautioned that small differences in ranking between countries should not be overstated. But he also warned that governments ignore the index at their peril. The index, he said, reflects how countries are viewed by businesspeople and country analysts across the globe.

Transparency International Vice-Chair Tunku Abdul Aziz also noted that perceived levels of corruption can be measured only by consistent shifts in behavior over time. He cautioned that, as a result, the index may not give new government leaders in, for instance, Nigeria,

Mexico, and the Philippines, credit for their determined efforts to counter years of rampant corruption.

Corruption victimizes the poor

“The new index illustrates once more the vicious circle of poverty and corruption,” Eigen emphasized. He pointed to instances where parents have to bribe underpaid teachers to secure an education for their children and noted that inadequately resourced health services provide a breeding ground for corruption. “The world’s poorest are the greatest victims of corruption,” he argued. “Vast amounts of public funds are being wasted and stolen by corrupt officials. HIV/AIDS is killing millions of Africans,” he continued, “and in many of the countries where AIDS is at its deadliest, the problem is compounded by the fact that corruption levels are seen to be very high. While it is imperative that richer countries provide the fruits of medical research at an affordable price to address this human tragedy, it is also essential that corrupt governments do not steal from their own people. This is now an urgent priority if lives are to be saved.”

The index also registers very high levels of perceived corruption in countries in transition, notably the former Soviet Union. Eigen noted: “The leaders of the countries of the former Soviet Union must do far more to establish the rule of law and transparency in government.”

Industrial countries not exempt

Scores of most leading industrial countries are quite high, according to Transparency International’s press release, because the index focuses only on corruption involving public officials; it does not reflect secret payments to finance political campaigns, the complicity of banks in money laundering, or bribery by multinational companies. Transparency International is increasing its efforts to stimulate greater transparency in politics, business, and banking. Vice-Chair Frank Vogl noted that the organization aims to publish a new Bribe Payers Index in early 2002 “to shine the spotlight on the propensity of Western firms to use bribes in emerging market economies.”

The index and supplementary material are available on the Transparency International website (www.transparency.org). ■

Photo credits: Evan Schneider for UN/DPI, page 229 (bottom); AFP, page 229 (top), 230, 232–34, and 236; ITAR-TASS POOL for AFP, page 235; Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF, page 239; KIER, page 243 and 244.

More emerging market economies seen to be adopting inflation targeting

Emerging market countries have been moving their monetary regimes away from “soft” pegged exchange rates and gravitating toward either “hard” pegs or floating exchange rates in conjunction with inflation targeting. The chapter in the May 2001 World Economic Outlook on the decline of inflation in emerging market countries included this summary (adapted for the IMF Survey) of inflation targeting issues.

In recent years, several emerging market countries have joined a number of industrial countries in adopting monetary frameworks that formally target inflation. Brazil, Chile, the Czech Republic, Israel, Poland, and South Africa have adopted full-fledged inflation targeting, while others are moving toward this framework.

The experiences of countries that have adopted inflation targeting suggest that the foundations for successful inflation targeting are built on a mandate to achieve price stability, central bank instrument independence, transparent policies to build accountability and credibility, a good framework for forecasting inflation, a reasonable understanding of transmission channels between policy instruments and inflation, a well-developed financial system, absence of fiscal dominance (that is, the conduct of domestic monetary policy should not be dictated by fiscal needs), and a reasonable degree of macroeconomic stability.

Challenges

Although these elements need not be considered prerequisites for beginning the transition toward full-fledged inflation targeting, they can pose important challenges for many emerging market countries seeking to go down this path. In many cases, central banks have yet to be granted the operational independence (that is, an ability to set policy instruments without government oversight) needed to set monetary policy in accordance with a price stability objective, and they are often reluctant to communicate their economic outlooks and policy intentions in a transparent manner. Ongoing structural change in their economies may impede their ability to forecast inflation, while weak links between monetary policy and inflation often associated with underdeveloped financial systems or partial dollarization complicate the assessment of the appropriate policy response. In addition, it might take some time to establish the credibility of an inflation targeting framework, particularly in cases where there are large fiscal debt burdens or an inadequate track record of entrenched macroeconomic stability. That said, it is also true that many of these issues pose similar challenges for other monetary regimes, particularly those using floating exchange rates.

An examination of the differences between emerging market countries that target inflation and those that do not sheds some light on the preferred starting point and conditions that favor the choice of inflation targeting. Usually, inflation targeting countries are relatively well developed and have more complex domestic financial systems, suggesting these attributes should be considered by other countries thinking of adopting this monetary framework. They are also countries that have opted for significant exchange rate flexibility, in part because their terms of trade may follow cycles different than those of their major trading partners.

