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Annual Meetings 2000

Governors to gather amid improved outlook, will focus on sustaining growth, fighting poverty

The Prague Congress Center will be the setting for the Annual Meetings. An article on the Czech Republic's recent economic recovery begins on page 298.

The fifty-fifth Annual Meetings of the IMF and the World Bank will formally open at the Prague Congress Center, Czech Republic, on Tuesday, September 26, in a global environment marked by strong economic growth, including recoveries from the 1997–98 financial crises in emerging markets. The discussions of the governors in the plenary session are likely to focus on ways in which growth can be sustained and progress made in the fight against world poverty. The meetings will be chaired by Trevor Manuel, the South African Finance Minister (see box, page 286). They will also be the first in which Horst Köhler will participate as IMF Managing Director. In his opening address, he is expected to articulate his vision of the IMF of the future.

The Annual Meetings will be preceded on Sunday, September 24, by the meeting of the International Monetary and Financial Committee (IMFC), the IMF's principal advisory body, *(Please turn to the following page)*

International Capital Markets

Staff report sees easing of global credit concerns, although risk of rise in U.S. inflation persists

Global financial conditions generally improved during 1999 and the first half of 2000, along with the strong rebound in the world economy as a whole, according to the IMF staff's latest *International Capital Markets* released on September 11. Following the severe market turbulence of 1997–98, the report observes, credit concerns have eased, and global investors have become more willing to engage in risk taking, particularly by investing in the technology-related companies of the "new economy."

As markets recovered, mature market credit spreads remained appropriately above precrisis levels, the report finds. What it terms the remarkable, continued rapid growth of U.S. productivity—largely related to the new economy—helped to contain the slow expansion of inflation and spur both U.S. and worldwide investment. Despite the rise in global interest rates, equity markets rose to record highs in many countries, while the deepening and broadening of credit markets in the euro area helped to boost global debt issuance.

Risks in mature markets

The staff report notes, however, that a key risk for international financial markets lies in a sharper-than-expected rise in U.S. inflation. Mounting evidence of increased inflation in early 2000 heightened investor uncertainty about both the size and the timing of interest rate increases and the sustainability of strong noninflationary growth. The report states that it is unusually difficult at this time to gauge whether markets fully appreciate, and properly price, the risk of an unexpectedly sharp rise in U.S. inflation and an abrupt policy tightening. If not, it warns, there could be a further correction in U.S. equity and corporate bond markets, a repricing of financial risks, and widespread portfolio rebalancing. If portfolios are *(Continued on page 287)*

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Progress made by the transition economies is discussed by John Odling-Smee. See page 289.

Prague Annual Meetings face range of issues

(Continued from front page) chaired by Gordon Brown, the U.K. Chancellor of the Exchequer. The Joint Bank and Fund Committee on the Transfer of Real Resources to Developing Countries (Development Committee) will meet the following day. It is also expected that there will again be a joint meeting of the IMFC and the Development Committee to discuss progress under the Heavily Indebted Poor Countries (HIPC) Initiative and with poverty reduction strategy papers. The first joint meeting was held at the time of the 1999 Annual Meetings.

Against the encouraging world economic background, the IMFC will assess the prospects and policies for sustaining global growth, the outlook for international capital markets, and the progress made by, and prospects for, the countries in transition. To assist its deliberations, the IMFC will receive summaries of the IMF staff's *World Economic Outlook* and *International Capital Markets* reports.

In its consideration of issues relating to the strengthening of the international financial system and the future role of the IMF, the IMFC is expected to receive a presentation from the Managing Director on his vision of the IMF of the future and to discuss ways of enhancing IMF surveillance and promoting stability and transparency in the financial sector. The committee is also expected to consider the subject of private sector involvement in forestalling and resolving financial crises and review IMF financial facilities to consider whether it would be desirable to further streamline them.

The IMFC will consider a statement prepared for it and the Development Committee by the Managing Director and by World Bank President James Wolfensohn on progress on the HIPC Initiative and poverty reduction strategy papers and the implementation of the Enhanced HIPC Initiative. The committee will also review the status of financing for the HIPC Initiative and the poverty reduction strategy papers process.

The IMFC meeting will benefit from discussions in a preparatory meeting held in London on September 11. Other meetings preliminary to the Annual Meetings will include those of the ministers of the Group of 24 developing countries on September 23 and its deputies the preceding day, and the ministers of the Group of 10 industrial countries on September 24.

A number of briefings and other events for the press will take place in the days preceding the Annual Meetings. Stanley Fischer, IMF First Deputy Managing Director, will discuss the 2000 *Annual Report* of the IMF's Executive Board on September 14. Michael Mussa, the Economic Counsellor of the IMF and Director of the Research Department, will brief the press on the staff's *World Economic Outlook* on September 19. IMF Managing Director Horst Köhler will hold press conferences on September 20 and at the conclusion of the meetings on September 28.

The opening ceremonies of the Annual Meetings on Tuesday, September 26, will be followed by addresses of Chairman Manuel, IMF Managing Director Köhler, and World Bank President Wolfensohn. Köhler is expected to emphasize the need for a sharper focus on the core purposes and responsibilities of the IMF. He outlined these in a September 5 article in the Czech newspaper *Pravo*, saying the objectives are to promote growth by fostering sound fiscal, monetary, and exchange rate policies, and robust financial systems in member countries, as well as global financial stability. A sharpened focus on these core duties, he said, would increase the effectiveness of the IMF's work in crisis prevention, crisis resolution, and poverty reduction.

During the annual discussion in plenary session, from September 26 to September 28, the governors of the IMF and the Bank, representing industrial and developing countries and regional groupings, will address major issues affecting the world economy and the policies and operations of the two institutions.

A series of World Bank and IMF seminars and keynote speeches is to be held in conjunction with the meetings. These will address a wide range of topics on the theme "Making the Global Economy Work for Everyone" and will focus on the changing dynamics of global finance, trade and investment, information and technology, and human development. The seminars are designed to bring together corporate executives and

Manuel of South Africa will chair Annual Meetings

Trevor Manuel

Trevor Manuel will be the chair of the 2000 Annual Meetings in Prague. Manuel has been Minister of Finance in the South African government since April 1996. Before becoming Finance Minister, he served as Minister of Trade and Industry from 1994 to 1996.

Trained as a civil engineer, in 1982 Manuel played an active part in the founding of the United Democratic Front (UDF) in the Western Cape region. In 1983, he was elected Regional Secretary and National Executive Member of the UDF. Subsequently, he was repeatedly detained without trial or placed under house arrest, spending 35 months in detention from 1985 to 1990. After the ban on the African National Congress (ANC) was lifted, Manuel became head of the party's Department of Economic Planning with responsibility for shaping ANC economic policy. Since 1991, he has been a member of the ANC's National Executive and National Working Committee.

bankers, senior officials, and other opinion leaders for discussion and debate on key issues. On September 24, Josef Tošovský, the Governor of the Czech National Bank, will deliver the Per Jacobsson Foundation lecture, "Ten Years On—Some Lessons from the Transition." (Information on the foundation may be found on its new website at www.perjacobsson.org.) In addition, Czech President Vaclav Havel will host a reception at Prague Castle on September 23 for selected delegates, government officials, and representatives of civil society.

Some 15,000 persons are likely to attend the Annual Meetings, including about 4,000 delegates from the 182 member countries of the IMF and the Bank, 1,500 representatives of the media, and more than 5,000 visitors and special guests, primarily from private business, the banking community, and non-governmental organizations. In addition, the Managing Director, the President of the World Bank, and other IMF and Bank staff have had extensive meetings with representatives of civil society, both in the Czech Republic and in other countries, during the months leading up to the meetings, in which they discussed the policies and operations of both institutions. ■

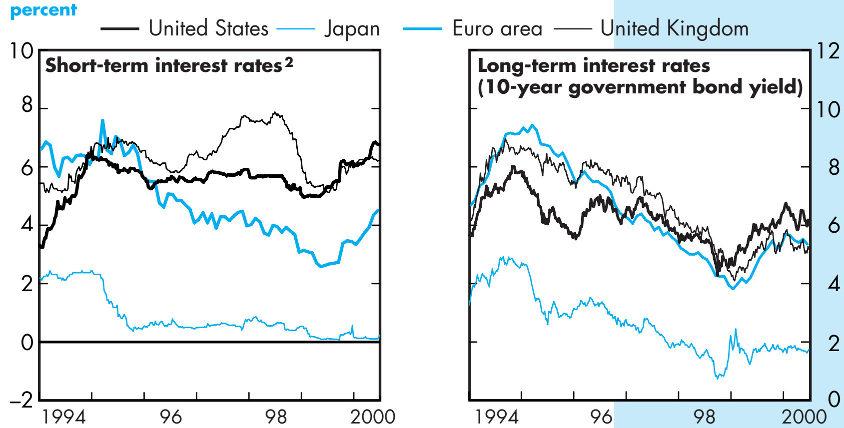
Capital markets report reviews key policy issues

(Continued from front page) rebalanced internationally, there could be a shift in the patterns of international capital flows and exchange rate adjustments.

Even if the risk of inflation does not materialize, the report cautions that there are more medium-term risks, related both to the high level of U.S. external imbalances and shifting cyclical positions in the major industrial countries and to changing expectations about asset returns. In this environment, it observes, markets may reassess whether the record U.S. external imbalances can be sustained at prevailing exchange rates and perhaps trigger a realignment among the euro, the U.S. dollar, and the Japanese yen. The risks are particularly evident for Japan, the report notes, where more private efforts are needed to put the financial and corporate sectors of the economy more securely on the path to a sustainable recovery. More generally, an increase in market volatility has led to a greater recognition of the risks in global financial markets, including those associated with the rapid integration of national financial markets into the global arena, a lack of transparency, and increased competitive pressures on financial institutions.

Short- and long-term interest rates

percent



[1]Weekly data for United States, Japan, and United Kingdom; and monthly data for euro area.
[2]For United States, Japan, and United Kingdom, three-month LIBOR; and for euro area, three-month EURIBOR.

Data: Bloomberg Financial Markets L.P. and European Central Bank

Emerging markets

Overall, there have been favorable developments in emerging market financing during the past year, according to the report, and financial flows to these markets have recovered to an encouraging extent. Moreover, although further structural reforms are still needed in many countries, macroeconomic policies are generally stronger than a few years ago, and several key emerging markets have introduced notable fiscal reforms.

The weakness in emerging market asset prices in March–May 2000, coinciding with the weakness in the mature markets, came as a sharp reminder that such assets are among the riskier asset classes, the report states. These assets were hit hard when global stock markets fell and the tightening of monetary policy in mature markets threatened to be more extensive than earlier expected. However, the correlations between emerging and mature market returns are far from perfect, and the report notes that the performance of emerging market assets will still depend substantially on the economic policies that these countries follow and the financial health of borrowers.

Over-the-counter derivatives

Derivatives markets are central to the functioning of global financial markets and both exchange-traded and over-the-counter derivatives have significantly improved the pricing and allocation of financial risks. The rapid growth of these transactions has accompanied, and in many ways driven, the international integration of national financial markets and the globalization of finance. Recent market turbulence has demonstrated the risks to market stability arising from certain features of over-the-counter derivatives and markets.

The report identifies those features that are a risk to market stability, as well as imperfections in the underlying infrastructure. Progress in ameliorating some of these risks has been limited, and further efforts are needed to reduce or avoid future instability. In particular, it notes, the private sector can reduce the potential for instability through more effective market discipline, risk management, and disclosure. Public efforts are needed to strengthen the incentives for market discipline, remove legal and regulatory uncertainties, and improve the effectiveness of surveillance over over-the-counter derivatives markets.

Competitive pressures created by foreign bank entry have improved banking system efficiency.

Private sector involvement

Recent public sector initiatives to strengthen private sector involvement in crisis prevention and resolution, and the extent to which they are interpreted as setting a precedent, have profound implications for the workings of the international financial system and the nature and structure of capital flows. The IMF staff found a considerable lack of awareness among national officials and market participants of recent work on standards, codes, and transparency. Those aware of the work, however, strongly supported the IMF's efforts to develop the Special Data Dissemination Standard and codes of transparency.

In general, private sector involvement in resolving financial crises is accepted as a "fact of life," the report states. It is also appreciated that no circumscribed set of rules can apply to all potential future crises. Moreover, market participants are confused about the official sector's policies on private sector involvement and would welcome a "framework" that would define when such involvement would be invoked, what would determine its scale, and whether it would be voluntary or involuntary.

The report concludes that the public sector should take into account that as particular lending instruments, such as bonds and interbank loans, are involved in a restructuring, the private sector will seek out new instruments that increase the probability of repayment and are insulated from future restructurings.

Role of foreign banks

Since the mid-1990s, there has been a sharp increase in foreign bank participation in many emerging markets, especially in Central Europe and Latin America. The report finds that competitive pressures created by foreign bank entry have improved banking system efficiency. It also notes that foreign banks could potentially add to the stability of the banking system. Foreign banks will be more likely to "cut and run" during a crisis, however, if their parent banks are in a weak financial condition.

The main policy issues involved in foreign bank participation, according to the report, are the need to coordinate and upgrade prudential supervisory and regulatory policies across borders, concentration issues arising out of large international bank mergers, and associated systemic issues. ■

International Capital Markets is prepared in the IMF Research Department and coordinated by Donald J. Mathieson, Chief of the Emerging Markets Division, and Garry J. Schinasi, Chief of the Capital Markets and Financial Studies Division. Copies of *International Capital Markets: Developments, Prospects, and Key Policy Issues* are available for $42.00 ($35.00 academic rate) each from IMF Publication Services. The text is also available on the IMF's website: www.imf.org. See page 292 for ordering information.

Available on the web (www.imf.org)

Press Releases

00/51: IMF Executive Board Grants Waiver on Noncomplying Disbursement to Malawi, August 24

News Briefs

00/73: IMF Completes First Ecuador Review, August 28

00/74: IMF Approval of Ghana PRGF Credit Takes Effect, August 29

00/75: IMF Publishes Financial Transactions Plan, August 31 (see page 295)

00/76: Release of Third PricewaterhouseCoopers Report on the National Bank of Ukraine, September 1

00/77: IMF Finds Ukraine National Bank Misreported International Reserves, Considers Circumstances, and Proposes Measures to Prevent Recurrences, September 6

00/78: IMF Completes First Review of Uganda Under PRGF-Supported Program, Extends Arrangement, and Approves $11.6 Million Credit, September 7

00/79: IMF and World Bank Review Progress in HIPC/PRSP Implementation, September 7

00/80: IMF and the Heavily Indebted Poor Countries (HIPCs), September 7

00/81: Supporting Poverty Reduction Strategies: What's New in the IMF's Approach, September 7

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Thomas Dawson, Director, External Relations Department, August 29

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Tanzania, August 29
Ecuador, August 29
Ghana, August 31
Nigeria, August 31

Heavily Indebted Poor Countries Initiative (date posted)

Rwanda (preliminary document), August 31

Poverty Reduction Strategy Papers (date posted)

Benin (interim), August 22
Zambia (interim), August 24

Interview with Odling-Smee

Healthy private sector, rule of law, accountability are key in transition to market economy

John Odling-Smee has been Director of the IMF's European II Department since its inception in 1992. The Department was created expressly to work with the Baltic states and the other countries of the former Soviet Union, which became members of the IMF following the breakup of the Soviet Union. Educated at Cambridge University, Odling-Smee held academic posts in the 1960s and 1970s. Subsequently, he served as Economic Advisor to the Prime Minister of Ghana, held various posts in the U.K. Treasury, and also worked briefly as a Senior Economist in the IMF's European Department in 1981. He rejoined the IMF staff in 1990 as a Senior Advisor in the European Department and was appointed its Deputy Director in 1991, before assuming the directorship of the newly created European II Department.