The legal frameworks of all inflation targeting countries give the central bank instrument independence and make price stability a primary objective. A comparison suggests that emerging market countries tend to prefer a more formal institutional framework in support of inflation targeting than industrial countries. Emerging market countries usually modify the central bank legal framework before adopting inflation targeting, and all emerging market countries explicitly limit central bank financing of government deficits in the primary market. The more formal inflation targeting frameworks in emerging market countries may reflect their histories of greater government intervention in monetary policy, higher and more variable rates of inflation, less developed financial systems, greater vulnerability to inflationary monetization of government debt, greater susceptibility to exchange rate crises, and IMF involvement.

Differences between emerging market and industrial countries

There are also differences in the operation and design of inflation targeting between emerging market and industrial countries. Central banks in emerging market countries tend to rely less on statistical models in the conduct of monetary policy, intervene more frequently in foreign exchange markets, use shorter horizons to achieve their objectives, and target wider bands than industrial countries. These differences presumably reflect underlying differences between the two groups of countries. Structural changes in underlying economic relationships are more prevalent in emerging market countries, and they are inclined to be more vulnerable to shocks, especially those emanating from volatile capital flows. By mixing and matching the elements of the framework (such as the choice of the price index to be targeted, a point target or a range, and escape clauses), an inflation targeting central bank can design a framework that gives it the appropriate trade-off between credibility and the discretion needed to respond to shocks, such as unexpected hikes in oil prices.

Coping with volatile capital flows

Volatile capital flows are usually associated with rapid movements in the exchange rate and pronounced swings in the spreads between domestic and international interest rates, which can be particularly disruptive for countries that are relatively open to trade or are large borrowers. In an inflation targeting framework, clear explanations by the central bank of the rationale underlying its policy stance may help to ensure that such shocks are not compounded by uncertainty regarding the conduct of monetary policy. Over time, a proven track record of attaining the inflation targets should help financial markets develop greater confidence in the motivations underpinning monetary actions. Nonetheless, central banks that target inflation have occasionally found it prudent to take action to moderate exchange rate movements to ensure that excessive changes do not destabilize inflation expectations or the domestic financial system while retaining exchange rate flexibility. Taking steps to moderate a rapid depreciation of the exchange rate can thus help countries avoid the more dramatic tightening that might otherwise occur in response to financial instability, rather than because a tighter monetary stance is desired. This can be particularly important for partially dollarized economies, where the private sector is often sensitive to exchange rate fluctuations. However, it is important to unwind such

actions as soon as practical to avoid moving away from the inflation target.

Making the transition

The transition to full-fledged inflation targeting is also an issue in many emerging market economies. Several countries have confronted the challenge of introducing this framework before exiting from an exchange rate targeting regime. The experiences of Israel and Poland suggest that a gradual shift from a fixed exchange rate regime to a looser exchange rate regime to an inflation targeting framework is feasible but needs sound and supportive fiscal and structural policies to manage the transition and minimize the risk of undermining the credibility and effectiveness of the new framework by saddling the central bank with conflicting objectives. ■

Mark Zelmer

IMF Monetary and Exchange Affairs Department

Copies of *World Economic Outlook, May 2001*, are available for \$42.00 (academic price: \$35.00) each from IMF Publication Services. For further reading, see also IMF Occasional Paper 202, *Adopting Inflation Targeting: Practical Issues for Emerging Market Countries*, by Andrea Schaechter, Mark R. Stone, and Mark Zelmer, which is also available from IMF Publications Services for \$20.00 (academic price: \$17.00). See page 231 for ordering information. The texts of *World Economic Outlook, May 2001*, and Occasional Paper 202 are also available on the IMF's website (www.imf.org).

Available on the web (www.imf.org)

Press Releases

- 01/32: IMF Executive Board Reviews Noncomplying PRGF Disbursement to Ghana, June 28
- 01/33: Azerbaijan: Three-Year PRGF Loan (in principle) of \$100 Million, July 2

News Briefs

- 01/50: Ghana: \$66 Million Disbursement Under PRGF, June 28
- 01/51: IMF Postpones Board Meeting on Turkey, Pending Prior Actions, July 2
- 01/52: Burkina Faso: \$7 Million Loan Under PRGF, July 2
- 01/53: Azerbaijan: \$100 Million Loan Under PRGF, July 6
- 01/54: IMF Reschedules Board Meeting for Turkey for July 12, July 10
- 01/55: IMF Approves \$8 Million Loan for Tajikistan
- 01/56: IMF Completes Second Review Under Pakistan's Stand-By Arrangement
- 01/57: IMF Approves \$1.5 Billion Tranche Stand-By Credit to Turkey (see page 239)