Odling-Smee met recently with the IMF Survey *to talk about developments in the transition economies of eastern Europe and their prospects for growth and integration in the international economy.*

IMF Survey: The economies in the European II Department reflect a wide range of progress along the transition path. What accounts for these differences?

Odling-Smee: There certainly are big differences. At one extreme are the three Baltic countries—Estonia, Latvia, and Lithuania—which are all applying for membership in the European Union. At the other extreme are three countries that have not moved very far at all in the reform process—Belarus, Turkmenistan, and Uzbekistan. In between are nine countries in various stages of reform, including the big ones, Russia and Ukraine. The immediate reason for these differences is that the countries have made different policy choices. The fast reformers wanted to go in the direction of a market economy. The slow reformers wanted to stay fairly close to a planned economy and were reluctant to take some of the major steps needed to introduce market mechanisms throughout the economy. The ones in between have all started down the road toward a market economy but have not always been able to institute the needed changes quickly enough.

Of course, you can take the question further back: why did they make these different policy choices? One, obviously oversimplistic, but interesting, view is that the policy choice depends on proximity to western Europe. It's not that simple, but there is obviously some basis for saying that the westernmost countries geographically were also those most aware of how to operate a market economy both from their own history and from their more significant contacts with western countries, even during Soviet times. The more eastern countries tended to be primarily within an isolated economic and political system and were therefore less able to see the benefits of moving quickly to a market economy.

The central European countries—Poland, Hungary, the Czech Republic, and Slovakia—have certainly moved faster because they felt closer to Europe. And now, of course, they feel the attraction of Europe; they want to do whatever is needed to get into the European Union.

Odling-Smee: The transition process involves dismantling the old government-controlled economy and creating an environment within which the private sector can grow.

IMF Survey: How does the IMF take account of these differences?

Odling-Smee: We try to treat each country according to its merits, to take account of what it needs from the IMF, and to respond accordingly. So, for example, in the area of technical assistance, in countries that have not moved very far toward developing a sophisticated central bank, our monetary experts advise them on the more elementary features of central banking. In countries that have moved further along, the technical assistance would deal with the more sophisticated requirements of a central bank.

In finance, the three Baltic countries, which are the most advanced, are not short of money and are not borrowing from us. However, they value our policy advice, so they have precautionary Stand-By Arrangements, which enable them to interact with us on policy discussions but don't involve their drawing any money. Farther east and south, the poorer countries in the Caucasus and central Asia do need the money, so our relationship is still a financial one. The types of reforms we discuss with them are less advanced than those we discuss with the Baltic countries.

IMF Survey: What role should the private sector be playing in these transition economies?

Odling-Smee: This question is right at the heart of the transition process, because the transition process, in its essence, involves dismantling the old government-controlled economy and creating an environment within which the private sector can grow. The countries have reached different levels of achievement in this respect. The Baltic countries have created an environment in which the private sector is thriving. In Russia and Ukraine, progress has been made in creating a good environment for the informal sector and for small retailing businesses. Russia has also made some progress in privatizing medium- and large-scale enterprises, although these enterprises don't always operate like truly private enterprises. They still have a rather close relationship with government. But in all countries except the Baltics, conditions are not very favorable for legitimate private sector activity, and the private sector is therefore not playing as large a role as it might have at this stage of the transition.

Odling-Smee: The vested interests that got there first have managed to accumulate a lot of economic and political power, which they use to protect their own position.

IMF SURVEY: The transition process in some countries appears to have stalled. What caused this "partial reform," and how can the process be restarted? What role can the IMF play?

ODLING-SMEE: In some stalled economies, attempts to create a more favorable environment for private enterprise are blocked by people who "got there first" and now want to prevent competition from newcomers. Countries at an intermediate stage between central planning and market economies have not yet developed the characteristics of a rule of law necessary for a market economy to work. The vested interests that got there first have managed to accumulate a lot of economic and political power, which they use to protect their own position, while the legitimate political authorities feel that they don't have the power to overrule these interests, break up these groups, and introduce level playing fields into economic and commercial legislation and practice.

Köhler, Wolfensohn issue joint statement on roles of IMF and World Bank

IMF Managing Director Horst Köhler and World Bank President James Wolfensohn issued a joint statement on September 5 setting out a vision for the roles and enhanced partnership of their two institutions for sustainable growth and poverty reduction. The statement, which was issued to Executive Board members and IMF and Bank staffs, stressed that both institutions share the same broad objective of helping to improve the quality of life and reduce poverty through sustainable and equitable growth. Within this broad objective, it said, the IMF's "core mandate is to promote international financial stability and the macroeconomic stability of member countries," while the Bank's is "to help countries reduce poverty, particularly by focusing on the institutional, structural, and social dimensions of development—thus complementing the IMF's macroeconomic focus." It added that "each institution needs to focus on its respective core tasks while working together in a complementary fashion in areas—such as the financial sector—where our responsibilities overlap."

The complete text of the joint statement is available on the IMF's website: www.imf.org.

The situation is not all gloomy, however. Many small and medium-sized businesses are operating in a more competitive way and are able, through the political process, to have a positive influence on the legislative environment. I believe that, in the long run, such influence will be constructive, as it has been in most western countries.

The IMF, of course, is not able to go in and change this sort of situation overnight. We can probably have an influence only at the margin. But there are a number of things we can do. First, we can explain to people what is going on, especially people inside the country. Second, we can advise the government directly on policies that would produce a more liberal system with more competition and therefore more opportunities for satisfactory development of the private sector. Third, if we have financial relations with the countries, we can, through our conditionality, try to have an impact on the measures that reform-minded governments may wish to implement. In attempting to do so, however, we may meet with resistance from vested interests.

IMF SURVEY: What are the main impediments to growth in the central Asian and Caucasus regions?

ODLING-SMEE: For the major oil and gas exporters—Azerbaijan, Kazakhstan, and Turkmenistan—growth in the energy sectors is reasonably assured. The big challenge is to avoid the "Dutch disease" and ensure that other sectors of the economy have the opportunity to develop. Armenia, Georgia, Tajikistan, and the Kyrgyz Republic are relatively poor, however. Here, the major challenge is to create the conditions in which the private sector can develop, to make private activity a more attractive proposition. The authorities in these countries tend to believe that nobody has any money or is willing to invest in them. That is really not true. Even in the poorest of the countries, there are people who have made quite a bit of money and would invest if circumstances were right. And there is also some interest from foreign investors. So those countries need to create opportunities for investment, which means liberalizing the system and strengthening the rule of law so that property rights are protected, and, above all, corruption is reduced.

IMF SURVEY: Some observers have suggested political economy considerations may not have been given adequate weight in decisions about the pace and sequencing of reform. Are these considerations relevant?

ODLING-SMEE: The general view that the IMF has held throughout the transition process—that a comprehensive and rapid reform is the best approach—has been based largely on political economy rather than on more technical considerations. We expected at the beginning that there would be quite a lot of resistance to reforms. What led many, including in the IMF, to favor rapid reform was the belief that if the reforms were not instituted all at once, political opposition would quickly build up and would prevent the reforms from going much further. Experience has shown this to be correct.

What lessons of a political economy nature might we want to draw for the future? For many countries, there is an implicit, and in some cases, explicit bargain between the political leadership and the leaders of major economic groups to conduct economic policy in the interests of those groups and not try to create a more open, liberal, and competitive system that would allow more new businesses to start up, including through foreign investments. We need to think of ways of loosening that coalition, to make it easier for policymakers to move in a liberal direction.

IMF Survey: Russia's problems, including debt and widespread corruption, seem overwhelming. What has gone wrong with Russia's reform programs, and what is the current thinking in the IMF on Russia's prospects?

Odling-Smee: One can answer the question of what went wrong at various levels, starting from the fairly narrow perspective of the IMF. We have been very concerned about Russia's fiscal difficulties, which at least up to last year came about largely because enterprises were not willing to pay the full amount of tax and the government didn't have the authority to extract the tax from them. The result was a serious and persistent revenue shortfall. This failure of the government to collect taxes means that enterprises are not subject to hard budget constraints. In those circumstances, the market economy doesn't work properly, and the transformation of the economy is impeded.

But I'd like to dwell a little more on the future because I think there are grounds for optimism, including the quality of the debate within Russia in the last 6 or 12 months about what is needed. I've been impressed with the consistent and clear message coming from the current Russian leadership—that they have to behave like a civilized country, which is a special expression used in Russia that means a law-based society and economy. Not only are they saying these things, but they know what kinds of laws they should have and what sanctions they should have in place for those who don't obey the law. The chances are therefore higher than they have been that Russia will become more law abiding, including in the tax arena. The stronger economy in the last year or so is also making it easier to move in this direction.

IMF Survey: In September 1999, the IMF suspended its $2.6 billion Extended Fund Facility (EFF) credit line to Ukraine after it failed to fulfill a number of conditions. What efforts are being made to restart the credit line? What obstructions remain?

Odling-Smee: Ukraine has been very slow to reform, and until late last year, we were rather disappointed in its performance and were continually encouraging it to speed up the reform process. At the time of the suspension of the EFF in September of last year, we made absolutely clear that after the presidential elections in November, the authorities should launch a major acceleration of structural reforms; otherwise, we would not be able to resume financial assistance. I am pleased that the authorities have made good progress on structural reforms this year, and I hope they can complete a structural reform package that would really signify a break with the past and would, when implemented, show that Ukraine was now joining the countries that are moving toward a market economy at a decent pace. If that is the case, I expect that the IMF would resume financing.

IMF Survey: The IMF has had to contend with misreporting of data and misuse of its funds in some transition economies. How great an impediment is this?

Odling-Smee: The cases that have come to our attention and to the attention of the wider public have all been investigated up to now. No evidence has been found so far of any misappropriation of funds, in the sense of IMF money falling into the wrong hands. A different problem has caused us some difficulty, however—misreporting by the authorities of the status of some of their monetary and international reserves figures. Some of that misreporting has been due to administrative inexperience, especially in some of the poorer countries. In other cases, it seems to have been an attempt to avoid the implications of not being able to report figures that would qualify them for the next disbursement from the IMF. To put that in context, one has to understand that the governments in the countries in the European II Department are all operating new systems. There were no national governments in these countries, just the local regional offices of the relevant Soviet Union ministries. There is a long tradition of misleading the central ministries in Moscow; and the local governments have some-

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
August 28	4.74	4.74	5.49
September 4	4.70	4.70	5.45

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (as of May 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (115.9 percent) of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/sdr.pl).

Data: IMF Treasurer's Department

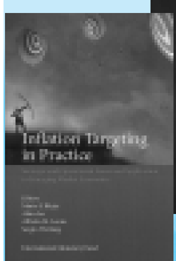
There are grounds for optimism, including the quality of the debate within Russia in the last 6 or 12 months about what is needed.

times regarded agreements they had with people from outside the country, including the IMF, as having similar characteristics. I think that this has changed and will continue to change over time—first, as the economic situation gets a little easier, so government officials don't feel under quite the same pressure; and, second, as they develop a greater understanding of the importance of straightforward dealing with partners in other countries and even within their own country. The whole process of transition is producing a realization that honest dealing is the way to conduct all relations, including with government and with international organizations. So I think that we will see misreporting disappear and not be an issue in the future.

IMF Survey: Do you see the venue for this year's Annual Meetings—the Czech Republic—as symbolically significant for the other transition economies?

Odling-Smee: It is good that the meetings are in a transition economy. The IMF's activities in transition economies over the past 10 years have been a very important part of our work. At the peak of our efforts, one-third of the IMF's technical assistance was going into the former Soviet Union countries—more than that if you add the central and eastern European countries. That is an enormous effort by the IMF. It was very successful at the level of technical assistance, especially in developing central banks and in various aspects of fiscal work. Our financial activities were very successful in a number of countries, and in all countries we had a big impact on macroeconomic stabilization, both in explaining why and how it was important and in creating the financial and moral support necessary to bring it about. By holding the meetings in Prague, we are recognizing both the achievements of the countries in transition and the contribution of the IMF to those countries. ■

Recent publications



Books

Inflation Targeting in Practice: Strategic and Operational Issues and Application to Emerging Market Economies, edited by Mario I. Blejer, Alain Ize, Alfredo M. Leone, and Sergio Werlang ($24.50)

Occasional Papers ($20.00, academic price $17.50)

No. 195: *The Eastern Caribbean Currency Union: Institutions, Performance, and Policy Issues*, Frits van Beek, José Roberto Rosales, Mayra Zermeño, Ruby Randall, and Jorge Shepherd

Working Papers ($10.00)

00/106: *A Game-Theoretic Analysis of Corruption in Bureaucracies*, Era Dabla-Norris

00/107: *Managing Financial Crises: The Experience in East Asia*, Jack Boorman, Timothy Lane, Nigeria, Marianne Schulze-Ghattas, Aleš Bulíř, Atish R. Ghosh, Javier Hamann, Alexandros Mourmouras, and Steven Phillips

00/108: *Real Exchange Rate Response to Capital Flows in Mexico: An Empirical Analysis*, Marcelo Dabós and V. Hugo Juan-Ramón

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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.

UNDP study reviews progress on human rights and convergence with human development

IMFSURVEY

The *Human Development Report*, flagship publication of the United Nations Development Program (UNDP), is celebrating its eleventh anniversary this year. The product of a select team that includes leading scholars and development practitioners commissioned by the UNDP, the report has over the years focused on a range of issues, such as globalization, growth, and poverty eradication, from the standpoint of human development.

This year's report takes on the ambitious task of analyzing progress in human rights and, in particular, convergence between human rights and human development. It argues that these goals share a common vision and a common purpose—to secure, for every human being, freedom, well-being, and dignity. It looks at human rights as an intrinsic part of development and at development as a means to realize human rights. It shows how human rights bring principles of accountability and social justice to the process of human development. The analysis is aided by a wealth of statistical indicators and human development indices.