Public Information Notices

- 01/60: Kuwait, June 29
- 01/63: Philippines, July 9
- 01/61: Netherlands, July 6
- 01/64: Samoa, July 11
- 01/62: Estonia, July 9

Speeches

- IMF First Deputy Managing Stanley Fischer, "Financial Sector Crisis Management," June 14 (posted June 26)

- IMF First Deputy Managing Director Stanley Fischer, "The Russian Economy: Prospects and Retrospect," Moscow, June 19 (see page 235)
- IMF Deputy Managing Director Eduardo Aninat, "Reflections on Globalization, Spain, and the IMF," San Sebastian, Spain, June 29 (see page 237)

Letters of Intent and Memorandums of Economic and Financial Policies*

- Federal Republic of Yugoslavia, June 27
- Azerbaijan, July 3
- Burkina Faso, July 5

Heavily Indebted Poor Countries (HIPC) Initiative*

- Ethiopia (update of preliminary document), July 8

Poverty Reduction Strategy Papers*

- Kyrgyz Republic (interim), June 26
- Azerbaijan (interim), July 9

Report on the Observance of Standards and Codes*

- Estonia, July 9

Issues Briefs

- 01/07: 100 Percent Debt Cancellation? A Response from the IMF and the World Bank, July 2001, July 10

Other

- IMF Financial Activities, June 29
- IMF Research Bulletin*, July 3

*Date posted

Korea's initial crisis responses appropriate, but structural reforms are key to long-term growth

Were Korea's policy responses to its 1997 crisis the most appropriate ones, given the circumstances? Will the crisis exert a longer-term impact on Korea's growth? A May 17–19 conference in Seoul, sponsored by the IMF and the Korea Institute for International Economic Policy (KIEP), examined these questions in the broad context of “Korean Crisis and Recovery.” As KIEP President Kyung-Tae Lee noted in his opening remarks, the conference, organized by David Coe of the IMF and Se-Jik Kim of KIEP (on leave from the IMF), was designed to explore the lessons from the Korean crisis and evaluate the policies adopted by the government and supported by a three-year Stand-By Arrangement with the IMF. The conference brought together economists from inside and outside Korea, private market participants, Korean policymakers, and IMF and World Bank staff. Several of the participants were directly involved in designing and implementing the Korean program.

Initial crisis response

The conference's first two sessions touched on various themes concerning Korea's initial response to the outbreak of the crisis. Ajai Chopra of the IMF's Asian and Pacific Department, presenting a paper coauthored with several colleagues (Kenneth Kang, Meral Karasulu, Long Liang, Henry Ma, and Anthony Richards), reviewed the origins of the crisis and the basis for the Korean program. Chopra noted that Korea largely met the objectives of its IMF-supported program: macroeconomic stabilization, rapid recovery, significant reduction in external vulnerability, and creation of a basic framework for corporate and financial sector restructuring. But Korea's long-term growth, he suggested, will depend much upon further implementation of reforms in the corporate and financial sector and a stronger role for markets to drive the restructuring process.

In reviewing the lessons from Korea's experience, Chopra said that fundamental weaknesses in companies and banks—not public sector excesses or poor macroeconomic fundamentals—were the primary causes of the crisis. Thus, crisis prediction frameworks should focus on structural vulnerabilities and microeconomic performance in addition to macroeconomic factors.

How should Korea have set its interest rate policy amid a twin financial and currency crisis? Yoon Je Cho of Sogang University analyzed the country's dilemma, concluding that although the decision to raise interest rates sharply aggravated the financial crisis, the

authorities were left with no other realistic option to stabilize the exchange rate. Instead, other complementary policies were needed, such as a debt rollover. Although a debt rollover at an earlier point would have been desirable, several participants noted that it was not feasible until international banks saw default as a possible outcome.

Econometric analysis by Chae-Shick Chung and Se-Jik Kim of KIEP found that high interest rates are effective in stabilizing the exchange rate in the long run but can have a perverse effect in the very short run (up to five days). However, several participants, notably Barry Eichengreen of the University of California at Berkeley, echoed a point made in the paper presented by Chopra—namely, that econometric studies will always face difficulties in assessing the effectiveness of higher interest rates in stabilizing exchange rates because of the endogeneity of policy responses. In other words, the degree of monetary tightening actually implemented may be a function of the magnitude of the depreciation that would have occurred in the absence of tightening.