Professor and Nobel Prize Laureate Amartya Sen provided the conceptual framework and contributed to the writing of the report. Described in a foreword by UNDP Administrator Mark Malloch-Brown as "unapologetically independent and provocative," the report underlines that human rights are not, as has sometimes been argued, a reward of development; they are critical to achieving it. Only with political freedoms can people genuinely take advantage of economic freedoms. The most important step toward generating the kind of economic growth needed to do that, the report stresses, is the establishment of transparent, accountable, and effective systems of institutions and laws.

Convergence

Until the last decade, according to the report, human development and human rights followed parallel paths in both concept and action: one path largely dominated by economists, social scientists, and policymakers; the other, by political activists, lawyers, and philosophers. Each group promoted divergent strategies of analysis and action: economic and social progress, on the one hand; political pressure, legal reform, and ethical questioning, on the other. But today, the report argues, as the two converge in both concept and action, the divide between the human development agenda and the human rights agenda is narrowing. Human rights add value to the agenda of development by drawing attention to accountability and respect for human rights, including by focusing on legal tools and institutions—laws, the judiciary, and the process of litigation—as means to secure freedoms and human development. Human development, in turn, brings a dynamic long-term perspective to the fulfillment of rights. It directs attention to the socioeconomic context in which rights can be realized—or threatened—taking account of resource constraints.

Link between rights and democracy

According to the report, democracy is the only form of political regime compatible with respecting all five categories of rights—economic, social, political, civil, and cultural. Four defining features of a democracy are based on human rights: holding free and fair elections contributes to the fulfillment of the right to political participation; allowing a free and independent media contributes to the fulfillment of the right to freedom of expression; separating powers among branches of government helps protect citizens from abuses of their civil and political rights; and encouraging an open civil society contributes to the fulfillment of the right to peaceful assembly and association. These rights are mutually reinforcing, with progress in one typically linked with advances in others. Openness of the media, for example, is usually correlated with the development of civil society institutions.

Integrating rights into economic policy

The process of economic policymaking for human development should honor the rights of participation and freedom of expression, according to the report. These rights imply that economic policy formulation must be open and transparent, allowing debate on the options and conferring the authority for the final decision on elected representatives. Economic policies have large effects on the rights of people. Those hurt by decisions have the right to know—and to participate in debate and discussion. That does not mean that they have veto power, but those adversely affected must be heard and, if appropriate, compensated. The report claims that the human rights angle brings to the table a focus on accountability.

Economic growth is key

The lack of economic growth in poor countries has been an enormous obstacle to the realization of all rights,

Only with political freedoms can people genuinely take advantage of economic freedoms.

Correction

In the August 28 issue of the *IMF Survey*, the agency that prepared East Timor's preliminary budget for 2000 was incorrectly identified on page 277. The United Nations Transitional Administration in East Timor (UNTAET) prepared the preliminary budget.

according to the report. A review of 159 countries for which GNP per capita growth data are available for 1990–98 shows that of the 33 human development countries with data available, only 5 achieved average annual per capita growth of more than 3 percent. For 13 of them, per capita growth was, in fact, negative. That is why accelerating economic growth in poor countries is essential to progress in securing all rights for all people. But growth is not enough, the report argues. There is a broad correlation between income and achievements in economic and social rights. However, countries with similar incomes can have sharply different achievements in eliminating illiteracy and infant mortality. In a sample of 174 countries, 97 rank higher on the human development index than on GDP per capita, suggesting they effectively converted income into human development. But 69 countries rank lower on the human development index than on GDP per capita. Thus, policies are needed to link growth and rights, and the allocation of resources-and the pattern of economic growth must be pro-poor, pro–human development, and pro–human rights.

Milestones in adopting major human rights instruments

1948 Universal Declaration of Human Rights
1965 International Convention on the Elimination of All Forms of Racial Discrimination
1966 International Covenant on Civil and Political Rights
1966 International Covenant on Economic, Social, and Cultural Rights
1979 Convention on the Elimination of All Forms of Discrimination Against Women
1984 Convention Against Torture and Other Cruel, Inhuman Treatment or Punishment
1989 Convention on the Rights of the Child

Ownership of programs

The typical process for international policy-based lending often suffers from a democratic deficit of broad participatory debate, for example, no parliamentary debate. It is, therefore, "ironic, but not surprising," the report notes, that a constant refrain in the international community is lack of ownership of the agreed policy program. This was one of the weaknesses of adjustment policies in the 1980s, when international financial agencies and national finance ministries often agreed to policies behind closed doors, the report argues. Although this account of history is debatable, the report is balanced on the future of structural adjustment, given rights, transparency, participation, and ownership. ■

Axel Palmason
IMF Office, United Nations

For more information about the *Human Development Report*, see http://www.undp.org/hdro.

Sakiko Fukuda-Parr

Report's director defines need for accountability, ownership of structural adjustment programs

Sakiko Fukuda-Parr, Director of the Human Development Report Office, spoke with Axel Palmason about the highlights of the United Nations Development Program's latest Human Development Report.

Palmason: The *Human Development Report* identifies basic rights rooted in the Universal Declaration of Human Rights of 1948. How does one define economic rights?

Fukuda-Parr: The Universal Declaration of Human Rights defines rights as entitlements to all human beings. While the domain of civil and political rights deals with such issues as freedom from torture and freedom of expression, economic rights relate to freedom from want. This translates into rights for food, clothing, and shelter. The declaration also refers to economic rights in the context of the right to hold private property, the right to work, and the right to social protection for the unemployed. While welfare states in advanced market economies or centrally planned economies have held themselves responsible for meeting many economic rights, resource constraints necessitate notions such as a "progressive realization of rights" and the need to establish priorities in meeting basic economic and social rights. Hence, we are not suggesting that developing countries need to adopt the welfare state instantly.

Palmason: How does the debate over conditionality and structural adjustment programs fit into the context of this report?

Fukuda-Parr: I am more concerned with the process than the content of structural adjustment and conditionality. The report deals at length with democracy and notes the need for democratic accountability and ownership of structural adjustment programs. It discusses examples, such as India, where widespread ownership has helped maintain continuity in the economic program despite frequent changes in government.

PALMASON: The importance of growth and good governance is increasingly recognized. How does that affect the development and rights debate?
FUKUDA-PARR: The debate on human rights is intricately linked to good governance. The report notes the importance of independent institutions, separation of powers, and open monitoring mechanisms against corruption and other abuses of power. Sound institutions facilitate meeting economic and political objectives. By making institutions open and accountable, the likelihood of increasing and sustaining growth is increased.

PALMASON: The IMF has committed considerable resources to the HIPC [Heavily Indebted Poor Countries] Initiative, the Poverty Reduction and Growth Facility (PRGF), and the poverty reduction strategy papers. How do these efforts correspond with the debate on rights to development and human rights?
FUKUDA-PARR: Human rights groups and others have emphasized the need to accelerate and deepen initiatives like the HIPC. The basic argument is that HIPC countries cannot expand the social investments they need because of debt-servicing obligations. Most complaints have been about the slow pace of the HIPC. On the PRGF and poverty reduction strategy papers, the main issue is to avoid separate agency programs on poverty and to develop these initiatives in collaboration with governments, other international agencies, and civil society in an open and participatory manner.

PALMASON: The report finds more convergence between the development and rights debates and between the development community and institutions concerned with macroeconomic policies. Has the collaboration between international institutions become more effective?
FUKUDA-PARR: There is much greater convergence than in the past. This is evident in the degree to which many of the issues raised by the *Human Development Report* have been integrated into the work of other international agencies. Over the next few years, there is considerable room for cooperation in governance, and social and economic policies. There are, however, important distinctions in some areas. Financial institutions are unlikely to undertake political reforms, build human rights institutions, and take on other work of this nature. At the same time, while the divide between economic and social policies narrows, there are important alliances to be made between UN agencies and international financial agencies. ■

Corrections—*Supplement on the IMF*

In the table on IMF credit outstanding for financial years 1997/2000 that appears on page 9, the unit statement should be billion SDRs and not million SDRs.

In the table of IMF quotas that appears on page 10, footnote one should read "Member has not consented to the increase in its quota." This footnote applies to Brunei Darussalam, Haiti, the Lao People's Democratic Republic, and Marshall Islands. Footnote two applies to Afghanistan, the Democratic Republic of the Congo, Iraq, Liberia, Somalia, and Sudan. St. Vincent and the Grenadines was incorrectly labeled as not having completed payment of its quota increase.

IMF financial information on the web

As part of an ongoing effort to increase the transparency of the IMF's finances, the IMF's Treasurer's Department, with the assistance of the External Relations Department and the Bureau of Information and Technology Services, has designed a new page for the IMF's external website (www.imf.org), entitled "IMF Finances." The page, launched in August, may be reached by clicking on www.imf.org/external/fin.htm.

One-stop browsing

A key benefit of this new page is to provide one-stop browsing by thematically arranging links to financially related material on the IMF's external website.

Substantial additional financial information is being provided for any given member or for all members in aggregate: disbursements, repayments, IMF credit outstanding, projected obligations (including charges), lending arrangements, SDR allocations and SDR holdings, and arrears.

A summary of the terms of IMF lending (a frequently asked question) is also included.

IMF sources of financing

On August 31, the IMF announced in a news brief that data on the amounts provided by members to finance the IMF's lending operations and other transactions would be posted on the IMF's website after completion of each quarterly financial transactions plan. The first set of data, posted on August 31, and an accompanying explanatory note, covers financial transactions for March–May 2000.

The regular publication of country-specific data on the sources of financing for IMF lending, the result of a decision taken by the IMF's Executive Board in February, is a significant further step in the IMF's efforts to enhance transparency and is designed to promote greater public understanding of the IMF's financial activities. The full text of News Brief No. 00/75 is available on the IMF's website (www.imf.org).

On August 31, IMF Deputy Treasurer Barry Newman (right) and James Corr (second right), Chief of the Financial Planning and Operations Division, held a press briefing to explain the new postings.

IMF SURVEY

Primer for macroeconomists

Health sector's unique characteristics argue for right mix of government, private sector roles

In a recent IMF Working Paper, What Should IMF Macroeconomists Know About Health Care Policy: A Primer, *William Hsiao examined the implications of health sector policy for equity, growth, and poverty reduction strategies. Hsiao, who is K.T. Li Professor of Economics at Harvard University and Director of the Program in Health Care Financing at Harvard's School of Public Health, talks with the* IMF Survey *about his findings.*

Hsiao: Both the market and the government have serious failures in financing and delivering health services.

IMF Survey: Why should macroeconomists, such as those at the IMF, be interested in the health sector?

Hsiao: For several reasons. First, microeconomists—including those from the World Bank—cannot do their jobs properly without compatible and coordinated policies on the macroeconomic side. Second, economic development is not the ultimate end in itself. We want higher incomes so we can have better lives, and for that we need better health. And, third, there is a practical matter: steady economic growth needs a stable political environment. When health and health care are distributed unequally, people become unhappy, which can lead to social instability and, in turn, political unrest. We have witnessed this relationship in China, Kenya, and the Philippines, among many countries.

Low-income countries in particular suffer from having top economic policymakers say they don't have time to worry about sectors like health. You just cannot provide people with reasonably good health care and protect them from impoverishment caused by catastrophic medical expenses without compatible macroeconomic policy.

IMF Survey: What roles do the private sector and government have in the health sector?

Hsiao: Economists often assume that the health sector operates like any other economic sector, but it does not. The free market that we rely on for economic activities addresses only efficiency issues, not equity issues. We all recognize the need for government to intervene in some sectors because we are not all created equal in health and in economic circumstances. Some people are healthier than others, and some are born with handicaps.

There are often two schools of thought on finance and delivery of health services: "Let the government do it," or "Let the market provide it." My paper argues that both the market and the government have serious failures in financing and delivering health services. Dozens of countries have put themselves up as natural experiments on how the private market can finance health care and provide health services. These natural experiments attest to the severity of the market failures.

In the United States, for example, the market enables people who are employed and earn average incomes to have health insurance. But the less healthy, the elderly, the disabled, and the poor are not insured by the market, and the U.S. government found it had to step in to finance health care for these groups. In the United States, 17 percent of the population is still uninsured because they are unemployed, partially employed, or work in low-wage jobs. The market has not been able to solve this problem. In the economic boom of the past decade, the number of people uninsured in the United States increased rather than decreased.

Why is this so? Well, the answer lies in the political economy. People who already have insurance and good incomes say, "Health insurance isn't an issue for me; why should I pay more taxes to support those other people?" The United States is the country that has gone furthest in relying on the market to finance and deliver health care. The market skimmed the cream off the top and left the rest for the government. The government was not able to withdraw and let the market take over. Right now, 45 percent of total health expenditures are financed by the government, a sizable percentage of the population remains uninsured, and there is no political support to do something universal.

On the delivery side, too, there are serious market failures—including the ability of health providers to induce demand. We go to our physicians for their expertise, follow their advice, and allow them to order tests. The health sector is driven by the supply side. The more surgeons we produce, the more operations we have. The United States has an oversupply of surgeons, and close to 20 percent of its surgery is unnecessary.

By contrast, the United Kingdom and many low-income countries depend on the government to organize and produce health services. This, we found, can be even worse than letting the market do it. Bureaucracy and politics seep into a vast system that delivers services on a daily basis. Governments just do not have the capacity to manage such a system efficiently or for the benefit of the patients. As patients, we want some compassion when we are ill, and government-managed services usually cannot provide that.

The world's experiences have taught us that on the financing side, we need significant government involvement. On the delivery side, government can set down strict rules and control supply, but should then allow the market to operate. Experience demonstrates that the health sector is extremely complex and that the right combination of government and market involvement is needed.

IMF Survey: Are there certain countries whose health sectors can serve as models?

Hsiao: My paper divides country experiences by income level. For high-income countries, most nations see the Canadian system as one of the best. It provides universal financial access to health services and offers patients a choice of primary care doctor and hospital. Choice is important because medicine is both a science and an art, and there will always be issues of personality, empathy, or culture. And in terms of results, by every measurable statistic, Canadians' health is as good as, or better than, other countries; Canadians are satisfied with the speed and kind of services they receive; and Canada has kept its health care costs under control.

IMF Survey: What type of health economics issues do low- and middle-income countries face and which countries come closest to meeting their needs?

Hsiao: My paper argues that health care is a means to an end. Societies universally want a health care system to improve people's health. Most countries also want good health distributed equitably, so that the rich don't live to be 100 while the poor die at 40. And, because a major health problem can bankrupt a family, societies generally seek to protect their people from catastrophic medical expenses and financial ruin. Also, the quality of care, and people's satisfaction with it, is a consideration in many societies.

Low-income countries, of course, have fewer financial and medical resources, and their health care outcomes are not as good as those in high-income countries. Many experts, however, tend to think that what works in the United Kingdom should work in India or Uganda, and they advise countries without factoring in all the resources, human knowledge, and institutions required to make the U.K. system work in a low-income country. When we equate high-income and low-income countries, we give inappropriate advice.