In a joint paper, Anne Krueger and Jungho Yoo of Stanford University argued that, contrary to the views of some critics, Korea's chosen policy path was actually weighted more heavily to exchange rate depreciation than to increased interest rates and that this was probably appropriate. A failure to raise interest rates would surely have perpetuated the currency crisis, they said. They also indicated that the *chaebol* had continued expanding in the precrisis period despite falling profitability. As a result, the *chaebol* sector was harder hit by the crisis than the other, more profitable smaller companies that had less access to debt financing.

Financial and corporate reforms

Several participants touched on the implications of different supervisory treatment across the financial sector and on questions about the overall speed of reform. Yoon Je Cho noted that policymakers' initial focus on the banking system contributed to a large shift of funds to the less regulated nonbank sector. While this helped to moderate somewhat the severe credit contraction, it also delayed the restructuring of the large *chaebol* and potentially increased the costs of restructurings substantially.

Changyong Rhee of Seoul National University and Gyutaeg Oh of Chungang University highlighted the problems in the corporate bond market arising from initially lax regulation of the nonbank sector. Bond

Fundamental weaknesses in companies and banks—not public sector excesses or poor macroeconomic fundamentals—were the primary causes of the crisis.

—Ajai Chopra



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July 16, 2001

244



Robert Barro (left, standing) of Harvard University addresses the IMF-KIEP Conference in Seoul, Korea.

investors, they noted, have not borne the costs of bad investments—for example, the bailout of investors in Daewoo's bonds and the recent Korea Development Bank bond-underwriting scheme. Won-Dong Cho of Korea's Ministry of Finance and Economy and Advisor at the IMF's Executive Board pointed out that prior to the crisis, the country had an essentially guaranteed corporate bond market. The government, he said, has managed to move the market to a partially guaranteed one where market discipline is now playing a larger role.

William Mako of the World Bank credited the authorities with effectively addressing short-run problems, stabilizing the situation, and ensuring that non-viable companies did not drag viable companies down with them. The biggest shortfall, however, was Korea's subsequent failure to bring about the required operational and financial restructuring. As a result, "zombie" companies continue to erode the profitability of viable ones, and the financial sector remains vulnerable. Mako said that Korea still needs to implement fundamental insolvency reform; operational restructuring, including asset sales; and stronger financial supervision.

Simon Johnson of the Massachusetts Institute of Technology and Todd Mitton of Brigham Young University addressed the question of why debt levels were so high in Asia. They linked Asia's experience to the new literature relating capital structure to corporate governance, investor protection, and the threat of expropriation of equity holders by management. Johnson and Mitton showed that the high debt levels may have reflected poor corporate governance and have left countries and firms more vulnerable to shocks, while weak investor protection may have undermined confidence. Taken together, these two factors, they argued, helped magnify a small shock into a large crisis. Their view is consistent with the new "Cambridge-Chicago" consensus that institutions drive firm behavior and affect macroeconomic out-

comes with implications for macroeconomic vulnerabilities.

Long-term impact

The second day of the conference focused on the impact of the crisis on long-term economic growth and the lessons that could be drawn from the Korean crisis and recovery. Robert Barro of Harvard University observed that while investment ratios and stock prices have not fully rebounded to precrisis levels, they are not likely to have had a permanent negative impact on Asian growth rates. In a related paper, Yung Chul Park and Jong Wha Lee, both of Korea University, after controlling for the origin and nature of the shock, initial condi-

tions, policy factors, and external environment, found no evidence that the presence of an IMF program affects the postcrisis recovery or that the crises have any negative long-run impact on growth rates.

The concluding "lessons" session was dominated by Barro's call for greater foreign ownership of the banking system and possible dollarization. He argued that foreign banks were better able to absorb potentially large losses, resist calls to provide subsidized financing to particular sectors, and reduce moral hazard stemming from expectations that the authorities would bail them out following lending mistakes. Dollarization, he argued, could also help eliminate the possibility of currency crises of the type that Korea had experienced and offered a means to boost trade with the United States.

Yusuke Horiguchi, Director of the IMF's Asia and Pacific Department, chaired the concluding session and asked participants if they had concerns about Korea's vulnerability to another crisis. In general, they did not. Participants did suggest, however, that future crises were more likely to arise from institutional deficiencies than from macroeconomic policies. They thus endorsed the IMF staff's call for greater attention to corporate and financial sector issues.

Other issues touched upon in the conference were the impact of the crisis on the labor market (Dae-Il Kim of Seoul National University), a detailed account of the negotiations for the bank debt restructuring process (Yang-Ho Byeon of Korea's Ministry of Finance and Economy and Woo Chan Kim of the Korea Development Institute School), international financial architecture issues (Barry Eichengreen), and exchange rate policy in Korea (Michael Dooley of University of California at Santa Cruz, Rudiger Dornbusch of MIT, and Yung Chul Park). ■

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