But what does work in low-income countries? Well, Sri Lanka—despite war and a shaky economy—has been able to maintain an effective health care system. Compare it, for example, with India. India spends 6 percent of its GDP on health care; Sri Lanka spends about 3 percent. But Sri Lanka produces much better results in terms of health outcomes, risk protection, and satisfaction. How? The structure of the health care system matters.

Sri Lanka has emphasized preventive services, such as immunization and education, and done a particularly good job in training mothers in proper hygiene and in identifying high-risk mothers early. Sri Lanka provides a very low level of hospital care, and about 85 percent of its people rely on government-run hospitals. But Sri Lanka, alone among the low-income countries I have studied, has been able to instill a sense of esprit de corps among its health care professionals.

Both India and Sri Lanka, for example, allow their doctors to maintain private practices. In India, however, many doctors don't show up at the public hospitals or cut back on their hours there. You rarely see that in Sri Lanka, where the health care professionals work full shifts and do the best they can with very few resources. Sri Lanka has been able to maintain the dedication of its health care professionals and develop real bonds between these professionals and the people they serve. Their midwives visit expectant mothers and families with children. When girls become teenagers, these midwives instruct them in sex education and hygiene. That human relationship makes a great difference.

Middle-income countries are usually much better off than low-income countries because they have greater economic capacity. They have more ways to tap financial resources, such as social insurance, and more extensive managerial skills to organize public and private activities. But these countries confront a double problem. In slums and rural areas, the rate of infectious diseases (tuberculosis, diarrhea) remains high while chronic conditions (arthritis, diabetes, cancer, heart disease) increase among the largely urban middle and upper classes, who are living longer. Typically, it is the urban elite in these countries who capture the public resources. They want MRIs [magnetic resonance imagings] and other expensive diagnostic procedures, although these may not result in a cure or even better treatment for their ailments. This is equivalent to the dilemma we will soon see as a result of the human genome project. Over the next two decades, we will spend billions more testing people for diseases we cannot yet treat or cure.

Among middle-income countries, Costa Rica has done very well for its people. It decided very early on to adopt an integrated financing strategy for all income groups rather than pursue separate Band-Aid solutions for the urban middle class, the farmers, and the poor and unemployed. Their integrated financing plan took everyone into account and allowed for differences in health services but guaranteed a minimum level of service. Initially, Costa Rica's social insurance ran its own facilities, but over time it found that efficiency declined and the quality of services became uneven. The country then converted its facilities into autonomous institutions that were nonetheless required to perform certain social functions. For example, visiting nurses provide immunizations that the government pays for.

Among the transition economies, very few have worked out a good solution yet. When a socialist economy transforms itself into a capitalist one, government revenues and services shrink drastically, and the average

Choice is important because medicine is both a science and an art, and there will always be issues of personality, empathy, or culture.

–Hsiao

person lacks resources, too. In addition, the average person resents paying for something that the government had provided as a part of an implicit contract between government and people. In these countries, the people had accepted lower cash wages in return for greater lifetime fringe benefits. Now the government is not honoring its commitments. Transition economies really have to struggle—making small, incremental, politically acceptable changes rather than drastic ones.

IMF Survey: How can best practices be replicated?

Hsiao: I'm quite optimistic about replication as long as we do not push for overly simplistic solutions. We must remember that the health sector is not like shoe manufacturing. It does have special characteristics. We can't say, "Just privatize it!" or "Leave it to the free market." Of course, we also have people on the other extreme saying, "Let government pay for it!" or "The government must control it!"

IMF economists, who interact with finance ministers and central bankers, can create a strong understanding in the minds of key decision makers. I would urge IMF economists not to draw simply on their home countries' experiences and to resist the temptation to give simple advice for this complex sector. There is no magic bullet to solve health care issues. Countries need a coherent and integrated public and private system to finance and deliver health care, and the system must be compatible with their culture and level of economic and social development.

IMF Survey: What would your advice be, then, for macroeconomists?

Hsiao: Don't treat the health sector as just another sector. Recognize that it has certain serious market and government failures. And acknowledge that health, like education, involves serious equity issues, and the free market simply does not deal with equity issues. So, the government's role has to be thought through carefully, and you will need to combine market and government roles. Also, while you cannot treat countries at different socioeconomic levels in the same way, you can design generic models that work at different income levels. My paper gives greater details about these key points and evidence to support them.

I don't expect IMF economists to become experts in health care, but if they take the health sector's unique features into account while giving advice to the key economic and financial decision makers, they could help the host country and its people, and facilitate the work of the World Bank. ■

Copies of Working Paper No. 00/136: *What Should IMF Macroeconomists Know About Health Care Policy: A Primer*, by William Hsiao, are available for $10.00 each from IMF Publication Services. See page 292 for ordering information.

Need for further reform

Recovery takes hold in Czech Republic; authorities begin to address structural problems

A recovery has taken hold in the Czech Republic, following a protracted recession that set the country apart from other advanced transition economies in the region that have enjoyed robust growth in recent years. The recession in the Czech Republic had its roots in serious structural problems that the authorities have begun to address. Much remains to be done, however, and perseverance will be essential in sustaining needed reforms.

Inadequate reforms

In 1997, the Czech Republic slipped into a recession that deepened over the following year (see chart, page 300). In hindsight, it is clear that the difficulties were rooted in reforms that did not deal in depth with the underlying structural problems and led to widening internal and external imbalances that culminated in a May 1997 currency crisis. The resulting tightening of monetary and fiscal policies controlled the crisis successfully but also triggered the onset of recession. The tight policies remained in place until late 1998, partly because of concerns about contagion from the Russian crisis. These policies helped sharply reduce the country's current account deficit and inflation (see table, page 299), but at a cost to economic activity.

However, serious structural weaknesses were at the heart of the country's problems. Incomplete reforms in the banking and enterprise sectors seriously impaired the supply side of the economy. The banking system saw a large accumulation of nonperforming loans—a result of supervision and regulation that had not kept pace with a rapidly growing sector and an incentive structure guiding lending decisions that was not conducive to prudent lending. In the enterprise sector, weak corporate governance—the product of a diffuse ownership structure that emerged from the voucher privatization scheme—delayed much-needed restructuring and, together with excessive credit growth, encouraged large real wage increases, misguided investments, and, in some cases, outright asset stripping. When enhanced bank supervision and prudential regulation as well as the prospect of privatization forced banks to restrict lending, many enterprises were brought to the verge of collapse.

Economic recovery

The Czech authorities began in late 1998 to loosen monetary and fiscal policies and to make significant progress in bank and enterprise restructuring. These steps laid the foundation for growth, and the Czech economy reached a turning point in the second quarter of 1999, with the more recent signs indicating a robust rebound in activity. The recovery has been led by modest consumption growth and strong export performance, which has been benefiting from buoyant activity in the European Union (EU). Moreover, the rise in investment in the first quarter of 2000—following nearly three years of contraction—has broadened the base of the recovery.

Recent developments on other fronts have also been favorable. After reaching a low of 1 percent in July 1999, inflation has remained relatively subdued despite a pickup to around 3³/₄ percent in recent months owing to temporary and external factors. The balance of payments position remains strong, underpinned by robust export performance and sustained foreign direct investment inflows, which approached 10 percent of GDP in 1999. Indeed, foreign direct investment has helped the recovery by boosting reliance on domestic suppliers and is expected to make the Czech economy more efficient. Following a depreciation in early 1999, the koruna has gradually strengthened (vis-à-vis the euro as well as in nominal effective terms) on the back of buoyant privatization-related inflows and anticipation of future privatization, without jeopardizing Czech exports. However, unemployment, currently at 9 percent, continues to feel the pressure of ongoing enterprise restructuring.

The Czech Republic largely relaxed macroeconomic policies over the course of the past year. The Czech National Bank cut its key policy rate aggressively from July 1998 through November 1999 but has refrained from further cuts amid growing signs of a recovery. The general government deficit (excluding privatization receipts and grants to transformation institutions) is expected to widen to 4¹/₄ percent of GDP in 2000, from 3¹/₄ of percent of GDP in 1999. The 2001 state budget is currently under preparation. The government is committed to reducing the state budget deficit by about ³/₄ of 1 percent of GDP, but the overall general government deficit will probably not contract by the same magnitude, as some expenditures are likely to be shifted to two extrabudgetary funds established to deal with infrastructure spending and housing projects.

Growing disparities

The recent favorable growth performance, however, masks significant disparities within the Czech economy. On the one hand, vibrant, export-oriented firms (primarily the ones with foreign participation) are leading the recovery, benefiting from a better overall competitive structure and access to credit. On the other hand, a large number of firms in the traditional enterprise sector continue to face financial difficulties and are burdened with excess labor, poor management, mounting losses, and debt. Problems in the enterprise sector have been exacerbated by the balance-sheet problems in the banking system that have had a chilling effect on lending activities, depriving enterprises of much-needed credit to finance restructuring operations and an expansion in activity. The restructuring process has taken a toll on employment, with the unemployment rate expected to exceed 9¹/₂ percent by the end of 2000. In addition, the incidence of unemployment is disproportionately high in regions heavily dependent on steel, mining, and agriculture. Unemployment in some of those regions is currently in excess of 15 percent, partly as the result of labor shedding by enterprises facing financial difficulties. To address rising joblessness, the government has provided investment incentives with particular emphasis on regions of high unemployment, including income tax reductions as well as job creation and training grants.

Selected economic indicators

	1996	1997	1998	1999	2000 Proj.[1]
			(percent change)		
Real GDP	4.8	–1.0	–2.2	–0.2	2.3
CPI inflation, 12-month change	8.6	10.0	6.8	2.5	3.8
Real wages (industry), period average	8.1	3.2	–0.2	4.6	1.0
Registered unemployed, period average (percent of labor force)	3.1	4.3	6.1	8.6	9.8
			(percent of GDP)		
Overall budget balance[2, 3]	–0.9	–1.7	–2.0	–3.3	–4.2
Gross debt[2]	13.3	12.8	13.4	15.0	18.0
			(12-month changes, in percent)		
Broad money	7.8	8.7	5.2	8.1	...
Credit to enterprises and households	10.6	9.4	–3.5	–3.9	...
			(percent of GDP)		
External current account	–7.4	–6.1	–2.4	–2.0	–3.4
Nondebt capital inflows	3.4	3.3	7.1	9.9	...
Gross official reserves (months of merchandise imports)	5.4	4.3	5.2	5.3	...
External debt in convertible currencies (percent of GDP)	36.2	44.3	39.9	44.3	...

Note: ... Denotes data were not available.
[1]IMF staff projections.
[2]General government.
[3]Excluding privatization revenues and grants to transformation institutions.

Data: Czech authorities and IMF staff estimates and projections

Progress in structural reforms

Following a period of inaction on the structural front—partly the result of insufficient political consensus—steady progress has been made since last year in several areas.

• In the banking system, two state-owned banks were sold to foreign interests, and a third is slated for privatization by early 2001. The authorities moved to strengthen the regulatory framework for bank supervision and tighten prudential standards—introducing some ingredients of consolidated supervision and reenforcing the capital adequacy requirement, incorporating market risk.

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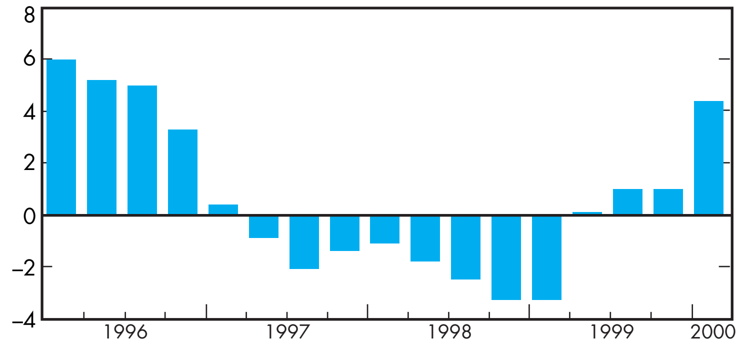
• In the enterprise sector, the Revitalization Agency has targeted eight large industrial enterprises for financial and organizational restructuring. Moreover, the legal framework governing economic transactions has been improved, most notably with the amendment of the Bankruptcy Act, which enhances creditor rights and aims at reducing the often long delays in the bankruptcy process.

• On the fiscal front, newly adopted budgetary rules enhance fiscal transparency and accountability, thereby limiting the scope for pursuing off-budget activities and accumulating contingent fiscal liabilities through government guarantees.

• On the legal front, new legislation has addressed several long-standing inadequacies and provided a more solid legal base for corporate and banking sector restructuring. Finally, the pace of adopting the legal requirements to bring accession countries into accordance with EU standards has accelerated markedly in 2000, opening the way for the implementation of reforms that would improve economic efficiency and the economy's growth prospects.

Real GDP

annual percent change



Data: Czech Statistical Office

Unfinished agenda

Despite considerable acceleration in the pace of structural reforms since last year, much remains to be done.

• Bank privatization needs to be completed and the legal and regulatory framework strengthened to improve banks' governance. The recent run on the deposits of a previously privatized bank and the subsequent imposition of forced administration and quick sale to a foreign-owned Czech bank have shown that privatization cannot solve the banking sector problems unless it is accompanied by improvements in governance and the disposal of nonperforming loans.

• The restructuring plans of the Revitalization Agency need to be carried out without political interference to ensure that targeted enterprises are placed on a competitive footing that will take them off government support. To avoid repeating past mistakes, it is imperative that the activities of the Revitalization Agency be carefully directed at restructuring the targeted enterprises—rather than financing ongoing operations—and clearly tied to ultimate sale. The ongoing enterprise restructuring will most likely imply high or even increasing levels of unemployment for some time to come. To prevent unemployment from becoming structural, the authorities will need to reform social benefits to increase incentives for job search and to relax rent controls—while continuing assistance to low-income households—to promote labor mobility. The legal framework governing the business environment can be further strengthened to protect creditor rights and facilitate expeditious liquidation of unprofitable firms.

• More critically, however, the authorities will need to implement fundamental fiscal reforms to address medium-term fiscal sustainability. With pressures on the budget expected to mount over the medium term—as a result of demographic changes, the drying-up of privatization receipts, and costs associated with EU membership and the restructuring of the banking and enterprise sectors—it becomes imperative to articulate a clear plan of fiscal consolidation and reform. Reform of the entitlement system will need to be at the center of such efforts.

Building upon a tradition of prudent macroeconomic policies and the recent progress in implementing structural reforms, the Czech Republic has the potential for sustained rapid growth. Experience elsewhere, however, suggests that it will take a long time to achieve sustained rapid growth. Bank privatization will need to be followed by restructuring, which will take several years to complete. Similarly, the process of enterprise reform will be protracted. Changes in laws and regulations are not enough in themselves. The legislative and regulatory practice must become more efficient and conducive to growth, and, again, this is a time-drawn process. The challenge ahead will be to persevere and sustain the pace of reforms. ■

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The next issue of the *IMF Survey*, to be published on October 9, will provide complete coverage of the IMF–World Bank Annual Meetings.